

Volume 2

TAS RESEARCH AND RELATED STUDIES

A Study of the IRS's Use of the Allowable Living Expense Standards

EXECUTIVE SUMMARY¹

Internal Revenue Code (IRC) § 7122(d)(2)(A) requires that the IRS “develop and publish schedules of national and local allowances designed to provide that taxpayers entering into a compromise have an adequate means to provide for basic living expenses.” However, the statute also allows for deviations. It instructs the IRS to review each taxpayer’s situation on a case-by-case basis and not use the Allowable Living Expense (ALE) standards if “such use would result in the taxpayer not having adequate means to provide for basic living expenses.”² The resulting ALE standards, which represent how much money the IRS believes a taxpayer needs to meet necessary expenses, have come to play a crucial role not just in offer in compromise cases but all types of collection cases. Given how important the ALE standards are to taxpayers who have a tax debt, the National Taxpayer Advocate charged TAS Research with analyzing how well the ALE standards perform in making sure taxpayers have “adequate means to provide for basic living expenses” before paying their tax debt.

TAS Research reviewed financial information received from taxpayers who entered into installment agreements (IAs). This information was then compared to applicable ALE standards. In nearly two-thirds of the cases reviewed, taxpayers claimed higher expenses in at least one of the ALE categories than was recognized by the ALE standards. The prevalence of the expense being greater than the ALE standard and the frequency of the IRS disallowing the excess expense varied according to expense type. Figure 2.1, below, shows the percent of taxpayers who claimed an ALE expense greater than the standard followed by the percent of instances where the IRS disallowed the excess expense.

FIGURE 2.1, Percent of Taxpayers with an Expense Claimed in Excess of the ALE Standard and the Percent of Those Instances That the IRS Disallowed

Expense Type	Percent of Taxpayers Claiming Allowable Living Expenses in Excess of ALE Standard	Percent of Instances Where Excess Allowable Living Expenses Are Disallowed
National Standards	28.4%	50.6%
Housing and Utilities	54.0%	36.7%
Public Transportation	8.6%	29.2%
Vehicle Ownership Costs	21.6%	40.0%
Vehicle Operating Costs	49.6%	37.0%
Out-of-pocket Health Care Costs	36.7%	35.3%

Fifty-four percent of taxpayers had housing and utility expenses in excess of the ALE standards. And of those, approximately 37 percent had their expenses disallowed. Around 28 percent of taxpayers had national standard expenses (food, clothing, etc.) in excess of the ALE standards but slightly over half of those taxpayers had their expenses disallowed.

Pursuant to statutory direction, internal IRS guidance promotes the use of good judgment in ALE analysis and allows deviations when necessary.³ Since the total ALE calculation represents what the IRS has determined is necessary for a taxpayer and his or her family to meet all necessary living expenses, TAS Research also considered the prevalence of a particular ALE expense being disallowed for being

1 The principal authors of this study are Terry Ashley, Jeff Wilson, and Kate Leifeld.

2 Internal Revenue Code (IRC) § 7122(d)(2)(B).

3 For example, see Internal Revenue Manual (IRM) 5.15.1.2(12), *Overview and Expectations* (Aug. 29, 2018).

excessive when in totality the taxpayer's expenses were less than his or her ALE amount. This would indicate the taxpayer is choosing to allocate budget dollars to an expense he or she prioritizes over other categories; that is, the taxpayer is willing to sacrifice in one area to cover over expenses.

Overall, the IRS disallowed expenses greater than those specifically allowed in the IRS ALE standards 28.8 percent of the time, even though the taxpayer was able to document the existence of the expense. *In over 90 percent of these cases, the IRS disallowed the additional expense even though the taxpayer's total expenses for the various ALE standards was less than the total of the applicable ALE standards, which could be allowed by the IRS.* In this situation, the taxpayer is living below the maximum allowable ALE standards for his or her household circumstances, even though one ALE expense is in excess.

TAS Research also considered expenses outside of the ALE standards but included on the IRS collection information statement (CIS). This category includes things such as health insurance and child care.⁴ When considering all disallowed expenses in this category, the taxpayer was able to document the expense over 44 percent of the time.

Last, TAS Research looked at expenses that are not considered in the ALE calculation at all. These expenses include things such as retirement savings contributions and higher education expenses. The study did not find a high rate of reporting for these expenses; however, it could be that they were included in the "other expense" category. When considering only these expenses, the IRS disallowed the expense in over 40 percent of the cases reviewed. Of the disallowed expenses, the taxpayer provided substantiation of the expense in approximately 38 percent of the cases.

This analysis shows that the ALE standards as designed may not be sufficient. For instance, we question whether we should not see such a high degree of taxpayers reporting expenses in excess of the ALE standards. *TAS Research has also documented that taxpayers are reporting expenses outside of what is allowed in the ALE standards. Some of these expenses are disallowed even when the taxpayer is already living below the maximum ALE amount calculated for his or her circumstances.* When the ALE standards fail to reflect what it truly costs to meet necessary living expenses, some taxpayers will forego a basic living expense in order to pay a tax debt. Additionally, the IRS appears not to be exercising the amount of statutorily authorized flexibility to allow for deviations when necessary, as evidenced by the number of disallowances even when the taxpayer documented the expense.

INTRODUCTION

Internal Revenue Code (IRC) § 7122(d)(2)(A) requires that the IRS "develop and publish schedules of national and local allowances designed to provide that taxpayers entering into a compromise have an adequate means to provide for basic living expenses."⁵ Congress also instructed the IRS to analyze the facts of each case involving these allowances and stipulated that if application of the allowances results in a taxpayer not being able to provide for basic living expenses, then the allowances should not be used.⁶

4 The National Taxpayer Advocate previously made this recommendation. See National Taxpayer Advocate 2016 Annual Report to Congress 192-202.

5 See also Treas. Reg. § 301.7122-1(c)(2)(i).

6 IRC § 7122(d)(2)(B).

The resulting Allowable Living Expense (ALE) standards have come to play a major role in analyzing several types of IRS collection cases.⁷

The IRS uses the “necessary test” when analyzing a taxpayer’s financial situation and allows an expense if it is “necessary to provide for a taxpayer’s and his or her family’s health and welfare and/or production of income.”⁸ When a taxpayer agrees to pay a tax debt even though his or her income is below the ALE standard, that taxpayer will most likely forego paying necessary living expenses in order to pay the tax debt. TAS Research has also shown that these taxpayers are more likely to default on their installment agreement and may not stay current with taxes.⁹

Given the important role of ALE standards in taxpayers’ wellbeing and future compliance, TAS Research conducted a study exploring how the IRS applies its ALE standards in a statistically valid sample of cases where the IRS entered into an installment agreement with the taxpayers after conducting a financial analysis.¹⁰ TAS Research analyzed how accurately the ALEs reflect the expenses reported by taxpayers. The study explores the frequency with which taxpayers have expenses in excess of the ALE standards, the frequency with which taxpayers claim other routine expenses not included in the ALE standards, and if the IRS is following its own ALE guidelines.

BACKGROUND

The ALE standards are broken down into national and local standards. National standards encompass the categories of food, clothing, and other items, as well as out-of-pocket health care expenses. Each category of the national standards is allotted a certain amount and taxpayers may claim up to that amount even if they spend less.¹¹ Local standards cover housing, utilities, and transportation. Unlike national standards, a taxpayer who claims an expense under the local standards is allowed the lesser of the amount spent or the local standard.¹²

The Internal Revenue Manual (IRM) provides that other expenses should be allowed as determined to be necessary for the taxpayer’s living expenses: “the standard amounts set forth in the national and local guidelines are designed to account for basic living expenses. In some cases, based on a taxpayer’s individual facts and circumstances, it will be appropriate to deviate from the standard amount when

⁷ Form 433-A, *Collection Information Statement for Wage Earners and Self-Employed Individuals*, is used to determine monthly expenses and primarily relies on the Allowable Living Expense (ALE) standards. This form is necessary for many types of case resolutions, including certain installment agreements (IAs) and offers in compromise (OIC). IRM 5.15.1.2, *Overview and Expectations* (Aug. 29, 2018).

⁸ IRM 5.15.1.8, *Allowable Expense Overview* (Aug. 29, 2018). While allowable living expenses (ALEs) receive the majority of IRS analysis, IRS employees are instructed to consider two other types of expenses in their financial analysis: “other necessary expenses” and “other conditional expenses.” “Other necessary expenses” are expenses that meet the necessary expense test and are normally allowed. IRM 5.15.1.8, *Allowable Expense Overview* (Aug. 29, 2018). An example of this expense is the category of child care costs, which are allowed if they are “reasonable,” making them subject to an individual IRS employee’s judgment. IRM 5.15.1.11, *Other Expenses* (Aug. 29, 2018). “Conditional expenses” are expenses which may not meet the necessary expense test but may be allowed based on the circumstances of an individual case. IRM 5.15.1.8, *Allowable Expense Overview* (Aug. 29, 2018).

⁹ National Taxpayer Advocate 2016 Annual Report to Congress vol. 2 54-66.

¹⁰ The sample is statistically valid at the 95 percent confidence level with a margin of error of plus or minus six percent.

¹¹ IRM 5.15.1.8(4), *Allowable Expense Overview* (Aug. 29, 2018).

¹² IRM 5.15.1.8(5), *Allowable Expense Overview* (Aug. 29, 2018).

failure to do so will cause the taxpayer economic hardship.”¹³ Substantiation of such an expense can consist of “credible verbal communication or written documentation received from the taxpayer.”¹⁴

In fiscal year (FY) 2018, the IRS agreed to nearly 2.9 million installment agreements (IAs). Over 72 percent (2,079,743) of these agreements were streamlined IAs, not requiring financial analysis or the use of ALE standards.¹⁵ However, over 800,000 of the FY 2018 IAs were non-streamlined and required the IRS to apply the ALE standards.¹⁶ Therefore, even though ALE standards are not used in most IAs, these standards still affect over three-quarter of a million taxpayers entering into IAs annually. Furthermore, over a quarter of the FY 2018 TAS collection issue cases dealt with an IA.¹⁷ Moreover, as TAS has shown elsewhere, the failure to obtain financial information has resulted in taxpayers entering into installment agreements when their income is less than their allowable expenses.¹⁸

The IRS uses its ALE standards to determine the taxpayer’s potentially collectible income, which is expected to go toward the tax debt.¹⁹ Over 20 percent of the IAs that defaulted in FY 2018 were agreements determined by applying ALEs. Even though IAs entered into with the use of the ALE standards are somewhat less likely to default than streamlined IAs not requiring financial analysis, over 200,000 of the IAs based on ALE standards defaulted in FY 2018.²⁰ When an IA defaults, the taxpayer and the IRS must devote resources to reworking defaulted IAs. The taxpayer may experience additional anxiety over the unresolved debt or become noncompliant because of the financial strain. In 2016, TAS Research determined that 40 percent of taxpayers entering into individual IAs in 2014 had incomes below their calculated ALE.²¹

The IRS bases national standard expenses, which include food, apparel, personal care, housekeeping, and services, on expenditures captured in the Bureau of Labor Statistics (BLS) consumer expenditure survey, notwithstanding a warning from BLS that it should not be used in relation to individual circumstances.²² This data is indexed by the number of individuals in a household. The standard

13 IRM 5.15.1.2(12), *Overview and Expectations* (Aug. 29, 2018).

14 *Id.*

15 IRM 5.14.5.1, *Overview* (May 23, 2014). Streamlined Criteria have two tiers, up to \$25,000, and \$25,001–\$50,000. In-Business Trust Fund Express IAs can be secured without securing financial information on business accounts up to \$25,000. For more information on streamlined IAs in particular, see IRM 5.14.5.2, *Streamlined Installment Agreements* (Dec. 23, 2015). The number of streamlined IAs reported above includes guaranteed IAs available to taxpayers under IRC § 6159(c), which also do not require financial analysis. Collection Activity Report 5000-6 (Sept. 1, 2019) only Individual Master File (IMF) IAs.

16 Collection Activity Report 5000-6 (Sept. 1, 2019) only IMF IAs.

17 Taxpayer Advocate Management Information System (TAMIS) cases received in fiscal year (FY) 2018 and coded with a Collection primary issue code. While this study focuses on ALE standards as applied to IAs, ALE standards impact thousands of taxpayers who have an outstanding liability with the IRS. About 470,000 taxpayers had their collection cases resolved as currently not collectible due to hardship, which would require a financial analysis. Collection Activity Report (CAR) 5000-149. In FY 2018, there were 32,621 accepted or rejected OICs. CAR 5000-108.

18 See Most Serious Problems: *Economic Hardship: The IRS Does Not Proactively Use Internal Data to Identify Taxpayers at Risk of Economic Hardship Throughout the Collection Process; Private Debt Collection: The IRS’s Expanding Private Debt Collection Program Continues to Burden Taxpayers Who Are Likely Experiencing Economic Hardship While Inactive PCA Inventory Accumulates*, *supra*.

19 IRM 5.15.1.3, *Analyzing Financial Information* (Aug. 29, 2018).

20 CAR 5000-6 (Oct. 1, 2018).

21 National Taxpayer Advocate 2016 Annual Report to Congress vol. 2, 60.

22 IRM 5.15.1.8(4), *Allowable Expense Overview* (Aug. 29, 2018). Bureau of Labor Statistics (BLS) warns that the “data shown in the published tables are averages for demographic groups of consumer units. Expenditures by individual consumer units may differ from the average even if the characteristics of the group are similar to those of the individual consumer unit. Income, family size, age of family members, geographic location, and individual tastes and preferences all influence expenditures.” BLS, *Consumer Expenditure Surveys, Frequently Asked Questions*, <https://www.bls.gov/cex/csxfqs.htm>.

includes an additional amount for miscellaneous expenses. Also, as part of national standards the IRS allows each taxpayer to claim out-of-pocket health care expenses.²³ A housing and utility category (part of the local standards) is computed for each county in every state as well as the District of Columbia using data from the Census Bureau and the BLS.²⁴ Expenses included in the housing and utility category are telephone, garbage disposal, cable television, internet expenses, and home maintenance and repairs.²⁵ The expenses for local standards are also indexed by household size so that larger families have a greater housing and utility allowance than smaller families. Transportation costs also use local standards. Vehicle operating standards are based on BLS data that are adjusted with Consumer Price Indices to allow for projected increases throughout the year. Fuel costs have a separate fuel price adjustment that is based on Energy Information Administration data, allowing for projected fuel price increases.²⁶

While the IRS is using government data sources for constructing its ALE standards, as a practical matter, each taxpayer presents unique financial circumstances, which can only be addressed by IRS personnel using flexibility and reasonable judgment.²⁷ In fact, the IRM notes that Collection personnel should make appropriate deviations from the ALE when necessary.²⁸

OBJECTIVES

The specific objectives of this study appear below:

- Determine the incidence of taxpayers having expenses in a specific ALE category that exceed the allocation for that ALE standard;
- Determine the incidence of taxpayers having expenses in one or more ALE categories that exceed the ALE standards for the category and the incidence of the IRS disallowing these excess expenses even though the taxpayer's total expenses are less than the sum of all relevant ALE standards;
- Determine the incidence of the IRS not allowing an expense because it is outside of the current accepted ALEs; and
- Determine the incidence of the IRS not allowing an expense because it is outside of the accepted ALE standards even when the taxpayer's total expenses are less than the sum of all relevant ALE standards.

23 IRM 5.15.1.8(4), *Allowable Expense Overview* (Aug. 29, 2018); Small Business/Self-Employed (SB/SE) Finance, *Research and Strategy 2014 Allowable Living Expense Project 4-6* (Aug. 2014). Currently, a taxpayer under the age of 65 can claim \$52 per month in out-of-pocket health care expenses and a taxpayer 65 or older can claim \$114. IRS, *National Standards: Out-of-Pocket Health Care*, <https://www.irs.gov/businesses/small-businesses-self-employed/national-standards-out-of-pocket-health-care>.

24 IRM 5.15.1.8(5), *Allowable Expense Overview* (Aug. 29, 2018).

25 *Id.*

26 *Id.*

27 As mentioned above, BLS warns against using the consumer data on an individual basis. This data reflects what taxpayers are spending, not what they need to pay in order to provide for their basic living expenses. National Taxpayer Advocate 2016 Annual Report to Congress 192-202.

28 IRM 5.15.1.2(12), *Overview and Expectations* (Aug. 29, 2018); IRM 5.19.13.2.2.2, *Allowable Living Expenses* (June 10, 2015). The language is as follows:

The standard amounts set forth in the national and local guidelines are designed to account for basic living expenses. In some cases, based on a taxpayer's individual facts and circumstances, it will be appropriate to deviate from the standard amount when failure to do so will cause the taxpayer economic hardship (See IRM 5.15.1.1(8)). The taxpayer must provide reasonable substantiation of all expenses claimed that exceed the standard amount.

METHODOLOGY

Since non-streamlined IAs require that the taxpayer submit financial information to the IRS, TAS reviewed the information provided by the taxpayer to the IRS on the collection information statement (CIS).²⁹ Unfortunately, records of IRS financial analysis did not always contain sufficient detail to answer the research questions. Based on a review of financial statements recorded by IRS employees on internal databases, TAS reviewed about 1,500 cases to obtain sufficient information to complete this study. TAS Research believes the results of this study will provide important data to substantiate the need for the IRS to make changes in how it administers ALEs.

TAS randomly sampled nearly 1,500 cases resolved with a non-streamlined IA between March 18, 2018 and September 29, 2018. Of those cases that TAS randomly selected for review, 278 cases contained sufficient data to complete the data collection instrument (DCI). The DCI recorded data on where the taxpayer resided, the taxpayer's household size, the number of delinquent modules, and whether the IA was secured by Automated Collection System (ACS) or Collection Field function employees. The DCI contained four specific questions for 21 separate expenses. The following four questions were asked about each expense type:

- The expense amount;
- Whether the taxpayer provided documentation for the existence of the expense;
- The amount of the ALE standard (if applicable); and
- Whether the expense was allowed.

Additionally, if possible, we recorded the reason for disallowance of the expense and any relevant comments.³⁰ We focused on the six expenses covered by the ALE standards including:

- National standards (expenses, such as food, clothing, necessary services);
- Housing and utility standards;
- Public transportation (if any);
- Vehicle ownership expense (if any);
- Vehicle operating expenses; and
- Out-of-pocket health care expenses.

We then examined claimed expenses in categories included on the standard IRS Collection Information Statement including the expenses claimed with respect to:

- Childcare;
- Health Insurance;
- Life Insurance;
- Other Expenses;
- Current Year Taxes;
- Secured Debts;

29 IRS, Form 433-A, *Collection Information Statement for Wage Earners and Self-Employed Individuals* (Dec. 2012); IRS, Form 433-B, *Collection Information Statement for Businesses* (Dec. 2012); IRS, Form 433-F, *Collection Information Statement* (Jan. 2017).

30 Few cases contained information about the reason for an expense disallowance.

- Court Ordered Payments; and
- Delinquent State or Local Taxes.

Finally, we recorded the incidence of three additional expenses, which we believe are often necessary expenses:

- Retirement savings contributions;
- Higher education or trade school expenses; and
- School-related expenses for children.

Because of the length of time required to review the financial information from the closed cases, eleven different reviewers completed DCIs. To help ensure consistency, the group reviewed a small group of cases jointly. Then after each reviewer completed a few cases, the reviewers discussed each of the completed DCIs to confirm the consistency of the reviews.

When considering this sample size, results are valid at the 95 percent confidence interval with a margin of error of no more than plus or minus six percent with a maximum variation of 50 percent. We also discuss subpopulations of the sample.³¹

On average, these 278 sample taxpayer cases had 6.4 delinquencies with the median being six. ACS secured the IA in 119 cases (42.8 percent), while the Collection Field function secured the IA in 159 cases (57.2 percent).

FINDINGS

The Incidence of Taxpayers Having Actual Expenses in a Specific ALE Category Exceeding the ALE Standard

In over 85 percent of the CISs reviewed, taxpayers claimed higher expenses in at least one of the ALE categories than was recognized by the ALE standards.³² The prevalence of taxpayers claiming expenses over the ALE standards and the rate at which IRS employees approved deviations varied by expense type. The following figure depicts the percent of sample cases where the taxpayer claimed more than the ALE expenses and the rate at which such deviations were disallowed. This could indicate that the method for setting the ALE standards is insufficient because it may not accurately reflect what it costs to meet basic expenses, the IRS may not be making appropriate deviations, or the standards may not reflect expenses of taxpayers who owe delinquencies.

31 This report does not show the confidence intervals for most of the subpopulations.

32 In 236 of the 278 sample cases, the taxpayer claimed total expenses greater than the maximum ALE standards.

FIGURE 2.2, Percent of Taxpayers With an Expense Claimed in Excess of the ALE Standard and the Percent of Those Instances That the IRS Disallowed

Expense Type	Percent of Taxpayers With ALE Expenses in Excess of ALE Standard	Percent of Instances Where Excess ALE Expenses Are Disallowed
National Standards	28.4%	50.6%
Housing and Utilities	54.0%	36.7%
Public Transportation	8.6%	29.3%
Vehicle Ownership Costs	21.6%	40.0%
Vehicle Operating Costs	49.6%	37.0%
Out-of-pocket Health Care Costs	36.7%	35.3%

Fifty-four percent of taxpayers had housing and utility expenses in excess of the ALE standards. And of those, approximately 37 percent had their expenses disallowed. Around 28 percent of taxpayers had national standard expenses in excess of the ALE standards but slightly over half of those taxpayers had their expenses disallowed. The high rate of disallowance may indicate that employee training on deviations needs to be improved.

Additionally, over 85 percent of those taxpayers whose expenses claimed for ALE standards did not exceed the total ALE amount for their age and family size claimed expenses outside of the items recognized by the IRS, which made their total of expenses claimed exceed their ALE standards. This means that a majority of the taxpayers who were able to fit within the IRS's system for ALE standards still fell outside of the limits because not all of their types of expenses were covered. Overall, about 60 percent of taxpayers claimed total expenses exceeding the amounts routinely allowed by the IRS. If the taxpayer is claiming reasonable expenses, the implications of this could be countering the congressional intent for ALE standards, which is to ensure that taxpayers do not enter into a payment arrangement for a tax liability that prevents them from meeting basic living expenses.

The TAS analyses also shed light in one area where perhaps IRS training can be improved. As of March 26, 2018, each taxpayer under age 65 is entitled to claim \$52 per month in out-of-pocket health care costs. Each taxpayer age 65 or over is entitled to claim \$114 per month.³³ However, in the review of 278 taxpayers, TAS found that only 254 cases reflected an allocation for this expense. That means that approximately eight percent of the cases did not receive the benefit of out-of-pocket health care costs each year, which should be guaranteed to each taxpayer.

33 Out-of-pocket health care expenses include medical services, prescription drugs, and medical supplies. IRM 5.15.1.8(4), *Allowable Expense Overview* (Aug. 29, 2018). In response to the IRS's decision to decrease the amount allowed for out-of-pocket expenses, the National Taxpayer Advocate previously recommended that this expense should be increased. National Taxpayer Advocate 2016 Annual Report to Congress 198.

The Incidence of Taxpayers Having Expenses in One or More ALE Categories That Exceed the ALE for the Category and Whether These Excess Expenses Are Disallowed Even Though the Taxpayer's Total Expenses Are Less Than the Sum of All Relevant ALE Standards

The IRM instructs IRS Collection personnel to allow expenses that exceed the ALE standard if taxpayers' circumstances warrant such an action and the expense can be substantiated through verbal communication or documentation.³⁴ In about 40 percent of the cases reviewed, the IRS disallowed expenses that exceeded the applicable ALE standard.

IRS employees are instructed to request documentation to substantiate an expense claimed in excess of the ALE standard. According to IRS procedures, the IRS should allow the national standard even if the taxpayer spends less on those expenses.³⁵ However, the IRS must accept the lesser of actual expenses or the local standard for housing and transportation.³⁶ Figure 2.3 shows, by the type of ALE standard, the percent of disallowed excess expenses where the taxpayer was able to document the existence of the expense. This table also shows the number of cases where the disallowance occurred even though the IRS allowed a smaller total amount of living expense than the maximum expense indicated by the guidelines.³⁷

FIGURE 2.3, Percentage of Cases Where the IRS Disallowed ALE Expenses Even Though Expense Was Documented or the IRS Allowed Less than the Maximum ALE Standards

Expense Type	Percent of Taxpayers With ALE Expenses > Standards Where the IRS Disallowed the Additional Expense Even Though the Taxpayer Was Able to Document the Existence of the Expense	Percent of Taxpayers With ALE Expenses > Indicated Standard Where the IRS Disallowed the Additional Expense Even Though the Taxpayer's Total ALE Expenses Were Less Than the Maximum Total ALE Expense Standard
National Standards	26.6%	13.9%
Housing and Utilities	33.3%	10.0%
Public Transportation	16.7%	54.2% ^a
Vehicle Ownership Costs	31.7%	11.7%
Vehicle Operating Costs	27.5%	26.8%
Out-of-pocket Health Care Costs	16.7%	28.4% ^b

a Only 24 cases claimed public transportation expenses.

b Includes instances where the IRS allowed no out-of-pocket health care expenses.

Overall, 26.3 percent of the sample taxpayers claimed more than the amount of at least one ALE standard, even though they claimed less than the total amount of all allowable ALE expenses for their specific circumstance. The IRS disallowed expenses greater than those specifically allowed by the ALE standards 28.8 percent of the time, even though the taxpayer's total expenses for the ALE standards was

34 IRM 5.15.1.2(12), *Overview and Expectations* (Aug. 29, 2018); IRM 5.15.1.8, *Allowable Expense Overview* (Aug. 29, 2018).

35 IRM 5.15.1.8(4), *Allowable Expense Overview* (Aug. 29, 2018). The exact language reads "Taxpayers are allowed the total National Standards amount monthly for their family size, without questioning the amounts they actually spend."

36 IRM 5.15.1.8(5), *Allowable Expense Overview* (Aug. 29, 2018).

37 *Id.* A taxpayer who claims an expense under the local standards is allowed the lesser of the amount spent or the local standard. Nevertheless, the IRS will allow the maximum amount of the expense for other taxpayers when expenses for the local standard equals or exceeds the expense standard.

less than the total applicable ALE standards, which is in contradiction for guidance related to national standards. In over 90 percent of these cases, the IRS disallowed the additional expense.³⁸

The Incidence of the IRS Not Allowing an Expense Because It Is Outside of the Currently Accepted ALEs

The IRS has exercised its discretion when it determines which expenses are necessary and included in the ALE standards. The third objective of this study examines the frequency with which the IRS allows expenses not included in its ALE standards. We divided these expenses between items which appear on the CIS (such as health or life insurance premiums) and other expenses not listed on the taxpayer's CIS but nevertheless potentially a legitimate expense (such as contributions to a retirement account).

TAS Research explored the prevalence of taxpayers claiming expenses not included in the ALE standards. The CIS allows taxpayers to report eight expenses not included in the ALE standards (listed in Figure 2.4).³⁹ Next to each expense type appears the percent of cases in which that expense was claimed, the percent of cases where the IRS disallowed this expense, and the percent of cases where the IRS disallowed the indicated expense, even though the taxpayer documented the existence of the expense.

FIGURE 2.4, Incidence of Expenses Appearing on the CIS Outside of the ALE Standards and Whether the IRS Allowed or Disallowed the Expenses with Substantiation

Expense Type	Percent of Cases Claiming Expense	Percent of Cases IRS Disallowed Expense	Percent of Taxpayers Where the IRS Disallowed the Additional Expense Even Though the Taxpayer Was Able to Document the Existence of the Expense
Child/Dependent Care Expenses	8.6%	16.7%	50.0%
Health Insurance	62.6%	9.8%	52.9%
Life Insurance	40.3%	20.5%	56.5%
Current Year Taxes	60.4%	19.6%	24.2%
Secured Debts	10.8%	26.7%	62.5%
Court Ordered Payments	16.2%	20.0%	55.6%
Payments on Delinquent Taxes	23.7%	27.3%	52.6%
Other Expenses	38.9%	50.9%	49.2%

When considered by individual expense category, the sample sizes for cases with disallowed expenses are small. This may be a result of the way in which the expenses were recorded by the IRS employee when conducting the financial analysis. Nevertheless, when considering all expense types not listed on the CIS, the IRS disallowed over 45 percent of the expenses even though the taxpayer was able to document the existence of the expense.⁴⁰

38 The IRS disallowed part of the expense claimed for at least one ALE standard in 73 of the 278 sample cases, even though the taxpayer's total expenses for the ALE standards was less than the total applicable ALE standards. In 21 of the 73 cases, the taxpayer provided documentation for the higher expense claimed and in 19 of these 21 cases, the IRS did not allow the full amount of the applicable ALE standards.

39 IRS, Form 433-A, *Collection Information Statement for Wage Earners and Self-Employed Individuals* 4 (Dec. 2012).

40 In 61 of 144 instances the IRS disallowed a documented expense. The 95 percent confidence interval ranges from 34.3 percent to 50.4 percent.

Some disallowed expenses could severely impact taxpayers' well-being. For instance, there is no standard for childcare expenses because it is considered an "other" expense.⁴¹ However, almost 17 percent of the cases claiming childcare expenses were disallowed, and in half of those cases the taxpayer submitted documentation to substantiate the expense. IRS employees are instructed to only consider reasonable amounts of childcare costs but the IRM does not define what is a "reasonable" cost for childcare is. Instead, employees are cautioned that the "cost of childcare can vary greatly. Do not allow unusually large child care expense if more reasonable alternatives are available. Consider the age of the child and if both parents work."⁴² Given the importance of this expense category to a parent working outside of the house, childcare should be established as its own ALE category, to ensure uniform inclusion by IRS employees.

A similar argument can be made for health care insurance costs. Here, only ten percent of the cases were disallowed, but approximately 53 percent of those disallowed cases had their expenses disallowed even after submitting documentation.

We also examined expenses that do not appear on the CIS because the expenses are not recognized by the IRS, including:

- Retirement savings contributions;
- Higher education or trade school expenses; and
- Children's school-related expenses.

Overall, these expenses were not recorded in the reviewed CISs with any significant frequency. The most common of these expenses was the presence of retirement allotments and trade school or other higher education expenses, which occurred in about 6.8 percent and 2.5 percent of the cases, respectively. However, IRS Collection personnel likely lump these expenses in "other" expenses highlighted above. When considering only these expenses, the IRS disallowed the expense in 43 percent of the cases reviewed, which is similar but somewhat lower than the rate at which IRS personnel disallowed "other" expenses. Of the disallowed expenses, the taxpayer provided substantiation of the expense in approximately 38 percent of the cases.

When combining these expenses with the "other" expenses detailed in the prior section of specific line items listed on the CIS but not included in one of the IRS ALE standards, taxpayers claimed such an expense in slightly over 44 of the cases reviewed.⁴³ The IRS disallowed these expenses about half of the time.⁴⁴ The taxpayer was able to document the expense in a third of the disallowed expense claims.

41 IRM 5.15.1.11(3), *Other Expenses* (Aug. 29, 2018). See National Taxpayer Advocate 2016 Annual Report to Congress 192-202.

42 IRM 5.15.1.11(3), *Other Expenses* (Aug. 29, 2018).

43 The sample point estimate is 50.7 percent.

44 The sample point estimate is 48.9 percent.

The Incidence of the IRS Not Allowing an Expense Because It Is Outside of the Accepted ALEs, but the Taxpayer's Total Expenses Are Less Than the Sum of All Relevant ALE Standards

This objective is similar to the second objective, except instead of analyzing individual ALE categories, TAS analyzed the frequency with which taxpayers claimed expenses outside of those covered by the ALE categories that were disallowed by the IRS, even though the taxpayer's total expenses were less than the maximum total for all ALE standards, given the taxpayer's individual circumstances.⁴⁵ In about 15 percent of the sample cases, the IRS allowed total expenses less than the maximum amount which could be allowed by the ALE standards. In almost two-thirds of these cases, the taxpayer had claimed another expense outside of the ALE standards.⁴⁶

CONCLUSIONS

Congress intended for the IRS to use ALE standards in order to ensure that taxpayers do not go into poverty in order to pay their outstanding tax liabilities. The current standards have come to play an important role in many types of collection cases. However, the way in which the ALEs are designed and used may impact how effectively taxpayers are protected.

- Taxpayers claim more than the recognized ALE standards nearly two-thirds of the time.
- Eighty-five percent of the taxpayers claimed total expenses greater than the amounts allowed by the ALE standards.
- When considering taxpayers with total expenses for the ALE standards less than the standard amount, about two-thirds claimed an expense outside of those covered by the ALE standards.
- On average, the IRS disallowed a claimed expense exceeding the corresponding ALE standard about 40 percent of the time. The IRS denied over half of the claimed expenses exceeding the national standard (food, clothing, etc.).
- The IRS disallowed about 45 percent of the expenses occurring on the CIS but outside of the ALE standards, even though the taxpayer documented the existence of the expense. Although other routine expenses not considered necessary (*e.g.*, retirement savings contributions or charitable contributions) were claimed relatively infrequently, the IRS also disallowed over 45 percent of these documented expenses.

The IRS allowed expenses less than the ALE standards in about 15 percent of the cases. In nearly two-thirds of these cases, the taxpayer had claimed an additional expense outside of those covered by the ALE standards, while the IRS disallowed these additional expenses about 15 percent of the time.

45 IRM 5.15.1.8(5), *Allowable Expense Overview* (Aug. 29, 2018). A taxpayer who claims an expense under the local standards is allowed the lesser of the amount spent or the local standard. Nevertheless, the IRS will allow the maximum amount of the expense for other taxpayers whose expenses for the local standard equals or exceeds the expense standard.

46 The point estimate is 14.8 percent with the 95 percent confidence interval ranging from 5.2 percent to 24.4 percent.

RECOMMENDATIONS

To minimize devoting resources to granting IAs that have a high probability of default, the IRS should utilize the flexibility that is already required in the tax code. In doing so, the IRS is also fulfilling congressional intent, which is to avoid having taxpayers suffer a financial hardship to meet tax liabilities. Accordingly, the IRS should consider the following recommendations:

1. Both the local and national standards should be viewed as a minimum allowance without substantiation. If the taxpayer claims more, then substantiation may be requested.
2. The IRM gives IRS employees broad discretion in allowing for deviations from the ALE standards; however, deviations are not utilized consistently. The IRS should provide more training to its collection employees on using deviations when necessary and exercising good judgment to analyze the financial situation of each taxpayer and his or her family.
3. Similarly, TAS Research data reflects documented expenses in excess of the ALE standards that the IRS considered and disallowed or reduced. However, IRS procedures allow for reasonable substantiation of expenses, including credible verbal communication. The IRS should review its employees' exercise of this discretion to ensure they do not deny legitimate expenses, especially where taxpayers' overall expenses are below ALEs.
4. The three expenses TAS reviewed that are not included currently in ALE standards arguably meet consideration for allowance under the necessary expense test. The IRS should expand the current ALE standards to retirement savings contributions, higher education or trade school expenses, and children's school-related expenses.