

## Introduction

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

The chart immediately following this Introduction summarizes congressional action on legislative recommendations the National Taxpayer Advocate proposed in her 2001 through 2007 Annual Reports to Congress.<sup>1</sup> The Office of the Taxpayer Advocate places a high priority on working with the tax-writing committees and other interested parties to try to resolve problems encountered by taxpayers. In addition to submitting legislative proposals in each Annual Report, the National Taxpayer Advocate meets regularly with Members of Congress and their staffs and testifies at hearings on the problems faced by taxpayers to ensure that a taxpayer perspective receives due congressional consideration. The following discussion details recent legislation incorporating the National Taxpayer Advocate's proposals.

On October 3, 2008, the President signed into law the Energy Improvement and Extension Act of 2008. The Act contains a significant proposal initially recommended by the National Taxpayer Advocate in her 2005 Annual Report to Congress. To assist taxpayers who sell stocks or mutual funds in correctly reporting gain or loss on their returns, the Act will require brokers to keep track of the investor's adjusted basis, to transfer adjusted basis information to a successor broker, and to report adjusted basis information to the taxpayer and the IRS (along with the amount of proceeds generated by the sale and whether the resulting gain or loss is long-term or short-term).<sup>2</sup> This provision will address the challenge facing taxpayers who hold stocks or mutual funds for many years and lose track of their original or adjusted basis. It will also enable the IRS to identify situations in which taxpayers deliberately overstate their basis to reduce or avoid tax.

The legislation also addressed some of the National Taxpayer Advocate's short-term concerns regarding the expanding application of the Alternative Minimum Tax (AMT). Specifically, the bill increases the AMT exemption amounts and allows personal credits to be used against the AMT.<sup>3</sup> In addition, the legislation included relief for taxpayers facing outstanding AMT liabilities from exercising incentive stock options (ISOs). The National Taxpayer Advocate has previously urged Congress to pass legislation to repeal or limit the scope of the AMT.<sup>4</sup>

<sup>1</sup> An electronic version of the chart is available on the Taxpayer Advocate Service website at <http://www.irs.gov/advocate>.

<sup>2</sup> Pub. L. No. 110-343, § 403, 122 Stat. 3765, 3854-60 (2008); National Taxpayer Advocate 2005 Annual Report to Congress 433-41.

<sup>3</sup> Tax Extenders and Alternative Minimum Tax Relief Act of 2008, Pub. L. No. 110-343, §§ 101-103, 122 Stat. 3861, 3863 (2008).

<sup>4</sup> National Taxpayer Advocate 2004 Annual Report to Congress 383-85; National Taxpayer Advocate 2001 Annual Report to Congress 82-100; National Taxpayer Advocate FY 2009 Objectives Report to Congress xxxiii-xxxix.

A number of legislative proposals made by the National Taxpayer Advocate in previous annual reports were included in H.R. 5716, the Taxpayer Bill of Rights Act of 2008, which was referred to the House Committee on Ways and Means in April 2008.<sup>5</sup> Specifically, H.R. 5716 included the following recommendations:

- **Taxpayer Bill of Rights.** Section 2 of the bill would require the Secretary of the Treasury to publish a summary statement of taxpayer rights and obligations. The National Taxpayer Advocate made a substantially similar proposal in her 2007 Annual Report.<sup>6</sup>
- **Grant Program for Return Preparation.** Based on a 2002 proposal of the National Taxpayer Advocate, § 3 of the bill would authorize the Secretary of the Treasury to make grants to provide matching funds for the development, expansion, or continuation of qualified return preparation clinics.<sup>7</sup>
- **Regulation of Return Preparers.** Section 4 of the bill would authorize the Secretary of the Treasury to promulgate regulations establishing a system to regulate compensated unenrolled return preparers. Preparers would be required to take an initial exam and renew eligibility every three years, at which point they would be required to demonstrate completion of continuing education requirements. This bill was modeled on a proposal initially recommended in the National Taxpayer Advocate's 2002 Annual Report to Congress.<sup>8</sup>
- **Increased Preparer Penalties.** Section 6 of the bill would increase preparer penalties in IRC § 6695 (a) through (c) from \$50 to \$1,000. The National Taxpayer Advocate recommended to raise these penalties as well as others.<sup>9</sup>

A separate bill, H.R. 5719, the Taxpayer Assistance and Simplification Act of 2008, passed the House and was referred to the Senate Committee on Finance.<sup>10</sup> The bill included the following recommendations of the National Taxpayer Advocate:

- **Home-Based Service Workers.** Section 5 of the bill is based on recommendations by the Taxpayer Advocate. In both the 2001 and 2007 Annual Reports, the National Taxpayer Advocate proposed that Congress clarify that home-based workers are employees rather than independent contractors.<sup>11</sup>

<sup>5</sup> H.R. 5716, 110th Cong. (2008).

<sup>6</sup> National Taxpayer Advocate 2007 Annual Report to Congress 478-89.

<sup>7</sup> National Taxpayer Advocate 2002 Annual Report to Congress vii-viii.

<sup>8</sup> National Taxpayer Advocate 2002 Annual Report to Congress 216-30; see also National Taxpayer Advocate 2006 Annual Report to Congress 197-221; National Taxpayer Advocate 2004 Annual Report to Congress 67-88; National Taxpayer Advocate 2003 Annual Report to Congress 270-301.

<sup>9</sup> National Taxpayer Advocate 2003 Annual Report to Congress 270-301.

<sup>10</sup> H.R. 5719, 110th Cong. (2008).

<sup>11</sup> National Taxpayer Advocate 2001 Annual Report to Congress 195-201; National Taxpayer Advocate 2007 Annual Report to Congress 556-57.

- **Referrals to Low Income Taxpayer Clinics (LITCs).** Section 6 of the bill is based on the National Taxpayer Advocate's 2007 recommendation to amend IRC § 7526(c) to permit IRS employees to refer taxpayers to specific LITCs.<sup>12</sup>
- **Return of Levy or Sale Proceeds.** Section 11 of the bill would extend the period of time within which a third party can request a return of levied funds or proceeds from the sale of levied property under IRC § 6343. It also would extend the time to return levied funds or sale proceeds. The National Taxpayer Advocate made a similar proposal in 2001.<sup>13</sup>
- **Reinstatement of Retirement Accounts.** Section 12 of the bill is based on a 2001 recommendation of the National Taxpayer Advocate.<sup>14</sup> The bill would amend the IRC to allow contributions to individual retirement accounts and other qualified plans from the funds returned to the taxpayer or third parties under IRC § 6343.
- **Private Debt Collection.** The National Taxpayer Advocate recommended in her 2006 Annual Report to Congress that Congress repeal the IRS's authority to enter into private debt collection (PDC) contracts.<sup>15</sup> Section 14 of H.R. 5719 would repeal that authority.

Finally, S. 2861, a bill introduced in the Senate and referred to the Committee on Finance, would prohibit any person from charging a fee for the electronic filing of federal tax returns. This provision is based on a recommendation made by the National Taxpayer Advocate in 2004.<sup>16</sup>

We continue to advocate for the proposals we have made previously. In this report, we present 17 Legislative Recommendations, the first ten of which are designed to simplify the tax laws.

## Legislative Recommendations

**Repeal the AMT for individuals.** Few people think of having children or living in a high-tax state as a tax-avoidance maneuver, but under the unique logic of the AMT, that is essentially how those actions are treated. The AMT effectively requires taxpayers to compute their taxes twice – once under the regular rules and again under the AMT rules – and then to pay the higher of the two amounts. The regular tax rules allow taxpayers to claim tax deductions for each dependent (recognizing the costs of maintaining a household and raising a family) and for taxes paid to state and local governments (reducing “double taxation” at the federal and state levels), but the AMT rules disallow those deductions. It is estimated that 77 percent of all additional income subject to tax under the AMT is attributable to the

<sup>12</sup> National Taxpayer Advocate 2007 Annual Report to Congress 551-53.

<sup>13</sup> National Taxpayer Advocate 2001 Annual Report to Congress 202-14.

<sup>14</sup> *Id.*

<sup>15</sup> National Taxpayer Advocate 2006 Annual Report to Congress 458-62.

<sup>16</sup> National Taxpayer Advocate 2004 Annual Report to Congress 471-77; S. 2861, 110th Cong. (2008).

disallowance of deductions for dependents and state and local tax payments. The AMT computations are also extremely burdensome. The National Taxpayer Advocate recommends that Congress repeal the AMT for individuals in the context of fundamental tax reform.

**Simplify the Family Status Provisions.** Notwithstanding the improvements brought about by enactment of a Uniform Definition of a Child in 2004, the IRC family status provisions continue to ensnare taxpayers and make tax administration difficult simply because of the number of such provisions and their structural interaction. These provisions include filing status, personal and dependency exemptions, the child tax credit, the earned income tax credit, the child and dependent care credit, and the separated spouse rule under IRC § 7703(b). Many of the eligibility requirements – such as support or maintenance costs of the home – are difficult for the IRS to verify without conducting audits into taxpayers' personal and private lives. The National Taxpayer Advocate recommends that, as part of a comprehensive reform of the tax treatment of families, Congress consolidate the numerous existing family status-related provisions into two categories: (1) a Family Credit and (2) a Worker Credit. The refundable Family Credit would reflect the costs of maintaining a household and raising a family, while the refundable Worker Credit would provide an incentive and subsidy for low income individuals to work.

**Simplify and Streamline Education Savings Tax Incentives.** The IRC contains at least 11 separate incentives to encourage taxpayers to save for and spend on education. The eligibility requirements, definitions of common terms, income-level thresholds, phase-out ranges, and inflation adjustments 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 enough with the particulars to make wise choices. The National Taxpayer Advocate recommends that Congress consolidate existing incentives and harmonize definitions and other terms to the extent possible.

**Simplify and Streamline Retirement Savings Tax Incentives.** The IRC contains at least 16 separate incentives to encourage taxpayers to save for retirement. These incentives are subject to different sets of rules governing eligibility, contribution limits, taxation of contributions and distributions, withdrawals, availability of loans, and portability. As with education incentives, the large number of options and lack of common definitions and terms can preclude taxpayers from making wise choices or understanding how each incentive works. The National Taxpayer Advocate recommends that Congress consolidate existing retirement incentives, particularly where the differences in plan attributes are minor. For instance, Congress should consider establishing one retirement plan for individual taxpayers, one for plans offered by small businesses, and one suitable for large businesses (eliminating plans that are limited to governmental entities). At a minimum, Congress should establish uniform rules regarding hardship withdrawals, plan loans, and portability.

**Worker Classification.** The complexity and ambiguities in the existing worker classification rules create uncertainty and lead to noncompliance. In general, businesses are only required to pay employment tax, withhold income tax, and provide benefits with respect to employees. As a consequence, businesses often classify workers as independent contractors to reduce their costs. Some employees seeking to avoid their tax obligations may also prefer to be classified as independent contractors if the employer does withhold taxes or report the payments to the IRS. Depending on the terms of the relationship between a business and a worker, however, many workers should be classified as independent contractors. The National Taxpayer Advocate recommends that Congress (1) replace Section 530 of the Revenue Act of 1978 with a provision applicable to both employment and income taxes and require the Secretary of the Treasury to issue associated guidance, including guidance with specific industry focus, (2) direct the IRS to develop an electronic tool to determinate worker classifications that employers would be entitled to use and rely upon, absent misrepresentation; (3) allow both employers and employees to request classification determinations and seek recourse in the United States Tax Court; and (4) direct the IRS to conduct public outreach and education campaigns to increase awareness of the rules as well as the consequences associated with worker classification.

**Simplify the Tax Treatment of Cancellation of Debt Income.** Most financially distressed individuals who lose their homes to foreclosure or cannot pay off their car loans, credit card balances, student loans, or medical bills probably do not realize that their delinquency may increase their tax liabilities, but it often does. The IRC generally treats canceled debts as taxable income. Congress has carved out a number of exclusions, including a recently enacted exclusion to help homeowners whose mortgage debts are canceled when their houses are foreclosed upon and sold, but taxpayers do not receive the benefit of these exclusions automatically. Moreover, the rules are complex, and a taxpayer must file Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)*, to claim an exclusion. Very few taxpayers or preparers are familiar with this intricate form. The National Taxpayer Advocate is concerned that tens of thousands and possibly hundreds of thousands of taxpayers who qualify to exclude canceled debts from gross income may not be filing Form 982. Instead, some of these taxpayers unnecessarily include the amount of the canceled debt in gross income (based on their receipt of a Form 1099-C, *Cancellation of Debt*), and other taxpayers who fail to include it unnecessarily face IRS examinations and tax assessments. The National Taxpayer Advocate recommends that Congress enact one of several proposed alternatives to remove taxpayers with modest amounts of debt cancellation from the cancellation of debt income regime.

**Eliminate (or Reduce) Procedural Incentives for Lawmakers to Enact Tax Sunsets.**

The IRC contains more than 100 provisions that are temporary and set to expire soon, up from about 21 in 1992. Tax benefits have increasingly been enacted for a limited number of years in order to reduce their cost for budget-scoring purposes. Tax sunsets make it difficult for both the government and taxpayers to plan ahead, especially when there is significant uncertainty about whether Congress will extend a provision that is set to expire.

The complexity and uncertainty caused by sunsets makes it more difficult for taxpayers to estimate liabilities and pay the correct amount of estimated taxes, complicates tax administration for the IRS, reduces the effectiveness of tax incentives, and may even reduce tax compliance. The National Taxpayer Advocate recommends that Congress consider several options to reduce or eliminate the procedural incentives to enact temporary tax provisions.

**Eliminate (or Simplify) Phase-Outs.** More than half of all individual income tax returns filed each year are affected by the phase-out of certain tax benefits as a taxpayer's income increases. Like tax sunsets, phase-outs are largely used to reduce the cost of tax provisions for budget-scoring purposes. However, phase-outs are burdensome for taxpayers, reduce the effectiveness of tax incentives, and make it more difficult for taxpayers to estimate their tax liabilities and pay the correct amount of withholding or estimated taxes, possibly reducing tax compliance. Phase-outs also create marginal "rate bubbles" – income ranges within which an additional dollar of income earned by a relatively low income taxpayer is taxed at a higher rate than an additional dollar of income earned by a relatively high income taxpayer. Because Congress could achieve a similar distribution of the tax burden based on income level by adjusting marginal rates, phase-outs introduce unnecessary complexity to the Code. The National Taxpayer Advocate recommends repealing phase-outs or at least taking another look at phase-outs to ensure that they are really necessary to accomplish their intended objective.

**Reforming the Penalty Regime.** The number of civil tax penalties has increased from about 14 in 1954 to more than 130 today. The last comprehensive reform of the IRC's penalty provisions was enacted in 1989, after careful study by Congress, the IRS, and others. Since then, legislative and administrative changes to the penalty regime have proceeded piecemeal, but without the kind of careful analysis conducted in 1989. The National Taxpayer Advocate's primary recommendation is that Congress direct the IRS to (1) collect and analyze more detailed penalty data on a regular basis and (2) conduct an empirical study to quantify the effect of each penalty on voluntary compliance. Congress should appropriate additional funds for this research, as necessary. In the meantime, based on penalty reform principles identified in 1989, the National Taxpayer Advocate recommends 11 common-sense reforms, which are described in *A Framework for Reforming the Penalty Regime* in volume 2 of this report.

**Modify Internal Revenue Code Section 6707A to Ameliorate Unconscionable Impact.** Section 6707A of the IRC imposes a penalty of \$100,000 per individual per year and \$200,000 per entity per year for failure to make special disclosures of a "listed transaction." Enacted in 2004 to help combat tax shelters, this penalty is having an unconscionable and possibly unconstitutional impact on taxpayers who have done nothing wrong. The penalty *must* be imposed where a taxpayer fails to make the special disclosures – even if the taxpayer had no knowledge that the transaction was listed or even questionable, even if the taxpayer derived no tax savings from the transaction, and even if the transaction is not "listed" until years after the taxpayer entered into it and filed a return on which

the transaction was reflected. A taxpayer who does business through a wholly owned S corporation is subject to a penalty of \$300,000 (\$200,000 at the entity level and \$100,000 at the individual level) for each year in which the transaction is reflected on a return. The requirement that this penalty be imposed without regard to culpability may have the effect of bankrupting middle class families who had no intention of entering into a tax shelter. The National Taxpayer Advocate recommends that Congress quickly amend Section 6707A so that the amount of the penalty bears a proportional relationship to the amount of any tax savings realized.

**The Time Has Come to Regulate Federal Tax Return Preparers.** Tax return preparers are an essential component of taxpayer rights and tax compliance. Despite the vital role return preparers play in effective tax administration, anyone can prepare a tax return for a fee — with no training, no licensing, and no oversight required. Attorneys, certified public accountants, and enrolled agents are all licensed by state or federal authorities and are subject to censure, suspension, or disbarment from practice before the IRS in the event of wrongdoing. Yet there is virtually no federal oversight over “unenrolled” preparers, who constitute the majority of tax return preparers today. The National Taxpayer Advocate recommends that Congress enact a registration, examination, certification, and enforcement program for unenrolled tax return preparers. In addition, Congress should direct the Department of the Treasury and the IRS to conduct a public awareness campaign to inform the public about the registration requirements.

**Refund Delivery Options.** Particularly in light of the current downturn in the economy, federal tax refunds are an important source of funds for many individual taxpayers. As a result, the Department of the Treasury and the IRS need to provide all taxpayers with the ability to receive refunds as quickly as possible and at minimal cost. The National Taxpayer Advocate recommends that Congress direct the Department of the Treasury and the IRS to (1) minimize refund turnaround times; (2) implement a Revenue Protection Indicator; (3) develop a program to enable unbanked taxpayers to receive refunds on stored value cards (SVCs); and (4) conduct a public awareness campaign to disseminate accurate information about refund delivery options.

**Crediting an Overpayment Against an Unassessed, Outstanding Tax Liability.** In August of 2007, the IRS issued Revenue Ruling 2007-51, permitting the IRS to (1) reduce refunds pursuant to IRC § 6402(a) to satisfy unassessed tax liabilities or (2) credit a decrease in tax resulting in a carryback adjustment against an unassessed liability. Permitting the IRS to reduce a refund to satisfy an unassessed liability inappropriately allows collection prior to assessment. The examples described in the revenue ruling were limited to corporations, and the Office of Chief Counsel has advised Congress that it is only applying the ruling to corporations. However, Revenue Ruling 2007-51 undermines taxpayers’ right under IRC § 6212 to challenge a proposed deficiency before assessment and payment of the tax. Absent compelling public policy, taxpayers, particularly low income taxpayers who rely on refunds to help pay for basic living expenses, should be protected from this type of

premature collection. If Congress shares the IRS's concern that large refunds or credits are being issued when corporations have significant unassessed liabilities, the National Taxpayer Advocate recommends that Congress carve out a specific exception in the Code for these circumstances.

**Waiver of Levy Prohibition Under Internal Revenue Code Section 6331(k).** IRC § 6331(k) generally provides that the IRS cannot levy on a taxpayer's assets while an offer in compromise (OIC) is pending or an installment agreement (IA) is pending or in effect. This prohibition does not apply, however, if the taxpayer files a written notice with the IRS waiving the levy restriction. The National Taxpayer Advocate has witnessed occasions when the IRS has attempted to require a waiver in exchange for agreeing to an IA. The IRS may make such a waiver a necessary condition to obtain an IA or OIC. To protect taxpayers from IRS overreaching, the National Taxpayer Advocate recommends that Congress amend IRC § 6331(k)(3)(A) to clarify that the IRS is prohibited from conditioning approval of an IA or OIC on the taxpayer's execution of a waiver of the levy prohibition.

**Mailing Duplicate Notices to Credible Alternate Addresses.** IRS notices often trigger the legal rights and obligations of taxpayers to take critical actions, such as contest a liability, challenge a notice of deficiency, or contest a lien filing, and most require the taxpayer to take the action within a specified number of days. The IRS mails these notices to the taxpayer's last known address. However, with a population that is mobile and transitory, the last known address contained in the IRS's Master File may not reflect the taxpayer's current residence. As a result, taxpayers who are between return filing seasons and have not updated their addresses with the IRS or the U.S. Postal Service may not receive critical notices from the IRS. The National Taxpayer Advocate recommends that Congress direct the Secretary of the Treasury to develop procedures for checking third party databases for credible alternate addresses prior to sending notices that establish legal rights and obligations and, when there is a credible alternate address, require the IRS to mail the notice simultaneously to the last known address and to the credible alternate address.

**Health Insurance Deductions for Self-Employed Individuals.** Many wage-earners participate in benefit plans that allow them to exclude the amount of their health insurance premiums from gross income, thereby avoiding Social Security and Medicare taxes. Unlike their wage-earning counterparts, self-employed individuals cannot deduct health insurance costs when determining net earnings for self-employment tax purposes. The National Taxpayer Advocate recommends that Congress repeal IRC § 162(l)(4) to place self-employed taxpayers on an equal footing with their wage-earning counterparts.

**Mileage Deduction for Charitable Activities.** IRC § 162(a) generally allows a trade or business to take a deduction for trade or business expenses associated with operating a passenger automobile. The IRS adjusts the standard mileage rate for business expenses annually, adjusting for inflation. Unlike the standard mileage deduction for business expenses, however, the deduction for charitable activities is specified in the IRC, which denies the

IRS the discretion to adjust the amount from year to year. The National Taxpayer Advocate recommends that Congress amend IRC § 170(i) to allow the Secretary of the Treasury to determine the standard mileage rate for charitable activities.

## National Taxpayer Advocate Legislative Recommendations with Congressional Action

## National Taxpayer Advocate Legislative Recommendations with Congressional Action

Alternative Minimum Tax (AMT)				
<b>Repeal the Individual AMT</b>				
National Taxpayer Advocate 2001 Annual Report to Congress 82-100; National Taxpayer Advocate 2004 Annual Report to Congress 383-385.		Repeal the AMT outright.		
	<b>Bill Number</b>	<b>Sponsor</b>	<b>Date</b>	<b>Status</b>
Legislative Activity 110th Congress	S 55	Baucus	1/4/2007	Referred to the Finance Committee
	S 14	Kyl	4/17/2007	Referred to the Finance Committee
	S 1040	Shelby	3/29/2007	Referred to the Finance Committee
	HR 1365	English	3/7/2007	Referred to the Ways & Means Committee
	HR 1942	Garrett	4/19/2007	Referred to the Ways & Means Committee
	HR 3970	Rangel	10/25/2007	Referred to the Ways & Means Committee
	S 2293	Lott	11/1/2007	Placed on Senate Legislative Calendar under General Orders. Calendar No. 464
Legislative Activity 109th Congress	HR 1186	English	3/9/2005	Referred to the Ways & Means Committee
	S 1103	Baucus	5/23/2005	Referred to the Finance Committee
	HR 2950	Neal	6/16/2005	Referred to the Ways & Means Committee
	HR 3841	Manzullo	9/2/2005	Referred to the Ways & Means Committee
Legislative Activity 108th Congress	HR 43	Collins	1/7/2003	Referred to the Ways & Means Committee
	HR 1233	English	3/12/2003	Referred to the Ways & Means Committee
	S 1040	Shelby	5/12/2003	Referred to the Finance Committee
	HR 3060	N. Smith	9/10/2003	Referred to the Ways & Means Committee
	HR 4131	Houghton	4/2/2004	Referred to the Ways & Means Committee
	HR 4164	Shuster	4/2/2004	Referred to the Ways & Means Committee
Legislative Activity 107th Congress	HR 437	English	2/6/2001	Referred to the Ways & Means Committee
	S 616	Hutchinson	3/26/2002	Referred to the Finance Committee
	HR 5166	Portman	7/18/2002	Referred to the Ways & Means Committee
<b>Index AMT for Inflation</b>				
National Taxpayer Advocate 2001 Annual Report to Congress 82-100.		If full repeal of the individual AMT is not possible, it should be indexed for inflation.		
	<b>Bill Number</b>	<b>Sponsor</b>	<b>Date</b>	<b>Status</b>
Legislative Activity 110th Congress	HR 1942	Garrett	4/19/2007	Referred to the Ways & Means Committee
Legislative Activity 109th Congress	HR 703	Garrett	2/9/2005	Referred to the Ways & Means Committee
	HR 4096	Reynolds	10/20/2005	12/7/2005-Passed House; 12/13/2005-Placed on Senate Legislative Calendar
Legislative Activity 108th Congress	HR 22	Houghton	1/3/2003	Referred to the Ways & Means Committee
Legislative Activity 107th Congress	HR 5505	Houghton	1/3/2003	Referred to the Ways & Means Committee
<b>Eliminate Several Adjustments for Individual AMT</b>				
National Taxpayer Advocate 2001 Annual Report to Congress 82-100.		Eliminate personal exemptions, the standard deduction, deductible state and local taxes, and miscellaneous itemized deductions as adjustment items for individual AMT purposes.		

## National Taxpayer Advocate Legislative Recommendations with Congressional Action

	Bill Number	Sponsor	Date	Status
Legislative Activity 110th Congress	S 102	Kerry	1/4/2007	Referred to the Finance Committee
Legislative Activity 109th Congress	S 1861	Harkin	10/7/2005	Referred to the Finance Committee
Legislative Activity 108th Congress	HR 1939	Neal	5/12/2003	Referred to the Ways & Means Committee
<b>Private Debt Collection (PDC)</b>				
<b>Repeal PDC Provisions</b>				
National Taxpayer Advocate 2006 Annual Report to Congress 458-462.	Repeal IRC § 6306, thereby terminating the PDC initiative.			
	Bill Number	Sponsor	Date	Status
Legislative Activity 110th Congress	HR 5719	Rangel	4/16/2008	Referred to the Finance Committee
	S 335	Dorgan	1/18/2007	Referred to the Finance Committee
	HR 695	Van Hollen	1/24/2007	Referred to the Ways & Means Committee
	HR 3056	Rangel	7/17/2007	10/15/2007-Referred to Senate Committee
<b>Tax Preparation and Low Income Taxpayer Clinics (LITC)</b>				
<b>Matching Grants for LITC for Return Preparation</b>				
National Taxpayer Advocate 2002 Annual Report to Congress vii-viii.	Create a grant program for return preparation similar to the LITC grant program. The program should be designed to avoid competition with VITA and should support the IRS's goal (and need) to have returns electronically filed.			
	Bill Number	Sponsor	Date	Status
Legislative Activity 110th Congress	<b>Pub. L. No. 110-161, Div. D, Title I, 121 Stat. 1975, 1976 (2007).</b>			
	HR 5716	Becerra	4/8/2008	Referred to the Ways & Means Committee
	S 1219	Bingaman	4/25/2007	Referred to the Finance Committee
	S 1967	Clinton	8/2/2007	Referred to the Finance Committee
Legislative Activity 109th Congress	HR 894	Becerra	2/17/2005	Referred to the Financial Institutions and Consumer Credit Subcommittee
	S 832	Bingaman	4/18/2005	Referred to the Finance Committee
	S 1321	Santorum	6/28/2005	9/15/2006-Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title; with S. Rep. No. 109-336 9/15/2006-Placed on Senate Legislative Calendar under General Orders. Calendar No. 614
Legislative Activity 108th Congress	S 476	Grassley	2/27/2003	Referred to the Finance Committee
	S 685	Bingaman	3/21/2003	Referred to the Finance Committee
	S 882	Baucus	4/10/2003	5/19/2004-S 882 was incorporated into HR 1528 as an amendment and HR 1528 passed in lieu of S 882
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee
	HR 3983	Becerra	3/17/2004	Referred to the Ways & Means Committee
Legislative Activity 107th Congress	HR 586	Lewis	2/13/2001	4/18/2002-Passed the House w/ an amendment-referred to Senate
	HR 3991	Houghton	3/19/2001	Referred to the Ways & Means Committee
	HR 7	Baucus	7/16/2002	Reported by Chairman Baucus, with an amendment referred to the Finance Committee

National Taxpayer Advocate Legislative Recommendations with Congressional Action

<p><b>Regulation of Income Tax Return Preparers</b> National Taxpayer Advocate 2002 Annual Report to Congress 216-230; National Taxpayer Advocate 2003 Annual Report to Congress 270-301.</p>	<p>Create an effective oversight and penalty regime for return preparers by taking the following steps:</p> <ul style="list-style-type: none"> <li>◆ Enact a registration, examination, certification, and enforcement program for federal tax return preparers;</li> <li>◆ Direct the Secretary of the Treasury to establish a joint task force to obtain accurate data about the composition of the return-preparer community and make recommendations about the most effective means to ensure accurate and professional return preparation and oversight;</li> <li>◆ Require the Secretary of the Treasury to study the impact cross-marketing tax preparation services with other consumer products and services has on the accuracy of returns and tax compliance; and</li> <li>◆ Require the IRS to take steps within its existing administrative authority, including requiring a check-box on all returns in which preparers would enter their category of return preparer (i.e., attorney, CPA, enrolled agent, or unenrolled preparer) and developing a simple, easy-to-read pamphlet for taxpayers that explains their protections.</li> </ul>			
<p>Legislative Activity 110th Congress</p>	<p><b>Bill Number</b></p>	<p><b>Sponsor</b></p>	<p><b>Date</b></p>	<p><b>Status</b></p>
<p>Legislative Activity 109th Congress</p>	<p>HR 5716</p>	<p>Becerra</p>	<p>4/8/2008</p>	<p>Referred to the Ways &amp; Means Committee</p>
<p>Legislative Activity 108th Congress</p>	<p>S 1219</p>	<p>Bingaman</p>	<p>4/25/2007</p>	<p>Referred to the Finance Committee</p>
<p>Legislative Activity 108th Congress</p>	<p>HR 894</p>	<p>Becerra</p>	<p>2/17/2005</p>	<p>Referred to the Financial Institutions and Consumer Credit Subcommittee</p>
<p>Legislative Activity 108th Congress</p>	<p>S 832</p>	<p>Bingaman</p>	<p>4/18/2005</p>	<p>Referred to the Finance Committee</p>
<p>Legislative Activity 108th Congress</p>	<p>S 1321</p>	<p>Santorum</p>	<p>6/28/2005</p>	<p>9/15/2006–Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title; with written report No. 109-336 9/15/2006–Placed on Senate Legislative Calendar under General Orders; Calendar No. 614</p>
<p>Legislative Activity 108th Congress</p>	<p>S 685</p>	<p>Bingaman</p>	<p>3/21/2003</p>	<p>Referred to the Finance Committee</p>
<p>Legislative Activity 108th Congress</p>	<p>S 882</p>	<p>Baucus</p>	<p>4/10/2003</p>	<p>5/19/2004–S 882 was incorporated into HR 1528 as an amendment and HR 1528 passed in lieu of S 882</p>
<p>Legislative Activity 108th Congress</p>	<p>HR 3983</p>	<p>Becerra</p>	<p>3/17/2004</p>	<p>Referred to the Ways &amp; Means Committee</p>
<p><b>Referrals to LITCs</b> National Taxpayer Advocate 2007 Annual Report to Congress 551-553.</p>	<p>Amend IRC § 7526(c) to add a special rule stating that notwithstanding any other provision of law, IRS employees may refer taxpayers to LITCs receiving funding under this section. This change will allow IRS employees to refer a taxpayer to a specific clinic for assistance.</p>			
<p>Legislative Activity 110th Congress</p>	<p><b>Bill Number</b></p>	<p><b>Sponsor</b></p>	<p><b>Date</b></p>	<p><b>Status</b></p>
<p>Legislative Activity 110th Congress</p>	<p>HR 5719</p>	<p>Rangel</p>	<p>4/16/2008</p>	<p>Referred to the Finance Committee</p>
<p><b>Public Awareness Campaign on Registration Requirements</b> National Taxpayer Advocate 2002 Annual Report to Congress 216-230.</p>	<p>Authorize the IRS to conduct a public information and consumer education campaign, utilizing paid advertising, to inform the public of the requirements that paid preparers must sign the return prepared for a fee and display registration cards.</p>			
<p>Legislative Activity 110th Congress</p>	<p>HR 5716</p>	<p>Becerra</p>	<p>4/8/2008</p>	<p>Referred to the Ways &amp; Means Committee</p>
<p>Legislative Activity 109th Congress</p>	<p>S 1219</p>	<p>Bingaman</p>	<p>4/25/2007</p>	<p>Referred to the Finance Committee</p>
<p>Legislative Activity 109th Congress</p>	<p>HR 894</p>	<p>Becerra</p>	<p>2/17/2005</p>	<p>Referred to the Financial Institutions and Consumer Credit Subcommittee</p>
<p>Legislative Activity 109th Congress</p>	<p>S 832</p>	<p>Bingaman</p>	<p>4/18/2005</p>	<p>Referred to the Finance Committee</p>
<p>Legislative Activity 109th Congress</p>	<p>S 1321</p>	<p>Santorum</p>	<p>6/28/2005</p>	<p>9/15/2006–Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title; with S. Rep. No. 109-336 9/15/2006–Placed on Senate Legislative Calendar under General Orders; Calendar No. 614</p>

## National Taxpayer Advocate Legislative Recommendations with Congressional Action

Legislative Activity 108th Congress	S 685	Bingaman	3/21/2003	Referred to the Finance Committee
	S 882	Baucus	4/10/2003	5/19/2004-S 882 was incorporated into HR 1528 as an amendment and HR 1528 passed in lieu of S 882
	HR 3983	Becerra	3/17/2004	Referred to the Ways & Means Committee
<b>Increase Preparer Penalties</b>				
National Taxpayer Advocate 2003 Annual Report to Congress 270-301.	Strengthen oversight of all preparers by enhancing due diligence and signature requirements, increasing the dollar amount of preparer penalties, and assessing and collecting those penalties, as appropriate.			
Legislative Activity 110th Congress	<b>Bill Number</b>	<b>Sponsor</b>	<b>Date</b>	<b>Status</b>
	HR 5719	Rangel	4/16/2008	Referred to the Finance Committee
	HR 4318	Crowley/ Ramstad	12/6/2007	Referred to the Ways & Means Committee
	S 2851	Bunning	4/14/2008	Referred to the Finance Committee
Legislative Activity 109th Congress	S 1219	Bingaman	4/25/2007	Referred to the Finance Committee
	HR 894	Becerra	2/17/2005	Referred to the Financial Institutions and Consumer Credit Subcommittee
	S 832	Bingaman	4/18/2005	Referred to the Finance Committee
Legislative Activity 108th Congress	S 1321	Santorum	6/28/2005	9/15/2006-Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title. With written report No. 109-336 9/15/2006-Placed on Senate Legislative Calendar under General Orders; Calendar No. 614
	S 685	Bingaman	3/21/2003	Referred to the Finance Committee
	S 882	Baucus	4/10/2003	5/19/2004-S 882 was incorporated into HR 1528 as an amendment and HR 1528 passed in lieu of S 882
HR 3983	Becerra	3/17/2004	Referred to the Ways & Means Committee	
<b>Taxpayer Bill of Rights</b>				
National Taxpayer Advocate 2007 Annual Report to Congress 481-482, 486-489.	Enact a Taxpayer Bill of Rights setting forth the fundamental rights and obligations of U.S. taxpayers.			
Legislative Activity 110th Congress	<b>Bill Number</b>	<b>Sponsor</b>	<b>Date</b>	<b>Status</b>
	HR 5716	Becerra	4/8/2008	Referred to the Ways & Means Committee
<b>Small Business Issues</b>				
<b>Health Insurance Deduction/Self-Employed Individuals</b>				
National Taxpayer Advocate 2001 Annual Report to Congress 223; National Taxpayer Advocate 2004 Annual Report to Congress 388-389.	Allow self-employed taxpayers to deduct the costs of health insurance premiums for purposes of self-employment taxes.			
Legislative Activity 110th Congress	<b>Bill Number</b>	<b>Sponsor</b>	<b>Date</b>	<b>Status</b>
	S 2239	Bingaman	10/25/2007	Referred to the Finance Committee
Legislative Activity 109th Congress	S 663	Bingaman	3/17/2005	Referred to the Finance Committee
	S 3857	Smith	9/16/2006	Referred to the Finance Committee
Legislative Activity 108th Congress	HR 741	Sanchez	2/12/2003	Referred to the Ways & Means Committee
	HR 1873	Manzullo Velazquez	4/30/2003	Referred to the Ways & Means Committee
Legislative Activity 107th Congress	S 2130	Bingaman	4/15/2002	Referred to the Finance Committee

## National Taxpayer Advocate Legislative Recommendations with Congressional Action

<b>Married Couples as Business Co-owners</b> National Taxpayer Advocate 2002 Annual Report to Congress 172-184.	Amend IRC § 761(a) to allow a married couple operating a business as co-owners to elect out of subchapter K of the IRC and file one Schedule C (or Schedule F in the case of a farming business) and two Schedules SE if certain conditions apply.			
Legislative Activity 110th Congress	<b>Pub.L. No. 110-28, Title VIII, § 8215, 121 Stat. 193, 194 (2007).</b>			
	<b>Bill Number</b>	<b>Sponsor</b>	<b>Date</b>	<b>Status</b>
Legislative Activity 109th Congress	HR 3629	Doggett	7/29/2005	Referred to the Ways & Means Committee
	HR 3841	Manzullo	9/2/2005	Referred to the Ways & Means Committee
Legislative Activity 108th Congress	HR 1528	Portman	6/20/2003	5/19/2004–Passed/agreed to in Senate, w/ an amendment
	S 842	Kerry	4/9/2003	Referred to the Finance Committee
	HR 1640	Udall	4/3/2003	Referred to the Ways & Means Committee
	HR 1558	Doggett	4/2/2003	Referred to the Ways & Means Committee
<b>Income Averaging for Commercial Fishermen</b> National Taxpayer Advocate 2001 Annual Report to Congress 226.	Amend IRC § 1301(a) to provide commercial fishermen the benefit of income averaging currently available to farmers.			
Legislative Activity 108th Congress	<b>Pub. L. No. 108-357, § 314, 118 Stat. 1468, 1469 (2004).</b>			
<b>Election to be treated as an S Corporation</b> National Taxpayer Advocate 2004 Annual Report to Congress 390-393.	Amend IRC § 1362(a) to allow a small business corporation to elect to be treated as an S corporation no later than the date it timely files (including extensions) its first Form 1120S, U.S. Income Tax Return for an S Corporation.			
	<b>Bill Number</b>	<b>Sponsor</b>	<b>Date</b>	<b>Status</b>
Legislative Activity 109th Congress	HR 3629	Doggett	7/29/2005	Referred to the Ways & Means Committee
	HR 3841	Manzullo	9/2/2005	Referred to the Ways & Means Committee
<b>Regulation of Payroll Tax Deposits Agents</b> National Taxpayer Advocate 2004 Annual Report to Congress 394-399.	Require payroll services to meet certain qualifications to protect businesses that use payroll service providers from tax deposit fund misappropriation or fraud.			
	<b>Bill Number</b>	<b>Sponsor</b>	<b>Date</b>	<b>Status</b>
Legislative Activity 110th Congress	S 1773	Snowe	7/12/2007	Referred to the Finance Committee
Legislative Activity 109th Congress	S 3583	Snowe	6/27/2006	Referred to the Finance Committee
	S 1321	Santorum	6/28/2005	9/15/2006–Committee on Finance. Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title; with written report No. 109-336 9/15/2006–Placed on Senate Legislative Calendar under General Orders; Calendar No. 614

National Taxpayer Advocate Legislative Recommendations with Congressional Action

Tax Gap Provisions					
<b>Reporting on Customer's Basis in Security Transaction</b>					
National Taxpayer Advocate 2005 Annual Report to Congress 433-441.		Require brokers to keep track of an investor's basis, transfer basis information to a successor broker if the investor transfers the stock or mutual fund holding, and report basis information to the taxpayer and the IRS (along with the proceeds generated by a sale) on Form 1099-B.			
Legislative Activity 110th Congress		<b>Pub. L. No. 110-343, § 403, 121 Stat. 3854, 3855 (2008).</b>			
	<b>Bill Number</b>	<b>Sponsor</b>	<b>Date</b>	<b>Status</b>	
	HR 878	Emanuel	2/7/2007	Referred to the Ways & Means Committee	
	S 601	Bayh	2/14/2007	Referred to the Finance Committee	
	S 1111	Wyden	4/16/2007	Referred to the Finance Committee	
	HR 2147	Emanuel	5/3/2007	Referred to the Ways & Means Committee	
	HR 3996 PCS	Rangel	10/30/2007	11/14/2007-Placed on Senate Calendar; became Pub. L. No. 110-166 (2007) without this provision	
Legislative Activity 109th Congress		S 2414	Bayh	3/14/2006	Referred to the Finance Committee
	HR 5176	Emanuel	4/25/2006	Referred to the Ways & Means Committee	
	HR 5367	Emanuel	5/11/2006	Referred to the Ways & Means Committee	
<b>IRS Promote Estimated Tax Payments Through the Electronic Federal Tax Payment System (EFTPS)</b>					
National Taxpayer Advocate 2005 Annual Report to Congress 381-396.		Amend IRC § 6302(h) to require the IRS to promote estimated tax payments through EFTPS and establish a goal of collecting at least 75 percent of all estimated tax payment dollars through EFTPS by fiscal year 2012.			
Legislative Activity 109th Congress		<b>Bill Number</b>	<b>Sponsor</b>	<b>Date</b>	<b>Status</b>
	S 1321RS	Santorum	6/28/2005	9/15/2006-Committee on Finance. Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title; with written report No. 109-336 9/15/2006-Placed on Senate Legislative Calendar under General Orders; Calendar No. 614	
<b>Study of Use of Voluntary Withholding Agreements</b>					
National Taxpayer Advocate 2004 Annual Report to Congress 478-489; National Taxpayer Advocate 2005 Annual Report to Congress 381-396.		Amend IRC § 3402(p)(3) to specifically authorize voluntary withholdings agreements between independent contractors and service-recipients as defined in IRC § 6041A(a)(1).			
Legislative Activity 109th Congress		<b>Bill Number</b>	<b>Sponsor</b>	<b>Date</b>	<b>Status</b>
	S 1321RS	Santorum	6/28/2005	9/15/2006-Committee on Finance. Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title; with written report No. 109-336. 9/15/2006-Placed on Senate Legislative Calendar under General Orders; Calendar No. 614	
Joint and Several Liability					
<b>Tax Court Review of Request for Equitable Innocent Spouse Relief</b>					
National Taxpayer Advocate 2001 Annual Report to Congress 128-165.		Amend IRC § 6015(e) to clarify that taxpayers have the right to petition the Tax Court to challenge determinations in cases seeking relief under IRC § 6015(f) alone.			
Legislative Activity 109th Congress		<b>Pub. L. No. 109-432, § 408, 120 Stat. 3061, 3062 (2006).</b>			

Legislative Recommendations

## National Taxpayer Advocate Legislative Recommendations with Congressional Action

Collection Issues				
<b>Return of Levy or Sale Proceeds</b>				
National Taxpayer Advocate 2001 Annual Report to Congress 202-214.	Amend IRC § 6343(b) to extend the period of time within which a third party 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. This amendment would also extend the period of time available to taxpayers under IRC § 6343(d) within which to request a return of levied funds or sale proceeds.			
	<b>Bill Number</b>	<b>Sponsor</b>	<b>Date</b>	<b>Status</b>
Legislative Activity 110th Congress	HR 5719	Rangel	4/16/2008	Referred to the Finance Committee
	HR 1677	Rangel	3/26/2007	Referred to the Finance Committee
Legislative Activity 109th Congress	S 1321 RS	Santorum	6/28/2005	9/15/2006-Committee on Finance. Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title. With written report No. 109-336 9/15/2006-Placed on Senate Legislative Calendar under General Orders. Calendar No. 614
Legislative Activity 108th Congress	HR 1528	Portman	6/20/2003	5/19/2004-Passed/agreed to in Senate, w/ an amendment
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee
Legislative Activity 107th Congress	HR 3991	Houghton	3/19/2002	Defeated in House
	HR 586	Lewis	2/13/2001	4/18/02-Passed the House w/ an amendment-referred to Senate
<b>Reinstatement of Retirement Accounts</b>				
National Taxpayer Advocate 2001 Annual Report to Congress 202-214.	Amend the following IRC sections to allow contributions to individual retirement accounts and other qualified plans from the funds returned to the taxpayer or to third parties under IRC § 6343: <ul style="list-style-type: none"> <li>◆ § 401 - Qualified Pension, Profit Sharing, Keogh, and Stock Bonus Plans</li> <li>◆ § 408 - Individual Retirement Account, and SEP-Individual Retirement Account</li> <li>◆ § 408A - Roth Individual Retirement Account</li> </ul>			
	<b>Bill Number</b>	<b>Sponsor</b>	<b>Date</b>	<b>Status</b>
Legislative Activity 110th Congress	HR 5719	Rangel	4/16/2008	Referred to the Finance Committee
	HR 1677	Rangel	3/26/2007	Referred to the Finance Committee
Legislative Activity 109th Congress	S 1321RS	Santorum	6/28/2005	9/15/2006-Committee on Finance. Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title. With written report No. 109-336 9/15/2006-Placed on Senate Legislative Calendar under General Orders. Calendar No. 614
Legislative Activity 108th Congress	HR 1528	Portman	6/20/2003	5/19/2004-Passed/agreed to in Senate, w/ an amendment
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee
	S 882	Baucus	4/10/2003	5/19/2004-S 882 was incorporated in H.R. 1528 an amendment and HR 1528 passed in lieu of S 882
Legislative Activity 107th Congress	HR 586	Lewis	2/13/2001	4/18/2002-Passed the House w/ an amendment-referred to Senate
	HR 3991	Houghton	3/19/2002	Defeated in House
<b>Consolidation of Appeals of Collection Due Process (CDP) Determinations</b>				
National Taxpayer Advocate 2004 Annual Report to Congress 451-470.	Consolidate judicial review of CDP hearings in the United States Tax Court, clarify the role and scope of Tax Court oversight of Appeals' continuing jurisdiction over CDP cases, and address the Tax Court's standard of review for the underlying liability in CDP cases.			

## National Taxpayer Advocate Legislative Recommendations with Congressional Action

Legislative Activity 109th Congress	<b>Pub. L. No. 109-280, § 855, 120 Stat. 1019 (2006).</b>			
<b>Partial Payment Installment Agreements</b>				
National Taxpayer Advocate 2001 Annual Report to Congress 210-214.	Amend IRC § 6159 to allow the IRS to enter into installment agreements that do not provide for full payment of the tax liability over the statutory limitations period for collection of tax where it appears to be in the best interests of the taxpayer and the Service.			
Legislative Activity 108th Congress	<b>Pub. L. No. 108-357, § 833, 118 Stat. 1589-1592 (2004).</b>			
<b>Penalties and Interest</b>				
<b>Interest Rate and Failure to Pay Penalty</b>				
National Taxpayer Advocate 2001 Annual Report to Congress 179-182.	Repeal the failure to pay penalty provisions of IRC § 6651 while revising IRC § 6621 to allow for a higher underpayment interest rate.			
Legislative Activity 108th Congress	<b>Bill Number</b>	<b>Sponsor</b>	<b>Date</b>	<b>Status</b>
	HR 1528	Portman	6/20/2003	5/19/2004—Passed/agreed to in Senate, w/ an amendment
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee
<b>Interest Abatement on Erroneous Refunds</b>				
National Taxpayer Advocate 2001 Annual Report to Congress 183-187.	Amend IRC § 6404(e)(2) to require the Secretary to abate the assessment of all interest on any erroneous refund under IRC § 6602 until the date the demand for repayment is made, unless the taxpayer (or a related party) has in any way caused such an erroneous refund. Further, the Secretary should have discretion not to abate any or all such interest where the Secretary can establish that the taxpayer had notice of the erroneous refund before the date of demand and the taxpayer did not attempt to resolve the issue with the IRS within 30 days of such notice.			
Legislative Activity 109th Congress	<b>Bill Number</b>	<b>Sponsor</b>	<b>Date</b>	<b>Status</b>
	HR 726	Sanchez	2/9/2005	Referred to the Ways & Means Committee
Legislative Activity 108th Congress	HR 1528	Portman	6/20/2003	5/19/2004—Passed/agreed to in Senate, w/ an amendment
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee
<b>First Time Penalty Waiver</b>				
National Taxpayer Advocate 2001 Annual Report to Congress 188-192.	Authorize the IRS to provide penalty relief for first-time filers and taxpayers with excellent compliance histories who make reasonable attempts to comply with the tax rules.			
Legislative Activity 108th Congress	<b>Bill Number</b>	<b>Sponsor</b>	<b>Date</b>	<b>Status</b>
	HR 1528	Portman	6/20/2003	5/19/2004—Passed/agreed to in Senate, w/ an amendment
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee
Legislative Activity 107th Congress	HR 3991	Houghton	3/19/2002	Defeated in House
<b>Federal Tax Deposit (FTD) Avoidance Penalty</b>				
National Taxpayer Advocate 2001 Annual Report to Congress 222.	Reduce the maximum FTD penalty rate from ten to two percent for taxpayers who make deposits on time but not in the manner prescribed in the IRC.			
Legislative Activity 109th Congress	<b>Bill Number</b>	<b>Sponsor</b>	<b>Date</b>	<b>Status</b>
	HR 3629	Doggett	7/29/2005	Referred to the Ways & Means Committee
	HR 3841	Manzullo	9/2//2005	Referred to the Ways & Means Committee
	S 1321RS	Santorum	6/28/2005	9/15/2006—Committee on Finance. Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title; with written report No. 109-336 9/15/2006—Placed on Senate Legislative Calendar under General Orders; Calendar No. 614

## National Taxpayer Advocate Legislative Recommendations with Congressional Action

	Bill Number	Sponsor	Date	Status
Legislative Activity 108th Congress	HR 1528	Portman	6/20/2003	5/19/2004–Passed/agreed to in Senate, w/ an amendment
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee
Legislative Activity 107th Congress	HR 586	Lewis	2/13/2001	4/18/2002–Passed the House w/ an amendment–referred to Senate
	HR 3991	Houghton	3/19/2002	Defeated in House
<b>Family Issues</b>				
<b>Uniform Definition of a Qualifying Child</b>				
National Taxpayer Advocate 2001 Annual Report to Congress 78-100.	Create a uniform definition of “qualifying child” applicable to tax provisions relating to children and family status.			
Legislative Activity 108th Congress	<b>Pub. L. No. 108-311, § 201, 118 Stat. 1169-1175 (2004).</b>			
<b>Means Tested Public Assistance Benefits</b>				
National Taxpayer Advocate 2001 Annual Report to Congress 76-127.	Amend the IRC §§ 152, 2(b), and 7703(b) to provide that means-tested public benefits are excluded from the computation of support in determining whether a taxpayer is entitled to claim the dependency exemption and from the cost of maintenance test for the purpose of head-of-household filing status or “not married” status.			
	Bill Number	Sponsor	Date	Status
Legislative Activity 108th Congress	HR 22	Houghton	1/3/2003	Referred to the Ways & Means Committee
<b>Credits for the Elderly or the Permanently Disabled</b>				
National Taxpayer Advocate 2001 Annual Report to Congress 218-219.	Amending IRC § 22 to adjust the income threshold amount for past inflation and provide for future indexing for inflation.			
	Bill Number	Sponsor	Date	Status
Legislative Activity 107th Congress	S 2131	Bingaman	4/15/2002	Referred to the Finance Committee
<b>Electronic Filing Issues</b>				
<b>Direct Filing Portal</b>				
National Taxpayer Advocate 2004 Annual Report to Congress 471-477.	Amend IRC § 6011(f) to require the IRS to post fill-in forms on its website and make electronic filing free to all individual taxpayers.			
	Bill Number	Sponsor	Date	Status
Legislative Activity 109th Congress	S 1321RS	Santorum	6/28/2005	9/15/2006–Referred to Committee on Finance; Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title; with written report No. 109-336 9/15/2006–Placed on Senate Legislative Calendar under General Orders; Calendar No. 614
<b>Free Electronic Filing For All Taxpayers</b>				
National Taxpayer Advocate 2004 Annual Report to Congress 471-477.	Revise IRC § 6011(f) to provide that the Secretary shall make electronic return preparation and electronic filing available without charge to all individual taxpayers.			
	Bill Number	Sponsor	Date	Status
Legislative Activity 110th Congress	S 2861	Schumer	4/15/2008	Referred to the Finance Committee

## National Taxpayer Advocate Legislative Recommendations with Congressional Action

Office of the National Taxpayer Advocate				
<b>Confidentiality of Taxpayer Communications</b>				
National Taxpayer Advocate 2002 Annual Report to Congress 198-215.		Strengthen the independence of the National Taxpayer Advocate and the Office of the Taxpayer Advocate by amending IRC §§ 7803(c)(3) and 7811. Amend IRC § 7803(c)(4)(A)(iv) to clarify that, notwithstanding any other provision of the IRC, Local Taxpayer Advocates have the discretion to withhold from the IRS the fact that a taxpayer contacted the TAS or any information provided by a taxpayer to TAS.		
Legislative Activity 108th Congress	<b>Bill Number</b>	<b>Sponsor</b>	<b>Date</b>	<b>Status</b>
	HR 1528	Portman	6/20/2003	5/19/2004–Passed/agreed to in Senate, w/ an amendment
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee
<b>Access to Independent Legal Counsel</b>				
National Taxpayer Advocate 2002 Annual Report to Congress 198-215.		Amend IRC § 7803(c)(3) to provide for the position of Counsel to the National Taxpayer Advocate, who shall advise the National Taxpayer Advocate on matters pertaining to taxpayer rights, tax administration, and the Office of Taxpayer Advocate, including commenting on rules, regulations, and significant procedures, and the preparation of amicus briefs.		
Legislative Activity 108th Congress	<b>Bill Number</b>	<b>Sponsor</b>	<b>Date</b>	<b>Status</b>
	HR 1528	Portman	6/20/2003	Referred to the Senate
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee
<b>Other Issues</b>				
<b>Disclosure Regarding Suicide Threats</b>				
National Taxpayer Advocate 2001 Annual Report to Congress 227.		Amend IRC § 6103(i)(3)(B) to allow the IRS to contact and provide necessary return information to specified local law enforcement agencies and local suicide prevention authorities, in addition to federal and state law enforcement agencies in situations involving danger of death or physical injury.		
Legislative Activity 108th Congress	<b>Bill Number</b>	<b>Sponsor</b>	<b>Date</b>	<b>Status</b>
	HR 1528	Portman	6/20/2003	5/19/2004–Passed/agreed to in Senate, w/ an amendment
	S 882	Baucus	4/10/2003	5/19/2004–S 882 was incorporated in HR 1528 an amendment and HR 1528 passed in lieu of S 882
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee
<b>Attorney Fees</b>				
National Taxpayer Advocate 2002 Annual Report to Congress 161-171.		Allow successful plaintiffs in nonphysical personal injury cases who must include legal fees in gross income to deduct the fees “above the line.” Thus, the net tax effect would not vary depending on the state in which a plaintiff resides.		
Legislative Activity 108th Congress		<b>Pub. L. No. 108-357, § 703, 118 Stat. 1546-1548 (2004).</b>		
<b>Attainment of Age Definition</b>				
National Taxpayer Advocate 2003 Annual Report to Congress 308-311.		Amend IRC § 7701 by adding a new subsection as follows: “Attainment of Age. An individual attains the next age on the anniversary of his date of birth.”		
Legislative Activity 108th Congress	<b>Bill Number</b>	<b>Sponsor</b>	<b>Date</b>	<b>Status</b>
	HR 4841	Burns	7/15/2004	7/21/2004–Passed House; 7/22/2004–Received in the Senate
<b>Home-Based Service Workers (HBSW)</b>				
National Taxpayer Advocate 2001 Annual Report to Congress 193-201.		Amend IRC § 3121(d) to clarify that HBSWs are employees rather than independent contractors.		
Legislative Activity 110th Congress	<b>Bill Number</b>	<b>Sponsor</b>	<b>Date</b>	<b>Status</b>
	HR 5719	Rangel	4/16/2008	Referred to the Finance Committee
Legislative Activity 107th Congress	S 2129	Bingaman	4/15/2002	Referred to the Finance Committee

LR  
#1**Repeal the Alternative Minimum Tax for Individuals****Problem****The AMT Imposes Undue Burden on Taxpayers**

The individual alternative minimum tax (AMT) is a parallel and complex tax structure that is imposed on top of the regular tax structure.<sup>1</sup> The AMT concept, originally enacted in response to a report that 155 high-income taxpayers had paid no tax for the 1966 tax year,<sup>2</sup> now effectively requires taxpayers to compute their taxes twice – once under the regular rules and again under the AMT regime. The taxpayer is then generally required to pay the higher of the two amounts.<sup>3</sup>

Few people think of having children or living in a high-tax state as a tax avoidance maneuver, but under the unique logic of the AMT, that is essentially how these actions are treated. While the AMT was originally conceived to prevent wealthy taxpayers from escaping tax liability through the use of tax-avoidance transactions, most of the significant tax loopholes that enabled taxpayers to escape tax at the time the AMT was written have long since been closed. For tax year 2006, it is estimated that 77 percent of the additional income subject to tax under the AMT was attributable not to any such loopholes, but simply to family size or residing in a high-tax state.<sup>4</sup>

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

<sup>1</sup> The National Taxpayer Advocate has repeatedly identified the AMT as a serious problem for taxpayers and has recommended its repeal in prior reports and congressional testimony. See National Taxpayer Advocate 2006 Annual Report to Congress 3-5 (Most Serious Problem: *Alternative Minimum Tax for Individuals*); National Taxpayer Advocate 2004 Annual Report to Congress 383-85 (Legislative Recommendation: *Alternative Minimum Tax*); National Taxpayer Advocate 2003 Annual Report to Congress 5-19 (Most Serious Problem: *Alternative Minimum Tax for Individuals*); National Taxpayer Advocate 2001 Annual Report to Congress 166-77 (Legislative Recommendation: *Alternative Minimum Tax for Individuals*); see also *Alternative Minimum Tax: Hearing Before the Subcomm. On Select Revenue Measures of the House Comm. On Ways & Means* (Mar. 7, 2007) (statement of Nina E. Olson, National Taxpayer Advocate); *Blowing the Cover on the Stealth Tax: Exposing the Individual AMT: Hearing Before the Subcomm. On Taxation and IRS Oversight of the Senate Comm. On Finance* (May 23, 2005) (statement of Nina E. Olson, National Taxpayer Advocate).

<sup>2</sup> 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 forerunner of the AMT was an “add-on” minimum tax enacted in 1969.

<sup>3</sup> The AMT rules are contained in IRC §§ 55-59.

<sup>4</sup> See Tax Policy Center, *Tax Facts: AMT Preference Items 2002, 2004-2006* (citing unpublished tabulations from the Office of Tax Analysis, Department of the Treasury), available at [http://www.taxpolicycenter.org/taxfacts/Content/PDF/amt\\_preference.pdf](http://www.taxpolicycenter.org/taxfacts/Content/PDF/amt_preference.pdf).

Yet government has become so dependent on AMT revenue that Congress to date has been unwilling to make permanent changes in law to curtail the AMT. It is estimated that the cost of repealing the AMT outright over the 2008-2018 period would be \$966 billion if the tax cuts enacted under President Bush are extended and \$1.944 trillion if the tax cuts enacted under President Bush are allowed to expire.<sup>5</sup> Another perspective: One projection shows that by 2009 it would cost more to repeal the AMT than it would cost to repeal the regular tax system and leave the AMT in place.<sup>6</sup>

The AMT is ensnaring an increasing 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 \$177,000 today.<sup>7</sup> Instead, the exemption amount, after a temporary increase that will expire after 2008, is \$45,000 for married taxpayers and \$33,750 for most other taxpayers.<sup>8</sup> As a result, it is now projected that in 2010, just one year from now, 33 million individual taxpayers – or 35 percent of individual filers who pay income tax – will be subject to the AMT.<sup>9</sup> Among the categories of taxpayers hardest hit, 87 percent of married couples with adjusted gross incomes (AGI) between \$75,000 and \$100,000 with two or more children will owe AMT.<sup>10</sup> Significantly, a congressional decision to reduce tax rates by itself will do nothing to assist taxpayers with AMT liabilities, because any tax reduction provided under the regular tax rules will be offset by a corresponding increase in tax liability under the AMT regime.

The burden that the AMT imposes is substantial. In dollar terms, it is estimated that the average AMT taxpayer will owe an *additional* \$7,600 in tax in 2008.<sup>11</sup> In terms of complexity and time, taxpayers often must complete a 14-line worksheet,<sup>12</sup> read 12 pages of

<sup>5</sup> See Tax Policy Center, *Aggregate AMT Projections, 2008-2018*, Table T08-0248 (Nov. 4, 2008), available at <http://www.taxpolicycenter.org/numbers/Content/PDF/T08-0248.pdf>.

<sup>6</sup> *Id.*

<sup>7</sup> Department of Labor, Bureau of Labor Statistics, *Consumer Price Index – All Urban Consumers (CPI-U)* (Dec. 12, 2008). 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 sextupled since 1966, so the kinds of taxpayers who caught Congress’ attention at that time would be making over \$1.3 million today. See Department of Labor, Bureau of Labor Statistics, *Consumer Price Index – All Urban Consumers (CPI-U)* (Dec. 12, 2008). Yet the AMT today is not primarily affecting taxpayers with incomes over \$1.3 million. By 2010, it has been estimated that 80 percent of all taxpayers affected by the AMT will have incomes under \$200,000 – and 31 percent will have incomes under \$100,000. See Tax Policy Center, *Distribution of AMT and Regular Income Tax by Cash Income, Current Law*, Table T08-0252 (Nov. 4, 2008), available at <http://www.taxpolicycenter.org/numbers/Content/PDF/T08-0252.pdf>.

<sup>8</sup> IRC § 55(d).

<sup>9</sup> Tax Policy Center, *Aggregate AMT Projections, 2008-2018*, Table T08-0248 (Nov. 4, 2008), available at <http://www.taxpolicycenter.org/numbers/Content/PDF/T08-0248.pdf>. This projection is based on current law. Most observers believe that Congress, at a minimum, will pass another “patch” that limits the growth in the AMT by increasing the AMT exemption amounts.

<sup>10</sup> *Id.*

<sup>11</sup> *Id.*

<sup>12</sup> IRS Form 1040 Instructions, at 39 (2008).

instructions,<sup>13</sup> and complete a 55-line form<sup>14</sup> simply to determine whether they are subject to the AMT. Thus, it is hardly surprising that 77 percent of AMT taxpayers hire practitioners to prepare their returns.<sup>15</sup>

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 subjects these taxpayers to penalties.

Thus, while the concept of a minimum tax is not unreasonable, the AMT as currently structured has evolved into something that was never intended: The AMT hits taxpayers it was never intended to hit because its exemption amount has not been indexed for inflation; it primarily penalizes taxpayers for such nontax-driven behavior as having children or choosing to live in a state that happens to impose high taxes; it takes large numbers of taxpayers by surprise – and subjects them to penalties to boot; it imposes onerous compliance burdens; it alters the distribution of the tax burden that exists under the regular tax system; it changes the tax incentives built into that system; and it neutralizes the effects of changes to tax rates imposed under the regular tax rules.

### How the AMT Is Computed

After a taxpayer computes his tax liability under the regular tax rules, he must re-compute it under the AMT rules. The taxpayer generally pays the higher of the tax computed under the regular tax rules and the tax computed under the AMT rules.

More specifically, a taxpayer must take the following eight steps to determine his AMT liability, if any:

- 1. The taxpayer must calculate his regular tax liability.** The regular income tax rules provide preferred treatment for certain types of income and allow taxpayers to claim certain exemptions, deductions, exclusions, and credits.
- 2. The taxpayer must determine whether he is subject to additional tax under the AMT regime.** The IRS provides a 14-line worksheet (*Worksheet To See if You Should Fill in Form 6251 – Line 45*)<sup>16</sup> to help taxpayers determine whether they may be subject to the AMT. If the worksheet indicates that a taxpayer is potentially subject to the AMT, the taxpayer must complete Form 6251, *Alternative Minimum Tax – Individuals*, which

<sup>13</sup> IRS Form 6251 Instructions (2008).

<sup>14</sup> IRS Form 6251, *Alternative Minimum Tax – Individuals* (2008).

<sup>15</sup> IRS Compliance Data Warehouse, Individual Returns Transaction File (Tax Year 2006).

<sup>16</sup> IRS Form 1040 Instructions, at 39 (2008).

contains 55 lines. Many taxpayers are required to complete Form 6251 – only to find that they do not have an AMT liability.

3. **The taxpayer must compute his alternative minimum taxable income (AMTI) on Form 6251.** This computation generally requires the taxpayer to give up the benefit of tax preference items to which he is entitled under the regular tax rules (*e.g.*, personal exemptions, the standard deduction and itemized deductions for state and local taxes, employee business expenses, and legal fees).<sup>17</sup>
4. **The taxpayer must determine an “exemption amount” to which he is entitled based on filing status.** In 2008, the AMT exemption amounts were \$69,950 for married taxpayers filing jointly and \$46,200 for singles.<sup>18</sup> The exemption amounts are phased out for married taxpayers with AMTI exceeding \$150,000 and non-married taxpayers with AMTI exceeding \$112,500.<sup>19</sup>
5. **The taxpayer must compute his “taxable excess.”** The taxable excess is computed by subtracting the exemption amount from AMTI.
6. **A taxpayer with a positive taxable excess must compute his “tentative minimum tax.”** A taxable excess of \$175,000 or less is taxed at a flat 26 percent rate, and any additional taxable excess is taxed at a flat 28 percent rate (excluding the effects of the phase-out described in step 4 above). The sum of the two amounts, minus the AMT foreign tax credit, is the tentative minimum tax.<sup>20</sup>
7. **The taxpayer must compute his “alternative minimum tax” or “AMT.”** The AMT is equal to the excess of the taxpayer’s tentative minimum tax, if any, over his regular tax liability (reduced by any tax from Form 4972, *Tax on Lump Sum Distributions*, and any foreign tax credit from Form 1040). If the net result is a negative number or zero, the taxpayer does not owe AMT.
8. **If the taxpayer owes AMT, he computes his total tax liability by adding his regular tax liability and his AMT liability.**<sup>21</sup>

<sup>17</sup> Required adjustments listed on Form 6251 include adjustments for medical and dental expenses, state and local taxes, certain non-allowable home mortgage interest, miscellaneous itemized deductions, tax refunds, investment interest, depletion, certain net operating losses, interest from specified private activity bonds, qualified small business stock, the exercise of incentive stock options, estates and trusts, electing large partnerships, property dispositions, depreciation on certain assets, passive activities, loss limitations, circulation costs, long-term contracts, mining costs, research and experimental costs, income from pre-1987 installment sales, intangible drilling costs, certain other adjustments and alternative tax net operating loss deductions. See IRC §§ 56 and 57; IRS Form 6251, *Alternative Minimum Tax – Individuals*, Part I.

<sup>18</sup> IRC § 55(d). In the absence of an AMT “patch” for 2009, the exemption amounts will revert to their 1993 levels – \$45,000 for married taxpayers filing jointly and \$33,750 for singles. *Id.* Where married taxpayers file separate returns, the exemption amount for each spouse is 50 percent of the exemption amount allowed for married taxpayers filing joint returns (*i.e.*, \$22,500 per spouse under permanent law and \$34,975 per spouse under the AMT patch in effect for 2008).

<sup>19</sup> IRC § 55(d)(3). Although the maximum stated AMT tax rate is 28 percent, a taxpayer’s marginal AMT tax rate may reach 35 percent due to the phase-out of the AMT exemption amount. For a detailed discussion of the tax administration concerns that phase-outs raise, see Legislative Recommendation: *Eliminate (or Simplify) Phase-Outs*, *infra*.

<sup>20</sup> IRC § 55(b)(1)(A). The AMT rate threshold is not indexed for inflation.

<sup>21</sup> In many cases, the taxpayer’s final tax liability is the greater of his regular tax liability or his tentative minimum tax liability. But because the Code requires adjustments for credits and other taxes, steps 7 and 8 are required to ensure that taxpayers with these tax items obtain the correct result.

Then the taxpayer applies any applicable tax credits. Except for years in which Congress has enacted an AMT “patch,” often retroactively, a taxpayer can use nonrefundable tax credits to offset regular tax liability, but not to offset the AMT.<sup>22</sup>

A taxpayer’s AMT liability may generate an AMT credit that generally can be used in future years to offset his regular tax liability if, and to the extent that, his regular tax liability exceeds his tentative minimum tax.<sup>23</sup> However, a taxpayer who owes AMT generates an AMT credit only to the extent that the AMT is attributable to “deferral” items and not to “exclusion” items.<sup>24</sup> Deferral items are tax benefits that are allowed under both the regular and AMT systems but are accounted for in different tax years under the two systems. For example, both the regular and AMT rules allow deductions for depreciation, but the AMT in some instances requires taxpayers to depreciate property over a longer period of time. By contrast, exclusion items are tax benefits allowed under the regular tax system but permanently disallowed under the AMT (*e.g.*, the standard deduction, personal exemptions, and certain itemized deductions). Thus, many individual taxpayers who pay AMT do not receive AMT credits.

## Examples

### Example 1: AMT Penalty for Having Children

Mr. and Mrs. Brady live in California in a rented home with their six children, ages 5-16. They filed a joint return and claimed the \$10,700 standard deduction in 2007. Mr. Brady, an architect, made \$73,160. Mrs. Brady worked part-time as a teacher and earned \$28,000. The Bradys owed \$2,709 in taxes under the regular tax system, but their tax bill rose to \$3,077 with the AMT because the tax benefits of the personal exemptions for their children were phased out under the AMT.

### Example 2: AMT Marriage Penalty

Assume the same facts as in the prior example except that Mr. and Mrs. Brady did not marry. If each used the “Head of Household” filing status and claimed three of the children, the AMT would not have applied to either of them and their combined tax bill would have been lower. Mrs. Brady would have paid no tax and received \$4,397 in refundable credits (*i.e.*, a \$2,055 earned income tax credit and a \$2,342 child tax credit (CTC)), and Mr. Brady would have paid tax of \$5,106. Their combined tax liability would have been \$709 (*i.e.*, \$5,106 minus \$4,397) – or \$2,368 less than if they were married. Part of the difference in

<sup>22</sup> Nonrefundable business credits such as the alternative motor vehicle credit or the alternative fuel vehicle refueling credit are generally not allowed against the AMT. See, *e.g.*, IRC § 30(b)(3); IRC § 30(b)(g)(2)(B). In the absence of an extension of the AMT patch, as noted above, nonrefundable personal credits such as the dependent care credit or the credit for the elderly and disabled also cannot be applied to reduce the AMT. IRC § 26(a).

<sup>23</sup> In general, an AMT credit may be used in the future only when the taxpayer’s regular tax liability, reduced by other nonrefundable credits, exceeds the taxpayer’s tentative minimum tax for the year. IRC § 53. In certain circumstances, however, AMT credits that cannot be used for a substantial period of time may qualify as refundable credits which the taxpayer may use even in years in which he is subject to AMT liability. IRC § 53(e).

<sup>24</sup> IRC § 53(d)(1)(B)(ii).

tax in these two examples is attributable to a “marriage penalty,” but a significant portion is caused by the AMT.

### **Example 3: AMT Penalty for High State and Local Taxes**

A married couple filed a joint return claiming two dependent children for 2007. The taxpayers had an AGI of \$190,000 and paid state income and property taxes totaling \$28,000. In an attempt to comply with the estimated tax payment requirements, the taxpayers had 90 percent of their regular tax liability withheld from their paychecks. When the taxpayers prepared their return, they discovered they had an additional liability of \$4,042 due to the AMT, and because of the additional liability, they also owed a \$184 penalty for failure to pay estimated tax.

### **Example 4: AMT Penalty Due to Combination of Having Children and Using “Married Filing Separately” Filing Status**

A mother of five earned \$57,500 in 2007. She is seeking a legal separation from her husband and lived apart from him during the final months of the year. Thus, she claimed “married filing separately” filing status. Because she was entitled to claim the children as her dependents and to claim the CTC, she had no tax liability under the regular tax rules and therefore had no tax withheld from her paychecks. When she prepared her tax return, however, she discovered that she had a tax liability of \$1,488 due to the AMT. Because of the AMT tax liability, she also owed a penalty of \$68 for failure to pay estimated tax.

## **Recommendation**

The National Taxpayer Advocate recommends that Congress repeal the provisions of the Internal Revenue Code that pertain to the AMT for individuals in the context of fundamental tax reform.<sup>25</sup>

The obvious challenge in repealing the AMT (or even permanently indexing the AMT exemption amounts) is that the AMT’s increasing revenue stream has been built into revenue estimates, so if the AMT is repealed, either Congress will have to raise tax receipts in other ways or budget deficits will balloon. To provide taxpayers with partial short-term relief from the AMT, Congress has enacted a series of “patches” since 2001 that have temporarily increased the AMT exemption amounts to prevent the AMT from affecting a larger number of taxpayers.<sup>26</sup>

<sup>25</sup> 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.

<sup>26</sup> See Economic Growth and Tax Relief Reconciliation Act, Pub. L. No. 107-16, § 701, 115 Stat. 38 (2001); Job Creation and Worker Assistance Act, Pub. L. No. 107-147, § 601, 116 Stat. 21 (2002); Jobs and Growth Tax Relief Reconciliation Act, Pub. L. No. 108-27, § 106(a)(1), 117 Stat. 752 (2003); Working Families Tax Relief Act, Pub. L. No. 108-311, § 103, 118 Stat. 1168 (2004); Tax Increase Prevention and Reconciliation Act, Pub. L. No. 109-222, § 301(a)(1), 120 Stat. 345 (2006); Tax Increase Prevention Act, Pub. L. No. 110-166, § 2, 121 Stat. 2461 (2007); Tax Extenders and Alternative Minimum Tax Relief Act, Pub. L. No. 110-343, § 102, 122 Stat. 3, 765 (2008). For additional discussion of problems associated with temporary tax provisions, see Legislative Recommendation: *Eliminate (or Reduce) Procedural Incentives for Lawmakers to Enact Tax Sunsets*, *infra*.

While short-term relief from the AMT is better than no relief at all, the use of annual patches is not a desirable long-term solution for several reasons. First, patches still leave large numbers of taxpayers potentially exposed to the AMT. Second, the absence of a permanent rule makes it more difficult for taxpayers to estimate their tax liabilities for the year and to save and pay estimated tax accordingly. This uncertainty increases the risk that taxpayers will not save enough to pay their full tax liabilities or will be subject to penalties for failure to pay sufficient estimated tax, thereby causing taxpayer frustration and loss of confidence in the fairness of the tax system. Third, the uncertainty imposes significant burdens on the IRS as the tax administrator. Each year, the IRS must program its computer systems with millions of lines of code to process tax returns. When Congress enacts annual patches, especially if it does so late in the year, the IRS must perform substantial reprogramming. In 2008, the late enactment of an AMT patch at the end of the prior year delayed the start of the filing season for 13.5 million taxpayers (which, in turn, delayed many refunds) and required the IRS to shelve or postpone other priority programming work.<sup>27</sup>

Because AMT revenue projections for future years are made on the basis of current law (*i.e.*, the low permanent AMT exemption amounts), the long-term costs of repealing the AMT outright increase substantially each year. For reasons discussed elsewhere in this report, the National Taxpayer Advocate urges Congress to pass fundamental tax simplification, and she recommends that Congress repeal the AMT in that context.<sup>28</sup>

<sup>27</sup> See IRS Fact Sheet, *Highlights of 2007 Tax Changes: Law Raises AMT Exemption, Filers of Five Forms Must Wait Until Feb. 11*, FS-2008-1 (Jan. 2008). For a detailed discussion of the impact of late-year tax-law changes, see National Taxpayer Advocate 2007 Annual Report to Congress 3-12 (Most Serious Problem: *The Impact of Late-Year Tax-Law Changes on Taxpayers*).

<sup>28</sup> See Most Serious Problem: *The Complexity of the Tax Code*, *supra*.

## Simplify the Family Status Provisions

### Problem

A taxpayer's "family status" is central to the way the taxpayer is taxed in relation to at least six of the most basic provisions in the Internal Revenue Code (IRC):

- Filing status (*i.e.*, single, married filing jointly, married filing separately, and head of household);<sup>1</sup>
- Personal and dependency exemptions;<sup>2</sup>
- Child Tax Credit (CTC);<sup>3</sup>
- Earned Income Tax Credit (EITC);<sup>4</sup>
- Child and Dependent Care Credit (CDCC);<sup>5</sup> and
- Separated spouse rules.<sup>6</sup>

Each of these provisions affects the amount of tax a taxpayer pays or the amount of refund he or she receives. These provisions, directly or indirectly, confer tax benefits on taxpayers if they meet certain eligibility requirements, and at least one of these six provisions impacts every individual income tax return in the United States.

Prior to 2005, each of these provisions defined "child" in a different manner. In 2001, the National Taxpayer Advocate recommended that Congress adopt a uniform definition of a child for purposes of the Code, in order to eliminate some of the confusion and inconsistencies generated by these numerous definitions.<sup>7</sup> Congress adopted a Uniform Definition of a Child (UDOC) in the Working Families Tax Relief Act of 2004, effective for tax years

<sup>1</sup> IRC §§ 1 and 2.

<sup>2</sup> IRC §§ 151 and 152.

<sup>3</sup> IRC § 24.

<sup>4</sup> IRC § 32.

<sup>5</sup> IRC §§ 21 and 129.

<sup>6</sup> IRC § 7703.

<sup>7</sup> National Taxpayer Advocate 2001 Annual Report to Congress 82-100. UDOC was supported by the Bush Administration, the Joint Committee on Taxation, and many tax professional groups (including the American Bar Association, the American Institute of Certified Public Accountants, and Tax Executives Institute). See, e.g., Department of the Treasury, *Proposal for Uniform Definition of a Qualifying Child* (Apr. 2002); Lindy Paull, Chief of Staff, Joint Committee on Taxation, Testimony Before the House Committee on Ways and Means (July 17, 2001); Staff of the Joint Committee on Taxation, *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*, JCS-3-01, vol. II, at 44-66 (Apr. 2001); Tax Executives Institute, *Letter Regarding Recommendations of the AICPA/ABA/TEI Task Force on Tax Simplification* (Sept. 13, 2002); and American Bar Association Section of Taxation, *Letter Regarding Pending Tax Legislation* (June 30, 2004).

beginning after December 31, 2004.<sup>8</sup> The new definitions of “qualifying child” and “qualifying relative” apply to the EITC, CTC, CDCC, dependency exemption, and head of household filing status. For most taxpayers today, determining whether a child qualifies as a “child” for purposes of the Code’s family status provisions involves an inquiry into whether the child has the appropriate relationship to the taxpayer, has the same principal place of abode as the taxpayer for more than half the year, and is the appropriate age.

Notwithstanding the improvements brought about by the enactment of UDOC, the tax code’s family status provisions continue to ensnare taxpayers and make tax administration difficult because of the number of provisions and their structural interaction.<sup>9</sup> Moreover, many of the eligibility requirements – such as support or maintenance costs of the home – are difficult for the IRS to verify without conducting audits into taxpayers’ personal and private lives. And despite the IRS’s best efforts, some of the provisions – especially those involving refundable credits such as the EITC – offer opportunities for some to attempt to defraud the federal government and its taxpayers.

In 2002, the IRS and the Department of the Treasury established a joint task force to identify ways to improve administration of the EITC, including minimizing fraud and inadvertent errors and reducing taxpayer compliance burdens.<sup>10</sup> Among other things, the task force recommended that the IRS explore requiring certain taxpayers to precertify their eligibility for the EITC. As a consequence, the IRS conducted several research studies involving representative samples of the EITC population to test different methods of verifying eligibility and to enhance its understanding of the EITC taxpayer base.<sup>11</sup> As a result of the research conducted for the task force as well as separate EITC certification studies, we learned that the IRS is able to systemically verify the relationship between the taxpayer and child in 80 percent of the tax returns claiming EITC.<sup>12</sup> We have also learned that where the IRS cannot systemically verify the claim, taxpayers may not be opposed to providing documentation in advance of filing.<sup>13</sup> In addition, the IRS has sought out and tested government databases that could enhance its ability to verify a taxpayer’s eligibility systemically, without the need to contact (or audit) the taxpayer.

<sup>8</sup> Pub. L. No. 108-311, § 201, 118 Stat. 1166, 1169 (2004). Congress made further revisions to the uniform definition of a child in Pub. L. No. 109-135, § 404(a), 119 Stat. 2577, 2632 (2005), and Pub. L. No. 110-351, § 501, 122 Stat. 3949, 3979 (2008).

<sup>9</sup> For a discussion of some of these lingering complexities, see National Taxpayer Advocate 2006 Annual Report to Congress 463–69, and American Bar Association Section of Taxation, *Report Regarding the Uniform Definition of Qualifying Child 8-9* (July 24, 2006).

<sup>10</sup> Department of Treasury Press Release, PO-1059, *Treasury, IRS Announce Task Force On Improving The Administration Of The Earned Income Tax Credit*, Feb. 28, 2002.

<sup>11</sup> IRS Earned Income Tax Credit (EITC) Initiative, *Final Report to Congress* (Oct. 2005).

<sup>12</sup> For example, the 2002 joint Treasury-IRS EITC Task Force found that the IRS was able to systemically verify relationships between taxpayer and child in 80 percent of the tax returns claiming EITC. Moreover, the IRS was able to be reasonably confident, based on its own and other studies, that where the child was claimed by the mother or on a married-filing-jointly return, the child actually did reside with the claimant for more than one-half the year. This population accounted for 80 percent of EITC tax returns.

<sup>13</sup> About 72 percent of the test group and about 63 percent of the control group of taxpayers believed that they should show that they meet the EITC requirements before they receive the EITC. IRS, *Earned Income Tax Credit Initiative* (Jan. 2007). IRS Earned Income Tax Credit (EITC) Initiative, *Final Report to Congress* (Oct. 2005).

The easiest and least burdensome provisions – from both the taxpayers’ and the IRS’s perspectives – are those with eligibility requirements that can be validated systemically by reference to a reliable data source. Today, with respect to the family status provisions, the IRS can relatively easily verify:

- The existence and age of the person associated with a Social Security number (SSN);
- The mother and often the father of the person associated with a SSN;
- The consistency of current year return data with prior year returns (including filing status); and
- The earnings and other income of the taxpayer as reported by a third party (including on Form W-2, *Wage and Tax Statement*, and other information returns).

Moreover, by utilizing data from other government agency programs where eligibility is often verified before granting benefits (*e.g.*, Medicaid and food stamps), the IRS can be reasonably confident that where the child was claimed by the mother or on a married-filing-jointly return, the child actually did reside with the claimant for more than half the year. As noted, this population accounts for about 80 percent of EITC tax returns.<sup>14</sup> Thus, the IRS can now systemically verify (or identify a reasonable proxy for) the relationship, age, income, and even residence of a taxpayer’s family unit. The National Taxpayer Advocate recommends that Congress utilize these factors as the building blocks for reform of the Code’s complicated family status provisions.

Between 2004 and 2005, the National Taxpayer Advocate also conducted a review of the approach to taxation of the family unit taken in other countries, including the United Kingdom, Canada, Australia, and New Zealand. This research led the National Taxpayer Advocate to recommend in her 2005 Annual Report to Congress that Congress restructure the Code’s family status provisions to better reflect the living situations of families today, incorporate greater flexibility into their design, and improve horizontal and vertical equity as well as administrability.

We particularly have sought to identify and refine the rationale for so many family status provisions, which introduce enormous complexity for taxpayers – particularly for low income taxpayers who are more likely to have difficulty in understanding and applying these rules – and increase the risk of fraud and the burden on the IRS in administering these multiple provisions. In essence, we concluded that all of these tax benefits, at their core, provide reductions in tax for two purposes. One purpose is to give taxpayers tax relief that reflects the costs of maintaining a household and raising a family (*i.e.*, filing status, dependency exemption, CTC, the portion of the EITC that varies based on the number of qualifying children, and CDCC). The second purpose is to provide tax relief and a subsidy as an incentive for low income individuals to work (*i.e.*, the portion of the EITC that does

<sup>14</sup> Department of Treasury Press Release, PO-1059, *Treasury, IRS Announce Task Force On Improving The Administration Of The Earned Income Tax Credit*, Feb. 28, 2002.

not vary based on the number of qualifying children). In light of this analysis, we have focused on consolidating the numerous existing family status-related provisions into two categories: (1) a Family Credit and (2) a Worker Credit. Revenue estimators could compute the total amount of tax expenditures associated with each of the existing family status provisions and Congress could then reallocate the same dollar amount (or a different dollar amount if it chooses) between the Family Credit and the Worker Credit, as more fully described below.

Since 2005, the National Taxpayer Advocate has continued to study this issue and engage in discussions with U.S. and international tax professionals, economists, academics, and tax administrators. We have revised our 2005 recommendations to reflect some of the concerns raised in these discussions. While the 2004 Uniform Definition of a Child increased consistency, as the example below demonstrates, problems remain. There are still inconsistent tests among the family status provisions, particularly with respect to “qualifying relatives.” Our current proposals build upon UDOC and take one more step toward consistency by eliminating head of household filing status and rolling all family status provisions into one credit, subject to UDOC.

### Example

Taxpayer, an employed adult, provides a home and support for her 12-year-old cousin for the entire year. To claim the child as a “qualifying” child, Taxpayer must show (1) that the child has the requisite relationship to Taxpayer, (2) that the child had the same principal place of abode for more than half of the year, (3) that the child meets the age requirements, and (4) that the child did not provide more than half of his or her own support. Although Taxpayer is the only *individual* providing support for her cousin, Taxpayer receives food stamps and housing assistance from federal and state agencies for the benefit of the child in excess of half of the child’s support. Therefore, although the child meets the relationship, age, and residency requirements, Taxpayer cannot claim the child as a dependent on her tax return, and is ineligible for the Child Tax Credit and the Child and Dependent Care Credit, because the federal benefits received by Taxpayer are deemed to be contributed by the child for his or her own support. Since the amounts of federal and state assistance to the household exceed half of the cost of maintaining the home, Taxpayer also cannot claim head of household filing status. Moreover, Taxpayer has been estranged from her spouse for over ten years, but does not qualify as “not married” under IRC 7703(b) because (1) she cannot claim the child as a dependent and (2) she cannot show that she provides over one-half of the cost of maintaining the household. Thus, Taxpayer must file as “married filing separately” and is ineligible for the EITC.

## Recommendations

The National Taxpayer Advocate makes the following recommendations:

1. Consolidate the numerous family status provisions into two. One provision (the Family Credit) would reflect the costs of maintaining a household and raising a family. It would incorporate all current family status provisions that are based on the specific make-up of the family unit and its corresponding ability to pay taxes. The second provision (which could be called the “Worker Credit” or could continue to be called the EITC) would provide an incentive and subsidy for low income individuals to work.<sup>15</sup>
2. The refundable Family Credit, which would replace the personal and dependency exemptions, Child Tax Credit, Head of Household filing status, and the family-size differential of the EITC, would be available to all taxpayers regardless of income.<sup>16</sup> The Family Credit would consist of two components – one would apply to each taxpayer and a second aspect would be available to any taxpayer who claims a “qualifying child” under IRC § 152(c) or a “qualifying relative” under IRC § 152(d).<sup>17</sup> There would be no cap on the number of qualifying children the taxpayer could claim.
3. Amend IRC § 152(d)(1)(D) so that the term “qualifying relative” means an individual “who is not claimed as a qualifying child of such taxpayer or any other taxpayer for any taxable year in the calendar year in which such taxable year begins.”
4. Amend IRC § 152(f) to provide a definition of “support” that excludes any means-tested federal, state, or local benefits paid on behalf of or for the qualifying child or qualifying relative.<sup>18</sup>

<sup>15</sup> The President’s Advisory Panel on Federal Tax Reform proposed replacing the standard deduction, personal exemptions, CTC, and head of household filing status with a family credit, and replacing the EITC and the refundable Child Tax Credit with a working credit. President’s Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America’s Tax System* (Nov. 2005). See also Adam Carasso, Jeffrey Rohaly & C. Eugene Steuerle, *A Unified Children’s Tax Credit*, National Tax Association Proceedings (May 15, 2005); and Max B. Sawicky, Robert Cherry, & Robert Denk, *The Next Tax Reform: Advancing Benefits for Children*, Economic Policy Institute (2002).

<sup>16</sup> The National Taxpayer Advocate has never seen the logic of denying an affluent or wealthy family the recognition that it takes a certain base amount of funds to raise a child. The recommendation to make the Family Credit a refundable tax credit (instead of an exemption or deduction) available to all taxpayers addresses vertical equity concerns. Moreover, provisions involving phase-outs unnecessarily complicate the Code and reduce transparency, which can increase noncompliance. See Legislative Recommendation, *Eliminate (or Simplify) Phase-outs, infra*; National Taxpayer Advocate 2006 Annual Report to Congress 470-82 (Key Legislative Recommendation, *Eliminate (or Simplify) Phase-outs*). See also Lawrence Zelenak, *Redesigning the Earned Income Tax Credit as a Family-Sized Adjustment to the Minimum Wage*, 57 Tax Law Rev. 301 (Spring 2004). To the extent that Congress believes high income families should pay more tax, it can achieve the same result more simply and transparently by adjusting marginal tax rates.

<sup>17</sup> In the National Taxpayer Advocate’s 2005 proposal, we suggested that the Family Credit be made available to the taxpayer who is the “main caregiver” of the child. The concept of a “main caregiver” was designed to introduce more flexibility into the family status provisions. While based on the current UDOC definition, the main caregiver would receive the credit so long as the child met age requirements and the main caregiver (a) had a primary relationship, (b) maintained the principal residence for the child, or (c) was the principal financial supporter of the child. As under current law, a tie-breaker rule would reconcile competing claims. See IRC § 152(c)(4). On reflection, we believe that the requisite flexibility can be achieved by maintaining a slightly revised version of UDOC, instead of introducing a new concept such as the “main caregiver.” This approach provides continuity with current law and also will yield better compliance results. We note that many competing claims will disappear by enacting the “noncustodial parent” add-on credit and eliminating the child-related EITC differential, described in Recommendations (6) and (7) herein.

<sup>18</sup> IRC § 152(c)(1)(D) requires that a qualifying child must not provide more than one-half of his or her own support. IRC § 152(d)(1)(C) requires the taxpayer who is claiming a qualifying relative must provide more than one-half of the support of that relative.

5. Once family status is determined under the rules of the Family Credit, the taxpayer could qualify for certain add-on credits. For example, if the child qualified as a qualifying child of the taxpayer, the taxpayer could receive an add-on for child care. Congress also could enact an add-on credit for disabled taxpayers or dependents or for taxpayers who provide primary care for members of their extended families inside or outside of their homes. As under current law, add-on credits may have supplemental eligibility requirements geared to the specific purpose of the credit, but the foundational eligibility requirements should be the same – those for the Family Credit.<sup>19</sup> This approach guards against inconsistencies and “complexity creep.”
6. Enact a refundable “add-on” credit for noncustodial parents of qualifying children who pay substantially all child support legally due for that tax year.<sup>20</sup> This add-on would recognize that noncustodial parents who pay child support have a reduced ability to pay federal income tax and would improve compliance by reducing unnecessary tax disputes arising from dueling tax claims by the custodial and noncustodial parent.<sup>21</sup> Moreover, the credit may eliminate the need to retain the complex special rules (and the resulting disputes) for divorced or separated parents regarding waiving the dependency exemption under IRC § 152(e).
7. Replace the current EITC with a modified EITC that is a refundable credit based solely on a taxpayer’s individual earned income and available to low income wage earners, age 18 or older, who are not qualified children or qualified relatives of another taxpayer.<sup>22</sup> The objective is to eliminate the variation in EITC amounts based on the number of qualifying children the taxpayer claims, if any, since tax relief based on family size would be reflected in the Family Credit discussed above. The adjusted gross income limitation of IRC § 32(a)(2)(B) and the investment income rule of IRC § 32(i) would be retained, thereby ensuring the refundable credit would go to low income taxpayers who do not have significant investment or other income.

<sup>19</sup> Congress can enact these “add-on” credits as refundable credits, where appropriate. Where compelling public policy considerations require a narrow targeting of the add-on credits, Congress could adopt different age and even income requirements, since these variations are fairly easy for the IRS to systemically verify. However, in the interests of reducing complexity in the IRC, income phase-outs should be kept to a minimum. See Legislative Recommendation, *Eliminate (or Simplify) Phase-outs, infra*; National Taxpayer Advocate 2006 Annual Report to Congress 470-82 (Key Legislative Recommendation, *Eliminate (or Simplify) Phase-outs*).

<sup>20</sup> President-elect Obama offered a similar proposal during the recent presidential campaign. See *Factsheet: Barack Obama’s Comprehensive Tax Plan*, at 2, at [http://www.barackobama.com/pdf/taxes/Factsheet\\_Tax\\_Plan\\_FINAL.pdf](http://www.barackobama.com/pdf/taxes/Factsheet_Tax_Plan_FINAL.pdf) (last visited on Dec. 26, 2008) (“Obama will ... increase the benefits available to noncustodial parents who fulfill their child support obligations”).

<sup>21</sup> We recognize that this provision presents administrability challenges, since the IRS has not yet identified a comprehensive and reliable third party data source to systemically verify payment of child support. It is worth exploring whether the IRS could achieve a satisfactory level of compliance by verifying claims against the child support enforcement database and otherwise requiring an affidavit from the payee parent. The National Taxpayer Advocate also recognizes that this provision does not provide any relief to noncustodial parents who have significant visitation with their children and provide support pursuant to an informal agreement. She believes that the credit should be extended to this population too, but has yet to come up with a way to systemically verify these claims, except to suggest that taxpayers submit a copy of any divorce decree or separation agreement that sets forth custody arrangements showing significant visitation.

<sup>22</sup> This recommendation is consistent with the “Making Work Pay” proposal that President-elect Obama made during the recent presidential campaign. See *Factsheet: Barack Obama’s Comprehensive Tax Plan*, at 2, at [http://www.barackobama.com/pdf/taxes/Factsheet\\_Tax\\_Plan\\_FINAL.pdf](http://www.barackobama.com/pdf/taxes/Factsheet_Tax_Plan_FINAL.pdf) (last visited Dec. 26, 2008) (“For 95 percent of workers and their families – 150 million workers overall – the “Making Work Pay” credit will provide a refundable tax cut of \$500 for workers or \$1,000 for working families. This credit will benefit over 15 million self employed workers and for 10 million low income Americans, will completely eliminate their federal income taxes.”).

8. Repeal the head of household filing status under IRC §§ 1(b) and 2(b). Allocate the tax savings provided by repeal to the Family Credit.
9. Amend IRC § 7703(b) to permit taxpayers who have a legally binding separation agreement and who live apart on the last day of the tax year to be considered “not married” for purposes of filing status.

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#3**Simplify and Streamline Education Tax Incentives****Problem**

In the 2004 Annual Report to Congress, the National Taxpayer Advocate recommended that Congress simplify the education provisions of the Internal Revenue Code (IRC).<sup>1</sup> The existing provisions are difficult to navigate and extremely complex.<sup>2</sup> Taxpayers face difficulties in merely understanding the eligibility requirements for these incentives, not to mention the burdens involved in calculating the tax incentives. Aside from the sheer number of education provisions, taxpayers face complexities and inconsistencies regarding:

- Student qualification standards;
- Types of eligible educational expenses;
- Income level requirements;
- Phase-out calculations;
- Inflationary or cost-of-living adjustments; and
- Expiration dates.<sup>3</sup>

The complexities involved in the education provisions of the Code impose a significant burden on taxpayers. Faced with too many complicated choices, taxpayers may not take full advantage of the benefits to which they are entitled. The complexity exposes taxpayers without skilled tax preparers to a higher risk of errors on their returns. Further, taxpayers who are planning for future education expenses, or simply trying to calculate their current quarterly estimated tax payments, face the daunting task of determining how the wide array of education incentives will affect their tax liabilities.

<sup>1</sup> For a more detailed discussion of the applicable education provisions and recommendations for simplification, see National Taxpayer Advocate 2004 Annual Report to Congress 403-422.

<sup>2</sup> Tax benefits for past educational expenses include the deduction for interest on education loans in IRC § 221 and an income exclusion for the cancellation of student loan debt in IRC § 108(f). Tax incentives for current expenses include the Hope and Lifetime Learning Credits in IRC § 25A, the above-the-line deduction for qualified tuition and related deductions in IRC § 222, the income exclusion for qualified scholarships in IRC § 117, and the income exclusion for employer education assistance programs in IRC § 127. Tax incentives for future education expenses include the exclusion of interest income from U.S. Savings Bonds used to pay education tuition and fees in IRC § 135, the income exclusion for early distributions to pay qualified higher education expenses from Roth IRAs in IRC § 408A, Qualified Tuition Programs in IRC § 529, and Coverdell Education Savings Accounts in IRC § 530.

<sup>3</sup> For a complete discussion of the various education incentives, their inherent complexities, and recommended solutions to simplify the provisions, see National Taxpayer Advocate, *2004 Annual Report to Congress* 403-422; Joint Committee on Taxation, *Present Law and Analysis Relating to Tax Benefits for Higher Education: Scheduled for a Public Hearing Before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means on May 1, 2008, JCX-35-08* (April 29, 2008).

## Example

During the 2008 tax year, a married couple contributed \$10,000 to each of their two children's college-related expenses. Both spouses are college educated, work full-time, and have a total household adjusted gross income (AGI) of \$100,000. They are adamant about not paying for tax return preparation and attempt to prepare their own 2008 joint return. To ascertain which tax credit or deduction is most beneficial, the couple must determine the eligibility requirements for each provision. To find out which incentives apply to their particular facts and circumstances, they navigate through the 80-page IRS Publication 970, *Tax Benefits for Education*. They learn the Hope Scholarship Credit (HSC) and Lifetime Learning Credit (LLC) of IRC § 25A will be partially phased out due to their income level.<sup>4</sup> However, their AGI does not exceed the phase-out threshold for the IRC § 222 Deduction for Qualified Tuition and Related Expenses.<sup>5</sup> In addition, the HSC is not available for expenses related to the oldest student because she is not in the first two years of school.<sup>6</sup> Once the couple determines which provisions apply, they must then calculate which ones produce the greatest tax benefit.<sup>7</sup> The couple fills out several worksheets in the IRS publication to compute each available incentive.

## Recommendation

The National Taxpayer Advocate recommends that Congress simplify the education provisions in the IRC through the following measures:

- Consolidate the provisions to the extent possible and clearly state how the remaining incentives interact. For example, Congress should consolidate the Hope Scholarship and Lifetime Learning Credits and make clear whether taxpayers can take advantage of several incentives in the same tax year.<sup>8</sup>
- Provide consistent standards regarding student eligibility, such as the relationship of the student to the taxpayer, the age of the student, and the type of enrollment.
- Provide a uniform definition of “qualifying higher education expenses” and “eligible education institution.”
- Provide consistent income-level thresholds, phase-out calculations, and inflationary adjustments, unless inconsistency is justified by compelling policy reasons.

<sup>4</sup> The credits begin to phase out once the couple's modified adjusted gross income exceeds \$80,000, as adjusted for inflation after 2001. IRC §§ 25A (d) and (h). In 2007, the AGI threshold equaled \$94,000. IRS Pub 970, *Tax Benefits for Education* 2.

<sup>5</sup> The deduction for qualified tuition and related expenses is fully available if their AGI does not exceed \$130,000, without any provision for inflationary adjustments. IRC § 222(b)(2)(B).

<sup>6</sup> IRC § 25A(b)(2)(C); IRS Pub 970, *Tax Benefits for Education* 12.

<sup>7</sup> Both IRC § 25A credits and the IRC § 222 deduction cover only tuition and required enrollment fees.

<sup>8</sup> Congress should consider, as part of the simplification, whether any consolidated provisions should be an above-the-line deduction, credit, or refundable credit. While an above-the-line deduction is available to all taxpayers, tax credits prove more beneficial the lower the income (based on marginal tax rates). However, many tax provisions hinge on the AGI amount. For example, taking a deduction as opposed to a credit can impact Earned Income Tax Credit (EITC) eligibility. IRC § 32.

- After initially using sunset provisions to test the education incentives and any associated simplification amendments, Congress should make all education incentives permanent.<sup>9</sup>

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<sup>9</sup> For a discussion of previous recommendations to simplify the education provisions in the Code, see Joint Committee on Taxation, *Present Law and Analysis Relating to Tax Benefits for Higher Education: Scheduled for a Public Hearing Before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means on May 1, 2008*, JCX-35-08 (April 29, 2008) 40-42.

## Simplify and Streamline Retirement Savings Tax Incentives

### Problem

The Internal Revenue Code contains numerous tax incentives for participants of certain retirement accounts. More than a dozen different tax-advantaged<sup>1</sup> retirement planning vehicles are available to the workforce today.<sup>2</sup> While these arrangements have a singular goal of helping taxpayers save for retirement, they are subject to different sets of rules regulating eligibility, contribution limits, tax treatment of contributions and distributions, withdrawals, availability of loans, and portability. Retirement plan administrators and participants alike may find themselves at a loss in trying to sort through the unnecessarily complex and often conflicting provisions of the various types of plans.<sup>3</sup>

### Example

Taxpayer A opened a Roth IRA account three years ago and has contributed the maximum each year. The taxpayer's current balance is \$12,000. Taxpayer A currently works part-time for Employers B and C. Employer B is a for-profit company that maintains a 401(k) plan for its employees. The present value of Taxpayer A's 401(k) account is \$60,000. Taxpayer A also participates in the 457(b) plan maintained by Employer C, a state agency. The present value of Taxpayer A's 457(b) plan is \$18,000.

Taxpayer A is faced with a medical emergency that will require surgery and force him to miss six months of work. Because his health insurance will cover only 70 percent of his estimated \$50,000 medical expenses, Taxpayer A will have out-of-pocket costs of \$15,000 for his surgery. Moreover, Taxpayer A estimates he will need an additional \$20,000 to cover living expenses for his family during the next six months, while he is on unpaid leave.

Taxpayer A recalls that some coworkers from Employer B could make "hardship" withdrawals from their retirement plans for occasions such as a home purchase. Taxpayer A would like to know whether he can make an early withdrawal or take a plan loan from his IRA or two employer-based plans to help pay his medical and living expenses for the

<sup>1</sup> The term "tax-advantaged" includes the ability to defer the taxation of income by making an elective deferral, the tax-deferred growth of account assets, or the tax-free withdrawals available to plan participants.

<sup>2</sup> We limit our discussion to retirement plans where plan participants make contributions to their account, including, but not limited to, traditional IRAs, nondeductible IRAs, nonworking spousal IRAs, Roth IRAs, rollover IRAs, SIMPLE IRAs, 401(k) and other defined contribution plans for private employers, Simplified Employee Pensions and SIMPLE 401(k) plans for small employers, 403(b) tax-sheltered annuity plans for 501(c)(3) organizations and public schools, and 457(b) deferred compensation plans for state and local governments. We exclude employer-funded defined benefit pension plans from our discussion.

<sup>3</sup> For further discussion of the need for retirement plan simplification and a detailed recommendation, see National Taxpayer Advocate 2004 Annual Report to Congress 423-32.

next six months. After spending two weeks reading through plan documents and talking with friends, colleagues, and plan administrators, Taxpayer A comes to the following conclusions:

- (1.) His Roth IRA plan does not allow for either plan loans or hardship withdrawals.
- (2.) His 401(k) plan with Employer B allows plan loans up to 50 percent of account balance as well as hardship withdrawals of his elective deferrals in instances of “immediate and heavy financial need.” Medical expenses, but not living expenses for the period he is unable to work, fall under the safe harbor definition of immediate and heavy financial need. Hardship distributions are included in taxable income, subject to the ten percent additional tax for early withdrawal.
- (3.) His 457(b) plan with Employer C allows plan loans up to 50 percent of account balance and allows hardship withdrawals for “unforeseeable emergencies.” Severe financial hardship resulting from an illness or accident is considered an instance of unforeseeable emergency. The ten percent additional tax does not apply to a hardship withdrawal from a 457(b) plan.

### Recommendation

The National Taxpayer Advocate urges Congress to take a fresh look at the significant complexity of the retirement plan system. Congress should consolidate retirement plans where the differences in plan attributes are trivial. Such consolidation would reduce confusion and may lead to increased participation, or at least to fewer inadvertent errors. For instance, Congress should consider establishing one retirement plan for individual taxpayers, one tailored for small businesses, and one suitable for large businesses (eliminating plans that are limited to governmental entities).

With or without consolidation of retirement plans, the National Taxpayer Advocate recommends that Congress establish uniform rules regarding hardship withdrawals, plan loans, and portability. Creating a uniform set of rules should (1) eliminate inadvertent errors, (2) enable greater portability among plans, and (3) increase participation by employers.

## Worker Classification

### Problem

Misclassification of workers can have serious consequences for the workers, the recipients of the services they provide, and tax administration in general. Whether a worker is classified as an employee or independent contractor affects the application of labor laws as well as tax treatment for both the worker and the service recipient. Worker classification rules are complicated and confusing, in part because the rules are not the same for federal income taxes and employment taxes.

In addition to their complexity, existing worker classification rules do not serve the best interests of tax administration. Whether inadvertent or deliberate, the misclassification of employees as independent contractors has a significant revenue impact due to the difference in, and in many cases the absence of, information reporting and tax withholding requirements for independent contractors. Further, the IRS is prohibited from issuing guidance on worker classification for employment tax purposes despite its responsibility to enforce the associated laws.

### Example

Worker provides services to Company A, which attempts to comply with the tax laws. Company A follows the lead of other businesses in the industry, which treat similar workers as independent contractors and file Forms 1099-MISC, *Miscellaneous Income*. After Worker has spent five years on the job, Company A is subjected to an IRS employment tax examination. The IRS reclassifies Worker as an employee and Company A decides not to petition the United States Tax Court to review the determination. Worker actually preferred independent contractor status because it allowed him to deduct work-related expenses, but has no standing to appeal the determination. In addition, Worker files a claim for refund of the excess Social Security and Medicare taxes paid (as Self-Employment Contributions Act taxes) during the period of misclassification, but the statute of limitations for refunds has expired for one of the five years of employment. Finally, when Worker is subsequently terminated in a cost-cutting measure, he learns he does not qualify as an employee for state unemployment benefits.

### Recommendation

To reduce complexity and confusion, promote compliance, and improve tax administration, the National Taxpayer Advocate recommends that Congress take the following legislative actions:

- Require the Department of Treasury and the IRS to publish guidance on classification for both income and employment taxes.
- Direct the IRS to develop a program similar to the Employment Status Indicator of the United Kingdom.
- Repeal § 530 of the Revenue Act of 1978<sup>1</sup> and replace it with an Internal Revenue Code (IRC) provision providing a safe harbor applicable to both federal income and employment taxes, which allows the taxpayer to establish a reasonable basis for the classification. In making the classification determination, the IRS should be authorized to consider industry practices.
- Amend Internal Revenue Code (IRC) § 7436 to permit workers to petition the United States Tax Court to review the IRS's classification determinations.
- Require service recipients to issue Forms 1099-MISC to incorporated service providers and increase the penalties for failure to comply with the information reporting requirements of IRC § 6041A.
- Amend IRC § 3402(p)(3) to authorize the IRS to agree not to challenge the classification of workers who are party to a voluntary income tax withholding agreement.
- Amend IRC § 3406 to require backup withholding for substantially noncompliant Schedule C filers. Congress should also authorize the Secretary to exempt service recipients from back-up withholding responsibilities on payments to Schedule C filers who present valid Compliance Certificates.
- Direct Treasury and the Joint Committee on Taxation to report on the operation of the revised worker classification rules and provide recommendations to increase compliance.
- Require the IRS and the Department of Labor to conduct targeted public awareness campaigns to inform workers of the comparative rights afforded to employees and independent contractors, the tax consequences associated with each classification, and the opportunity to enter into voluntary income tax withholding agreements.

## Present Law

### Common Law Test

The worker classification determination is generally made under a facts and circumstances test. A common law test, developed over the years by courts identifying various factors of relevance, determines whether an employee-employer relationship exists for both income and employment tax purposes.

<sup>1</sup> Pub. L. No. 95-600, 92 Stat. 2763, 2885-86.

In Revenue Ruling 87-41,<sup>2</sup> the IRS developed a list of 20 factors, based on cases and rulings decided over the years, to determine whether an employer-employee relationship exists. Pursuant to Rev. Rul. 87-41, the degree of importance for each factor varies depending on the occupation and the context in which the services are performed.

In an effort to clarify the analysis of worker classification, the IRS in 1996 developed training materials focused on the concept of “right to control.” These materials identified three categories of evidence in determining whether the requisite control exists under the common-law test:

1. Behavioral control;
2. Financial control; and
3. Relationship of the parties.

The training materials also noted:

- Factors in addition to the 20 factors may be relevant;
- Weight of the factors varies based on circumstances; and
- Relevant factors may change over time.<sup>3</sup>

The common law test is also incorporated into the Internal Revenue Code and Treasury Regulations. For example, IRC § 3121(d)(2) defines “employee” by referring to the common law test.<sup>4</sup> Similarly, Treas. Reg. § 31.3401(c) provides that:

[g]enerally the relationship of employer and employee exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished.

In addition, certain Code provisions prescribe treatment for a specific category of worker. For example, IRC § 3508 provides that certain real estate agents and direct sellers are treated as independent contractors for all tax purposes.

### Employment Taxes

The common law test discussed above also applies for employment tax purposes. However, § 530 of the Revenue Act of 1978 was crafted to address the increased enforcement of

<sup>2</sup> Rev. Rul. 87-41, 1987-1 C.B. 296.

<sup>3</sup> IRS, *Independent Contractor or Employee? Training Materials*, Training 3320-102, TPDS 842381, at 2-7 (Oct. 1996) available at <http://www.irs.gov/pub/irs-utl/emporind.pdf>.

<sup>4</sup> In defining “employee” for purposes of Chapter 21 (FICA), § 3121(d)(2) includes as one of the four provisions “any individual who, under the common law rules applicable in determining the employer-employee relationship, has the status of employee.”

employment tax laws in the late 1960s.<sup>5</sup> Controversies developed between the IRS and taxpayers regarding the classification of certain workers as self-employed rather than as employees. It is clear that the provision was intended to curb aggressive enforcement of classification issues by the IRS. In fact, the legislative history states that § 530 should be “construed liberally in favor of taxpayers.”<sup>6</sup>

Section 530 provides a safe harbor rule allowing service recipients to treat workers as independent contractors, regardless of their actual status under the common law test, if there is reasonable basis for treating the worker as an independent contractor and certain other requirements are met. Pursuant to § 530, a reasonable basis for treating a worker as an independent contractor exists if the taxpayer reasonably relies on:

1. Past IRS audit practice with respect to the taxpayer;
2. Published rulings or judicial precedent; or
3. Longstanding recognized practice in the taxpayer’s industry.<sup>7</sup>

If the taxpayer cannot satisfy one of the above three “safe harbors,” it may still qualify for relief if it had any “other reasonable basis” for treating a worker as an independent contractor.

To receive § 530 relief, the taxpayer must also:

1. Report payments made to independent contractors on Forms 1099-MISC;
2. Not have treated the worker as an employee for any period; and
3. Not have treated any worker holding a substantially similar position as an employee for employment tax purposes (the “substantive consistency requirement”).

The § 530 safe harbor, however, does not apply in whole or in part to certain professions. For example, the safe harbor is entirely inapplicable to a worker who, pursuant to an arrangement between the taxpayer and another person, provides services as an engineer,

<sup>5</sup> Pub. L. No. 95-600, 92 Stat. 2763, 2885-86; Joint Committee on Taxation, *Description and Analysis of Proposals Relating to the Deduction for Health Insurance Expenses of Self-Employees Individuals, Worker Classification, Taxation of Home Office Expenses, and Electronic Filing Scheduled for Public Hearing Before the Subcommittee on Taxation and IRS Oversight of the Senate Committee on Finance on June 5, 1997*, JCX-19-97 (June 4, 1997) (Text accompanying fn. 8).

<sup>6</sup> H.R. Conf. Rep. 104-737, 104th Cong., 2d Sess. § 1122 (Aug. 1, 1996); Joint Committee on Taxation, *Description and Analysis of Proposals Relating to the Deduction for Health Insurance Expenses of Self-Employees Individuals, Worker Classification, Taxation of Home Office Expenses, and Electronic Filing Scheduled for Public Hearing Before the Subcommittee on Taxation and IRS Oversight of the Senate Committee on Finance on June 5, 1997*, JCX-19-97 (June 4, 1997).

<sup>7</sup> The term “longstanding” was clarified so as not to be construed as requiring the practice to continue for more than ten years. The Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1112(a), 110 Stat. 1759.

designer, drafter, computer programmer, systems analyst, or similarly skilled worker engaged in a similar line of work.<sup>8</sup>

Finally, § 530 prohibits Treasury and the IRS from publishing regulations and revenue rulings with respect to the employment status of any individual for purposes of employment taxes.<sup>9</sup> However, a taxpayer (a business or a worker) may obtain a written determination from the IRS on the status of a particular worker for purposes of employment taxes and income tax withholding.<sup>10</sup>

### Right to Contest IRS's Determination

IRC § 7436 allows an employer that has been audited regarding employment taxes to petition the United States Tax Court to litigate the issue of whether a worker is an independent contractor or employee, or whether the employer is entitled to relief from any misclassification under § 530 of the Revenue Act of 1978. The collection of any underpayment of employment taxes is barred while the action is pending.<sup>11</sup> It is important to note that this provision does not authorize the *worker* to petition the Tax Court.

### Information Reporting

IRC § 6041A requires service recipients who pay independent contractors \$600 or more during the taxable year to file information returns with the IRS. The recipients must file Form 1099-MISC with the IRS and provide a copy to the contractor by January 31 of the following year. The penalty for failing to issue a required Form 1099-MISC is \$50 per return.<sup>12</sup>

The information reporting requirements have several exceptions. For example, the dollar threshold is set higher at \$5,000 for direct sales,<sup>13</sup> and there is an exemption from filing if the service provider (*i.e.*, worker) is incorporated.<sup>14</sup> However, the incorporation exemption does not apply if the service recipient is a federal executive agency, which is also subject to separate reporting requirements for contracts over \$25,000.<sup>15</sup>

<sup>8</sup> Section 530(d) of the Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763 (Nov. 6, 1978). Another example of the complexity is illustrated by the special rules applicable to test proctors and room supervisors. The similar worker consistency requirement does not apply to services performed after December 31, 2006 by test proctors or room supervisors assisting in the administration of college entrance or placement examinations. However, the exception only applies to proctors if the service recipient is a § 501(c) organization and the worker is not otherwise treated as an employee for employment tax purposes. Section 864, Pension Protection Act of 2006, Pub. L. No. 109-280, 120 Stat. 780 (Aug. 17, 2006).

<sup>9</sup> Section 530(b) of the Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763 (Nov. 6, 1978).

<sup>10</sup> Rev. Rul. 87-41; IRS Form SS-8, *Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding*; Rev. Proc. 2007-3, 2007-1 I.R.B. 108.

<sup>11</sup> Employers also have the option to pay some or all of those disputed taxes and proceed (after denial of their refund claims) to bring suit in their local U.S. district court or the United States Court of Federal Claims.

<sup>12</sup> IRC § 6721(a).

<sup>13</sup> IRC § 6041A(b).

<sup>14</sup> Treas. Reg. § 1.6041-3(p)(1).

<sup>15</sup> IRC §§ 6041A(d)(3)(A), 6050M; Treas. Reg. § 1.6050M-1(c)(1)(i); Rev. Rul. 2003-66, 2003-26 I.R.B. 1115, 2003-1 C.B. 1115 (June 30, 2003).

### Voluntary Withholding Agreements

IRC § 3402(p)(3) authorizes the Secretary to promulgate regulations to provide for withholding from any type of payment that does not constitute wages if the Secretary finds withholding would be appropriate and the payor and recipient of the payment agree to such withholding. However, the provision specifically states that the Secretary must find the withholding would be appropriate “under the provisions of [IRC chapter 24, Collection of Taxes at the Source].” IRC chapter 24 deals with collection of taxes at the source with respect to employees (*e.g.*, wage withholding). Thus, it is unclear whether the IRC § 3402(p)(3) authorizes the Secretary to draft regulations addressing non-wage withholding arrangements.<sup>16</sup>

### Reasons For Change

#### Revenue Impact of Misclassification

Income earned by independent contractors is not subject to withholding requirements. Research has shown that approximately 99 percent of income subject to withholding (*i.e.*, wages) is reported on tax returns.<sup>17</sup> When income is reported and taxes are withheld at the source, taxpayers have fewer opportunities to be noncompliant.<sup>18</sup>

The exact impact worker classification has on the tax gap is unclear.<sup>19</sup> However, in 1984, the IRS examined 3,331 employers and found:

- Nearly 15 percent misclassified employees as independent contractors;
- Section 530 protected nine percent of misclassified employees from reclassification;
- Nearly half of returns using § 530 safe harbor protections relied on the prior audit provision;
- When service recipients classified workers as employees, the employees reported more than 99 percent of income;
- Only 77 percent of gross income was reported when a Form 1099 was filed;
- Only 29 percent of gross income was reported when no Form 1099 was filed; and

<sup>16</sup> For a more detailed discussion of the National Taxpayer Advocate’s voluntary withholding agreement proposal and the legal impediments to achieve by regulation, see National Taxpayer Advocate 2005 Annual Report to Congress 392-394.

<sup>17</sup> IRS Research, Individual Income Tax Underreporting Gap Estimates, Tax Year 2001 (Feb. 2007), available at [http://www.irs.gov/pub/irs-utl/tax\\_gap\\_update\\_070212.pdf](http://www.irs.gov/pub/irs-utl/tax_gap_update_070212.pdf) (last visited September 26, 2008) (The net misreporting percentage for wages and salaries is 1.2 percent for items subject to substantial information reporting and withholding).

<sup>18</sup> *The Causes of and Solutions to the Federal Tax Gap: Hearing Before the Senate Comm. on the Budget 3* (Feb. 15, 2006) (Written Statement of Nina E. Olson, National Taxpayer Advocate).

<sup>19</sup> The IRS Tax Gap Map for Tax Year 2001 provides \$54 billion in underreporting employment taxes out of an estimated \$345 billion tax gap. It is unclear how much is attributable to worker misclassification. IRS Research, Tax Gap Map for Tax Year 2001 (in \$ Billions) (Feb. 2007), available at [http://www.irs.gov/pub/irs-utl/tax\\_gap\\_update\\_070212.pdf](http://www.irs.gov/pub/irs-utl/tax_gap_update_070212.pdf) (last visited September 26, 2008).

- Projecting the findings to the general population would result in misclassification of 3.4 million workers as independent contractors with an estimated tax loss of \$1.6 billion in 1984.<sup>20</sup>

Results from the IRS's Employment Tax Examination Program further illustrate the revenue impact of misclassifications. The IRS performed 11,380 audits from FY 1988 through FY 1994 to determine the employment status of personnel not classified as employees. The General Accounting Office (GAO, now the Government Accountability Office) studied the audits and found the IRS reclassified 483,000 workers and the audits led to proposed tax assessments of \$751 million.<sup>21</sup>

### Reasons for Misclassification

#### *Inadvertent Misclassification due to Complexity*

The rules surrounding classification are confusing. The 20-factor test to determine proper classification is complex, subjective, and does not always produce clear answers. The potential for errors and abuse is high in those gray areas where not all factors yield the same result, particularly because there are no weighting rules.

The National Federation of Independent Businesses (NFIB) has deemed worker classification as a top priority and is calling for a better definition of "independent contractor." According to the NFIB, the 20-factor test is an extremely tough challenge that handcuffs small businesses due to its vagueness and lack of clarity.<sup>22</sup>

In addition, the IRS's Small Business / Self-Employed Operating Division (SB/SE) conducted focus groups during the 2007 IRS Nationwide Tax Forums on the topic of employment tax compliance. The participants indicated the worker classification issue is very confusing because it involves numerous substantive tests that are different at the state and federal levels. They also felt that the worker classification determination by the IRS is arbitrary. To address the confusion surrounding these rules, the participants recommended a simple set of classification rules and an IRS publication with detailed examples.<sup>23</sup>

<sup>20</sup> Joint Committee on Taxation, *Present Law and Background Relating to Worker Classification for Federal Tax Purposes Scheduled for a Public Hearing Before the Subcommittee on Select Revenue Measures and the Subcommittee on Income Security and Family Support of the House Committee on Ways and Means on May 8, 2009*, JCX-26-07 (May 7, 2007); United States Government Accountability Office, *Employee Misclassification: Improved Outreach Could Help Ensure Proper Worker Classification*, GAO-07-859T (May 8, 2008) (GAO adjusted the 1984 tax loss of \$1.6 billion for inflation and estimated the tax loss to be \$2.72 billion in 2006 dollars).

<sup>21</sup> Joint Committee on Taxation, *Present Law and Background Relating to Worker Classification for Federal Tax Purposes Scheduled for a Public Hearing Before the Subcommittee on Select Revenue Measures and the Subcommittee on Income Security and Family Support of the House Committee on Ways and Means on May 8, 2007*, JCX-26-07 (May 7, 2007); Government Accountability Office, *Employee Misclassification: Improved Outreach Could Help Ensure Proper Worker Classification*, GAO-07-859T (May 8, 2008).

<sup>22</sup> National Federation of Independent Businesses, *IRS Rules Blur Lines Between Employees, Independent Contractors*, available at [http://www.nfib.com/page/independentContractor?\\_templateId=315](http://www.nfib.com/page/independentContractor?_templateId=315) (last visited on July 1, 2008).

<sup>23</sup> SB/SE Research, 2007 Nationwide Tax Forums: Employment Tax Compliance – Are your Clients at Risk? NCH0088 (May 2008).

### *Deliberate Misclassification*

Whether a worker is classified as an independent contractor produces significant tax consequences for both the worker and the service recipient. Some consequences favor employees while others favor independent contractors. Such consequences include:

- Income tax withholding requirements;<sup>24</sup>
- Employment tax requirements;
- Ability to exclude certain types of income or take deductions for certain types of expenses;<sup>25</sup> and
- Satisfaction of coverage requirements applicable to qualified retirement plans.<sup>26</sup>

The nontax consequences of worker classification may also drive the determination. Classifying workers as independent contractors excludes them from coverage under laws designed to protect them. Thus, it may be in the service recipient's interest to deliberately misclassify a worker as a contractor to avoid the burden associated with these protective laws. Such protections include the Fair Labor Standards Act (FLSA), which provides minimum wage, overtime pay, and child labor protections. Additional laws designed to protect employees include the Family Medical Leave Act, Occupational Safety and Health Act, and the National Labor Relations Act. Misclassified workers may also lose access to employer-provided benefits such as health insurance coverage and pensions.<sup>27</sup>

### *Section 530 Safe Harbor Rule Creates Confusion*

The safe harbor rule of § 530 adds confusion to an already complicated set of classification rules. Apparently, § 530 was enacted “to alleviate what was perceived as an overly zealous pursuit and assessment of taxes and penalties against employers who had, in good faith, misclassified their employees as independent contractors.”<sup>28</sup>

While § 530 was intended to reduce disputes between the IRS and taxpayers, interpretation of the provisions has become an additional source of disputes and confusion for the following reasons:

<sup>24</sup> Pursuant to IRC § 3402, every employer making payment of wages must deduct and withhold a tax on such wages pursuant to tables and computations prescribed in the Regulations. If the employer fails to deduct and withhold taxes, the employer is liable for penalties or additions to the applicable tax in case of a failure to deduct and withhold. The employer will not be relieved of his liability for payment of the tax required to be withheld unless he can show that the tax has been paid by the employee. IRC § 3402(d); Treas. Reg. § 31.3402(d)-1; Treas. Reg. § 31.3403-1.

<sup>25</sup> For example, an employee may exclude employer-provided benefits such as pension, health, and group-term life insurance. Independent contractors can establish pension plans and deduct contributions to the plan. Independent contractors can also deduct work-related expenses. For a more detailed discussion of the tax treatment of both classifications, see Joint Committee on Taxation, *Present Law and Background Relating to Worker Classification for Federal Tax Purposes Scheduled for a Public Hearing Before the Subcommittee on Select Revenue Measures and the Subcommittee on Income Security and Family Support of the House Committee on Ways and Means on May 8, 2007*, JCX-26-07 (May 7, 2007).

<sup>26</sup> IRC § 410(b).

<sup>27</sup> See Government Accountability Office, *Employee Misclassification: Improved Outreach Could Help Ensure Proper Worker Classification*, GAO-07-859T (May 8, 2007); Subcomm. on Income Security and Family Support, Comm. On Ways and Means, Advisory ISFS-6 (May 1, 2007).

<sup>28</sup> *Boles Trucking, Inc. v. U.S.*, 77 F.3d 236, 239 (8th Cir. 1996).

- The provision is difficult to find because it is not part of the Internal Revenue Code;
- Certain provisions rely on facts and circumstances;
- The provisions only apply to the service recipients and not the worker; and
- The provisions apply to employment tax, which is statutorily defined to include income tax withholding.<sup>29</sup>

Further, judicial decisions have made clear that there is no *de minimis* exception to the substantive consistency requirement of § 530, which looks as far back as 1978.<sup>30</sup> Thus, a service recipient could disqualify from the safe harbor by treating one individual as an employee for one hour of service by reporting that hour on a Form W-2 twenty years ago.

### Consequences of Reclassification by IRS

Whether misclassification is inadvertent or deliberate, significant tax consequences result if the IRS subsequently reclassifies the worker after an audit. For example, the service recipient may have a liability for employment taxes for a number of years,<sup>31</sup> interest, penalties, and potential disqualification of employee benefit plans. The worker may have to pay self-employment taxes and lose the ability to take certain business-related deductions. In addition, if the worker is classified as an employee, he or she may be barred from claiming a refund of self-employment taxes because the statutory period for claiming a refund expired while the IRS was dealing with the employer's classification issue. Further, the worker has no right to petition the classification determination to the Tax Court under IRC § 7436.

### Lack of Published Guidance

Because the Revenue Act of 1978 prohibits Treasury and the IRS from publishing regulations and revenue rulings on worker classification for employment taxes, there is no current guidance. Given that overtime and general working conditions have changed significantly over the last three decades, such a prohibition is contrary to sound tax administration and likely increases the potential for both deliberate and inadvertent misclassification. Although the IRS has published training materials on this issue, they do not carry the force of law.

<sup>29</sup> The Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763, § 530(c)(1) (Nov. 6, 1978) ("The term 'employment tax' means any tax imposed by subtitle C of the Internal Revenue Code of 1986").

<sup>30</sup> See *Institute for Resource Management, Inc. v. U.S.*, 90-2 U.S.T.C. Par. 50,586 (Cl. Ct. 1990).

<sup>31</sup> Where an employer fails to deduct and withhold income taxes due to treating the worker as a nonemployee, the resulting liability may be determined under IRC § 3509. To the extent § 3509 applies, the employer's liability for income tax withholding is determined as if the amount required to be deducted and withheld was equal to 1.5 percent (three percent where the employer disregards certain reporting requirements) of the wages paid to the individual erroneously treated as a nonemployee. The employer is also liable for 20 percent of the social security taxes (40 percent if the employer disregards reporting requirements). Section 3509 does not apply where the employer intentionally disregarded the deduction and withholding requirements. IRC § 3509(c).

### Recent Industry and Congressional Proposals

Congress and industry have made several proposals to address the worker misclassification problem. The Office of the Taxpayer Advocate reviewed these proposals, which are summarized below, and the legislative recommendation made herein incorporates what we deem to be the most effective and administrable provisions of the various proposals.

#### *Increase Information Reporting Requirements*

The Coalition to Preserve Independent Contractor Status supports the existing § 530 safe harbor. However, the organization has stated that a better approach to increase compliance is to redirect the focus away from worker classification, and instead enhance Form 1099 information reporting requirements for independent contractors. The rationale behind the proposal is the significantly higher rate of compliance among independent contractors subject to information reporting requirements.<sup>32</sup>

#### *Check-the-Box Approach*

The “check-the-box” proposal allows the worker and service recipient to agree by contract to classification for all federal tax purposes. If the IRS agrees not to challenge the agreed upon status, this method would eliminate controversies regarding classification. However, this method would likely create a trap for the unwary worker who is unfamiliar with the tax consequences of each classification. Thus, this approach is most certainly going to lead to more favorable tax results for the party with the greater bargaining power, which is generally the service recipient.<sup>33</sup>

#### *Limiting the Relevant Factors*

To eliminate the uncertainty surrounding the 20-factor test, several proposals have attempted to limit the number of relevant factors. This approach would reduce but not eliminate complexity due to the inevitable evaluation of facts and circumstance.<sup>34</sup>

<sup>32</sup> Coalition to Preserve Independent Contractor Status, *Coalition Submits Statement for the Record: Hearing Before the U.S. House of Representatives, Committee on Ways and Means* (May 8, 2007), available at <http://www.iccoalition.org/Display-Article.asp?cat=Latest%20News&subcat=Federal&a=208> (“Rather than pursuing a broad campaign aimed at reclassifying independent contractors to employees, the Coalition submits that a better approach would be to increase the level of Form 1099 information reporting among independent contractors.”). It is unclear exactly how the Coalition would enhance the reporting requirements. The National Taxpayer Advocate believes that because the IRC § 6041A filing thresholds have not been adjusted for inflation, they have already been effectively lowered over the years.

<sup>33</sup> Joint Committee on Taxation, *Present Law and Background Relating to Worker Classification for Federal Tax Purposes Scheduled for a Public Hearing Before the Subcommittee on Select Revenue Measures and the Subcommittee on Income Security and Family Support of the House Committee on Ways and Means on May 8, 2007*, JCX-26-07 (May 7, 2007).

<sup>34</sup> For example, some proposals focus on whether the worker has substantial investment in training or education. Others would focus on whether the worker has a substantial investment in work facilities or substantial unreimbursed business expenses. Joint Committee on Taxation, *Present Law and Background Relating to Worker Classification for Federal Tax Purposes Scheduled for a Public Hearing Before the Subcommittee on Select Revenue Measures and the Subcommittee on Income Security and Family Support of the House Committee on Ways and Means on May 8, 2007*, JCX-26-07 (May 7, 2007).

***Amend Section 530 Safe Harbor***

Several congressional bills have attempted to amend or repeal and replace the provisions of the § 530 safe harbor provision in an effort to increase compliance and improve tax administration.

*The Independent Contractor Proper Classification Act of 2007*<sup>35</sup> amends § 530 as follows:

- Allows the IRS to issue guidance on classification issues;
- Eliminates the service recipient's ability to rely on industry classification practices;
- Requires the IRS to develop a process for workers to petition for a determination of status;
- Guards against employee retaliation;
- Requires the IRS and Department of Labor to share information about misclassification practices;
- Requires employers to notify independent contractors of their rights and federal tax obligations; and
- Requires service recipients to retain a list of the names of independent contractors for three years.

*The Taxpayer Responsibility, Accountability, and Consistency Act of 2008*<sup>36</sup> is similar to S. 2044 above. The bill would replace § 530 with a new safe harbor provision to be incorporated into the Code under a new IRC § 3511. The bill provides the following:

- The proposed safe harbor does not ban Treasury and the IRS from issuing guidance;
- The safe harbor only protects the taxpayer from reclassification if the taxpayer did not receive a written IRS determination that the covered workers are employees;
- The taxpayer must consistently treat the worker as an independent contractor for employment tax purposes (since 1978);
- Compensation to the worker must be reported on Form 1099; and
- The taxpayer must have a reasonable basis to treat the worker as an independent contractor. The taxpayer can establish reasonable basis in two ways:
  1. A written IRS determination issued within the past seven years addressing the worker in question or another individual with a substantially similar position with the taxpayer;<sup>37</sup> or

<sup>35</sup> S. 2044, 110th Cong, 1st Sess. (Sept. 12, 2007).

<sup>36</sup> H.R. 5804, 110th Cong. (April 15, 2008).

<sup>37</sup> The bill also requires Treasury to develop a new procedure for workers to petition for an IRS determination of their status for employment tax purposes. Workers would have appeal rights following a determination of independent contractor.

2. A concluded IRS examination (for employment tax purposes) of whether the worker or individual with substantially similar position should be treated as an employee.<sup>38</sup>

Like S. 2044, H.R. 5804 contains anti-retaliation provisions prohibiting a taxpayer from discriminating against an individual for filing a petition seeking a determination of worker status.

### *Penalties for Misclassification*

The Employee Misclassification Act of 2008<sup>39</sup> allows successful plaintiffs claiming misclassification as independent contractors and denial of overtime and/or minimum wages under the Fair Labor Standards Act (FLSA) to recover triple damages. In addition, the bill would subject service recipients to new recordkeeping requirements, which include the names of independent contractors, their remuneration, and hours of service. The service recipient must also provide all employees and contractors with information on the workers, status, legal rights, and Department of Labor contact information. Further, employers that have repeatedly or willfully misclassified workers as independent contractors would be subject to a civil penalty of up to \$10,000 per misclassified worker.

While the bill addresses the FLSA, adverse decisions may lead to inquiries by the IRS as well as state agencies. This approach also appears to severely penalize both inadvertent and deliberate misclassifications. Thus, if the IRS were to adopt a similar rule, it should require repetitive offenses as well as requisite intent.

### **Explanation of Recommendation**

The National Taxpayer Advocate believes the complexity of the existing worker classification rules creates confusion and uncertainty, and encourages noncompliance. Accordingly, the National Taxpayer Advocate has reviewed various proposals to improve the worker classification rules and makes specific recommendations to minimize worker misclassification. Specifically, we recommend that Congress replace § 530 with a provision in the Code applicable to both employment and income taxes and require the Secretary to issue associated guidance, including some with specific industry focus. In addition, employers should be able to use and rely upon an electronic tool developed by the IRS to determine worker classification. Further, both employers and employees should be able to request classification determinations and seek recourse in Tax Court. The IRS should conduct public outreach and education campaigns to increase awareness of the rules as well as the consequences associated with worker classification. Finally, we also recommend several measures we have previously proposed to improve compliance with employment tax obligations. We believe our proposals, adopted in their entirety, appropriately balance the needs of workers, service

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<sup>38</sup> H.R. 5804, 110th Cong. (April 15, 2008).

<sup>39</sup> H.R. 6111, 110th Cong. (May 22, 2008).

recipients, and the IRS. In addition, the proposals address fairness as well as the need to encourage compliance in this area.

### **Administrative Guidance on Worker Classification**

The repeal of the existing § 530 safe harbor provisions will lift the prohibition on Treasury and the IRS from issuing administrative guidance on worker classification for employment tax purposes. Without the prohibition, the IRS should issue straightforward guidance to clarify the application of the common law to different facts and circumstances. In addition, the guidance should provide consistent rules for both income and employment taxes.

### **Self-Help Tool to Determine Classification**

In conjunction with the additional guidance issued by Treasury and the IRS, the IRS should develop a program similar to that of the United Kingdom. Her Majesty's Revenue and Customs (HMRC) provides taxpayers with a free, web-based service called the Employment Status Indicator (ESI), which asks service recipients a series of questions and, based on the answers given, supplies an "indication of employment status." ESI specifically provides that the determination is not a binding opinion. The IRS can develop a similar program to use as a factor in establishing reasonable basis for the safe harbor.<sup>40</sup> Employers should be able to rely upon the classification generated from the online tool, unless they misrepresent the information input into the system while answering questions or circumstances have materially changed.

### **Repeal Section 530 of the Revenue Act of 1978**

The National Taxpayer Advocate recommends the repeal of § 530. The safe harbor was enacted to protect service recipients and their workers from aggressive IRS enforcement initiatives. However, the current provision creates unnecessary confusion due to its location outside of the IRC. In addition, the rule introduces a new set of facts and circumstances tests, which only lead to more disputes. Finally, it is not in the best interest of tax administration to prohibit the tax administrator from issuing guidance on laws it must enforce.

Section 530 should be replaced with a Code provision to eliminate any unnecessary confusion. In addition, the new safe harbor rule should:

1. Clearly state that it applies to both income taxes and employment taxes;
2. Require the taxpayer to have a reasonable basis to treat the worker as an independent contractor. However, in establishing reasonable basis, the taxpayer can only rely on an IRS determination or completed examination. Rather than permitting the taxpayer to rely on industry practices to establish reasonable basis, the IRS should look to industry

<sup>40</sup> For more information on the ESI, see <http://www.hmrc.gov.uk/calcs/esi.htm> (last visited on Sept. 17, 2008).

practices in reaching its decision, either in a written determination or examination. Finally, the provision would have anti-retaliation protections; and

3. Retain a substantive consistency requirement, but with a *de minimis* exception. Thus, a service recipient would still qualify for the safe harbor if it treated an individual as an employee for a brief time before changing the classification to independent contractor.

### Right to Contest IRS's Determination

Congress should amend IRC § 7436 to permit service providers to petition the United States Tax Court to litigate the classification issue or whether the worker is entitled to relief from any misclassification. Currently, IRC § 7436 only permits a service recipient that has been audited regarding employment taxes to file a petition in the Tax Court to litigate the issue. However, the service provider also incurs potentially detrimental tax consequences upon the IRS's classification determination and should have the right to petition the Tax Court to review the IRS's determination.

In addition, Congress should direct the Department of Treasury and the IRS to create procedures allowing the worker to initiate an administrative review of worker classification. The worker should also have the right to appeal any IRS classification determination.

### Information Reporting for Independent Contractors

Increasing Form 1099-MISC reporting requirements would increase compliance among independent contractors. The National Taxpayer Advocate recommends that Congress amend information reporting requirements for independent contractors in the following manner:<sup>41</sup>

- Increase the IRC § 6721(a) penalty for failing to issue Form 1099-MISC;<sup>42</sup> and
- Require service recipients to issue Form 1099-MISCs to incorporated service providers.<sup>43</sup>

### Voluntary Withholding Agreements

To reduce both underreporting by independent contractors and the controversy associated with worker classification, Congress should amend IRC § 3402(p)(3) to authorize the IRS to agree not to challenge the classification of a worker who is party to a voluntary withholding agreement. Under this arrangement, an independent contractor and a service recipient agree the service recipient will withhold taxes at a specified rate. As discussed previously, it is questionable whether the existing statutory language provides authority for Treasury to

<sup>41</sup> See *The IRS and the Tax Gap: Hearing Before the House Comm. on the Budget 5* (Feb 16, 2007) (Statement of Nina E. Olson, National Taxpayer Advocate); *Hearing Before the Subcomm. on Federal Financial Management, Government Information, and International Security, Comm. on Homeland Security and Government Affairs 21* (Oct. 26, 2005) (Statement of Nina E. Olson, National Taxpayer Advocate).

<sup>42</sup> The current penalty is \$50 for each return per return with a maximum of \$250,000 per calendar year. IRC § 6721(a)(1).

<sup>43</sup> See National Taxpayer Advocate 2007 Annual Report to Congress 494-496; National Taxpayer Advocate 2005 Annual Report to Congress 381, 394; National Taxpayer Advocate 2004 Annual Report to Congress 478, 483.

draft regulations addressing withholding agreements for non-wage compensation between service recipients and independent contractors. Thus, additional legislative action may be warranted to authorize the IRS to agree not to challenge the worker classification based on these agreements.<sup>44</sup>

### **Backup Withholding on Substantially Noncompliant Schedule C Filers**

Because income-reporting compliance is nearly 100 percent when payments are subject to withholding,<sup>45</sup> the National Taxpayer Advocate recommends that Congress amend IRC § 3406 to require a form of “back-up withholding” by the payor in cases where a Schedule C filer has a demonstrated history of substantial noncompliance with the laws. In conjunction with the back-up withholding program, Congress should authorize the Secretary to exempt payors from back-up withholding on payments to Schedule C filers who present payors with a valid IRS “Compliance Certificate.” A taxpayer would be eligible for the certificate if the taxpayer has been in compliance with prior filings and payment obligations. Noncompliant taxpayers could “redeem themselves” and reestablish eligibility for the certificates by demonstrating “substantial compliance,” which entails the satisfaction of past obligations (or arrangements to satisfy them, such as an installment agreement) and scheduling a year’s worth of estimated tax payments through the Electronic Funds Transfer Payment System (EFTPS).<sup>46</sup> The United Kingdom has had success with a similar certificate program for independent contractors in the construction industry.<sup>47</sup>

An inherent benefit of the Compliance Certificate proposal is that market forces would act to oblige independent contractors to operate among the ranks of the tax compliant. Payors could avoid the burdens associated with backup withholding if they only hire contractors that present a valid Compliance Certificate. Thus, tax compliance would become a condition of conducting business.

### **Comprehensive Report on Rules**

Congress should direct Treasury and the Joint Committee on Taxation (JCT) to issue a report within six months of enactment of the aforementioned new safe harbor rule. The report should review the current rules for worker classification and make recommendations that are fair to both parties while improving tax compliance. In preparing the report, Treasury and JCT should consult with employer and employee representatives in round-table discussions as well as other forms of communication.

<sup>44</sup> For a detailed discussion of this proposal as well as legal impediments to authorizing such agreements by regulation, see National Taxpayer Advocate 2005 Annual Report to Congress 392-394.

<sup>45</sup> IRS National Headquarters Office of Research, Tax Gap Map for Year 2001 (June 7, 2005).

<sup>46</sup> For a more detailed discussion of this proposal, see National Taxpayer Advocate 2005 Annual Report to Congress 381-396.

<sup>47</sup> For more information on the Construction Industry Scheme of Her Royal Majesty Revenue and Customs (HMRC), see <http://www.hmrc.gov.uk/cis/> (last visited September 22, 2008).

**Public Awareness Campaign**

Congress should require the IRS to collaborate with the Department of Labor to conduct targeted public awareness campaigns on worker classification. The campaigns should inform workers of the comparative rights afforded to employees and independent contractors as well as the tax consequences associated with each classification. By educating workers about their rights and benefits under each classification, the government will leave them better prepared to analyze their particular facts and circumstances, determine which classification is appropriate, and negotiate more effectively for their best interest.

LR  
#6**Simplify the Tax Treatment of Cancellation of Debt Income****Problem**

At a time when the government is taking extraordinary steps to assist individuals who stand to lose their homes to foreclosure, there is surprisingly little recognition that many of these individuals will face federal income tax consequences as a result. The same is true for individuals who default on consumer debt.<sup>1</sup> Many taxpayers will be required to include the amount of any debts written off by the lender in gross income and pay the associated tax. Some taxpayers will be entitled to exclude the amount of canceled debt from gross income, but they will have to navigate extremely challenging tax reporting requirements to do it.

When a borrower becomes unable to repay a debt and the lender cancels some or all of it, the Internal Revenue Code (IRC) generally provides that the amount of debt cancellation must be included in the gross income of the borrower.<sup>2</sup> This amount is referred to as “cancellation of debt income” (CODI). The Code also provides that in certain situations, a taxpayer may exclude CODI from gross income, including where a taxpayer is “insolvent,” (meaning that the taxpayer’s total liabilities exceed the taxpayer’s total assets)<sup>3</sup> or where “qualified” debt (also known as “qualified principal residence indebtedness”) is canceled in the course of a mortgage foreclosure.<sup>4</sup> However, the rules for claiming one of these exclusions are so complex that many and probably most taxpayers who qualify to exclude CODI from gross income do not do so. As a result, some taxpayers unnecessarily include CODI in gross income. Other taxpayers fail to report CODI and fail to claim a corresponding exclusion because they do not realize that debt forgiveness is a taxable event. These taxpayers may unnecessarily face IRS examination and tax assessment.<sup>5</sup>

The following is a list of some of the obstacles that prevent taxpayers from claiming exclusions to which they are entitled:

<sup>1</sup> According to an article in the *New York Times*, lenders wrote off an estimated \$21 billion in bad credit card loans during the first half of 2008. Eric Dash, *Consumers Feel the Next Crisis: It's Credit Cards*, *New York Times*, Oct. 29, 2008, at A1.

<sup>2</sup> IRC § 61(a)(12).

<sup>3</sup> IRC § 108(a)(1)(B).

<sup>4</sup> IRC § 108(a)(1)(E). The exclusion applies to the extent that the principal balance of the loan does not exceed \$2 million and the home is the taxpayer's principal residence.

<sup>5</sup> The IRS receives Forms 1099-C, *Cancellation of Debt*, from lenders reporting the amount of each canceled debt. The IRS document-matching program compares each Form 1099-C it receives against the tax return of the taxpayer with the same taxpayer identification number. If a canceled debt is reported to the IRS on Form 1099-C and the amount is not reported on the taxpayer's return, the discrepancy will be flagged and the taxpayer may face IRS examination and tax assessment.

1. **Requirement to File Form 982.** A taxpayer who qualifies for an exclusion does not receive it automatically. To claim an exclusion, the taxpayer must file Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness* (and *Section 1082 Basis Adjustment*). Form 982 is not simple. The IRS estimates that it takes business taxpayers ten hours and 43 minutes to complete it.<sup>6</sup> Moreover, many taxpayers and practitioners have never even encountered the form, which is not included in many tax software packages available to taxpayers.
2. **Requirement to Adjust Tax Attributes.** The main reason for the complexity of Form 982 is that taxpayers generally are required to reduce “tax attributes,” in a specified sequence, by the amount of CODI they are entitled to exclude. Among the tax attributes listed on the form are net operating losses, general business credit carryovers, minimum tax credits, net capital losses, nondepreciable and depreciable property, passive activity loss and credit carryovers, and foreign tax credit carryovers. These terms are baffling to most taxpayers. Non-business taxpayers who do not have most of these tax attributes are generally required to reduce their basis in personal property like furniture, jewelry, and clothing, and keep track of it prospectively.<sup>7</sup> Taxpayers often have no idea what this means or how practically to do it.<sup>8</sup>
3. **Qualified Principal Residence Indebtedness Exclusion.** In December 2007, Congress added the “qualified principal residence indebtedness” exclusion that generally allows homeowners whose mortgage debts are canceled in the course of a foreclosure or loan restructuring to exclude the resulting CODI from gross income.<sup>9</sup> In practice, however, many homeowners whose debts are canceled in the course of a foreclosure or loan restructuring will *not* qualify to exclude CODI from gross income. That is because the exclusion only applies with respect to funds used to *acquire or improve* a principal residence.<sup>10</sup> It appears that a significant percentage of homeowners with subprime mortgages – probably a majority – used a portion of the loan proceeds for non-qualified purposes like paying off car loans, medical bills, student loans, or credit card balances.<sup>11</sup> In these cases, the taxpayer must reduce the amount of CODI eligible for exclusion by the amount of mortgage debt used for such non-qualified purposes. Thus,

<sup>6</sup> The IRS does not provide a separate estimate of the amount of time individual taxpayers spend completing Form 982.

<sup>7</sup> However, no basis adjustment is required upon cancellation of qualified principal residence indebtedness where a taxpayer loses his home in a foreclosure. See IRS Publication 4681, *Canceled Debts, Foreclosures, Repossessions, and Abandonments* 13, *Example 2 – Mortgage loan foreclosure* (2007). Where a taxpayer retains his residence and excludes CODI solely under the qualified principal residence indebtedness exclusion, the taxpayer is required to reduce the basis in his residence by the amount of the canceled debt. IRC § 108(h)(1); IRS Pub. 4681, *Canceled Debts, Foreclosures, Repossessions, and Abandonments* 7 (2007).

<sup>8</sup> The reduction in the basis of these items of personal property is designed to increase any gain upon their disposition.

<sup>9</sup> Mortgage Forgiveness Debt Relief Act, Pub. L. No. 110-142, § 2(b) (2007).

<sup>10</sup> IRC § 108(h)(4) (providing that if only a portion of a mortgage loan constitutes “qualified principal residence indebtedness,” the qualified principal residence indebtedness exclusion applies only to the extent that the amount of debt canceled exceeds the portion of the loan that does not constitute qualified principal residence indebtedness).

<sup>11</sup> According to a federal government report issued in 2000: “The primary purpose of over 50 percent of first lien subprime mortgages and up to 75 percent of second lien subprime mortgages is debt consolidation and/or general consumer credit, not home purchase, home improvement or refinancing the rates and terms of a mortgage.” Department of Housing and Urban Development and Department of the Treasury Task Force on Predatory Lending, *Curbing Predatory Home Mortgage Lending* 26 (2000). We have not located more recent government data on this point.

despite last year's legislation, tens of thousands of taxpayers who lose their homes to foreclosure are still required to pay tax on some or all of the canceled debt unless another exclusion applies.

4. ***Insolvency Exclusion.*** The insolvency exclusion is generally designed to allow financially distressed taxpayers to exclude CODI from gross income. However, many taxpayers who qualify for the insolvency exclusion fail to claim it because they do not know it exists, do not understand the meaning of the word “insolvency,” or do not know how to claim it. In general, a taxpayer is considered insolvent if the sum of all of his liabilities exceeds the sum of all of his assets (including the value of such items as furniture, jewelry, and clothing). To claim the insolvency exclusion, it is not sufficient simply that the taxpayer know he is insolvent. Rather, the taxpayer is only entitled to claim an exclusion up to the amount of insolvency, so the taxpayer must compute the insolvent amount exactly. For example, if a taxpayer's liabilities are \$60,000 and his assets are worth \$56,500, the taxpayer is entitled to exclude up to \$3,500 in CODI from gross income; if the taxpayer has \$10,000 of CODI, he is taxable on the remaining \$6,500.
5. ***Combining Exclusions.*** In the case of a home foreclosure where a portion of the mortgage proceeds was used for nonqualified purposes, a taxpayer may be eligible to exclude some CODI under the qualified principal residence indebtedness exclusion and other CODI under the insolvency exclusion. For example, if a taxpayer takes out a mortgage for \$200,000 and uses \$25,000 to pay off medical bills and student debt, he may exclude CODI under the qualified principal residence indebtedness exclusion only to the extent that the amount of CODI exceeds \$25,000. If the taxpayer is also insolvent, he is generally entitled to exclude additional amounts up to the amount of the insolvency. Yet another provision entitles taxpayers to exclude canceled debts which would, if paid, have been deductible; for example, a taxpayer generally may exclude canceled medical bills from gross income to the extent they exceed 7.5 percent of adjusted gross income.<sup>12</sup> It is asking a lot to expect taxpayers to be cognizant of all these rules and the interaction among them.
6. ***Variation in Federal Tax Consequences Based on Taxpayer's Place of Residence.*** The federal tax treatment of CODI varies depending on the state in which the taxpayer resides. In most states, a borrower is personally liable for his debts, which means that the lender is entitled to pursue the borrower's other assets if the borrower defaults. This type of debt is referred to as “recourse” debt. In other states, including California, the lender's only remedy in case of default is generally to repossess the property that secures the debt.<sup>13</sup> This type of debt is referred to as “nonrecourse” debt. Because the lender has no right to pursue the borrower's other assets in the case of nonrecourse

<sup>12</sup> IRC § 108(e)(2).

<sup>13</sup> This result is achieved through anti-deficiency statutes. See, e.g., Cal. Civ. Proc. § 580(b); Ariz. Rev. Stat. Ann. § 33-729(A); N.C. Gen. Stat. § 45-21.38; S.D. Codified Laws Ann. § 44-8-25. In some states with anti-deficiency statutes, a lender may be able to collect additional amounts if the matter is pursued through judicial proceedings.

debt, the lender is not considered to cancel any unpaid balance and the borrower has no CODI. Most taxpayers do not understand the differences between recourse and nonrecourse debt or the fact that the tax consequences of a debt default may differ depending on where they live.

The result of having to navigate this CODI minefield is that hundreds of thousands of taxpayers have cancellation of debt income each year, but very few claim exclusions. Overall, lenders send about two million Forms 1099-C, *Cancellation of Debt*, to the IRS each year reporting CODI.<sup>14</sup> Yet it appears that *less than one percent* of taxpayers with CODI may be filing Form 982 to claim the exclusion.<sup>15</sup> Taxpayers who default on their debts are generally experiencing significant financial problems, and almost by definition, their liabilities are high relative to their assets. The National Taxpayer Advocate believes that a significant percentage of taxpayers who qualify for exclusions, particularly the insolvency exclusion, do not make claims.<sup>16</sup>

### Example

Taxpayers purchased a house for their family in 2003 for \$200,000 and took out a 30 year, fixed-rate mortgage for \$160,000 (*i.e.*, 80 percent of the purchase price). In 2005, at a time when the taxpayers had other debts of \$50,000, including student loans and two car loan balances, a representative of a subprime lending company contacted them and urged them to refinance their mortgage so they could consolidate all of their debt at a lower interest rate. The subprime lender offered a mortgage product that required interest-only payments for three years. Because real estate values were then rising, the subprime lender offered them a mortgage for \$210,000. The taxpayers refinanced and used \$50,000 to pay off their student loans and car loans.

In 2008, the monthly mortgage payment increased to include payments on principal. At that time, the principal balance of the mortgage was still \$210,000, but the value of the house had fallen to \$170,000. The taxpayers could not make the higher payments, so the lender foreclosed and sold the house. The mortgage was considered recourse debt, and the lender canceled the remaining \$40,000 balance. The borrowers received a Form 1099-C from the lender reporting \$40,000 of CODI. Although Congress passed legislation generally

<sup>14</sup> IRS Document 6961, Table 2 (showing that the IRS expects to receive about 1.9 million Forms 1099-C in 2008 and about 2.1 million Forms 1099-C in 2009).

<sup>15</sup> For tax year 2005, the IRS received 495,495 electronically filed returns from taxpayers who had cancellation of debt income reported on a Form 1099-C. IRS Compliance Data Warehouse, Information Returns Master File and Individual Returns Transaction File (Tax Year 2005). By comparison, the IRS received only 4,571 electronically filed Forms 982 for that time period. IRS E-File Reports (Processing Year 2006). Note that the number of electronically filed returns actually was greater than 495,495 because our data search only reflects Forms 1099-C issued to taxpayers listed with the primary taxpayer identification number (TIN) on a tax return. It does not reflect cases where a spouse or a person whose TIN was listed as other than the primary TIN received a Form 1099-C. Note, too, that the data excludes returns filed on paper, which represented slightly less than half of all individual income tax returns filed. We could not determine how many Forms 982 were submitted with paper-filed returns.

<sup>16</sup> For a more detailed description of the complexity of the CODI rules and the tax administration problems arising from that complexity, see Most Serious Problem: *Understanding and Reporting the Tax Consequences of Cancellation of Debt Income*, *supra*. See also National Taxpayer Advocate 2007 Annual Report to Congress 13-34 (Most Serious Problem: *Tax Consequences of Cancellation of Debt Income*).

allowing taxpayers to exclude CODI arising from foreclosures, the exclusion provides that only CODI in excess of amounts borrowed for non-qualified purposes may be excluded. Since these taxpayers borrowed \$50,000 for non-qualified purposes, they are not entitled to exclude any portion of the CODI under the qualified principal residence indebtedness exclusion.

The taxpayers may be able to exclude some or all of the CODI under the insolvency exclusion. To make that determination, the taxpayers must compute the value of all their assets and all their liabilities. The fair market value of many assets, including cars, furniture, and clothing, is not clear-cut, requiring them to make judgments and develop substantiation in case they are later audited. If they wish to claim an exclusion, they must file Form 982 and make adjustments to their tax attributes. This is a particularly challenging exercise if one of the taxpayers is engaged in a trade or business.

If the taxpayers do not realize they have CODI or are not familiar with the CODI rules (perhaps, for example, because they lost their home and the Form 1099-C never reached them), they may fail to report the income or claim the exclusion. In that case, the IRS's document-matching system will generally flag the CODI amount as unreported income, and the IRS may issue a notice proposing additional tax. Once this notice is issued, the taxpayers at best will have to spend time understanding and responding to the notice to avoid a tax assessment. At worst, the taxpayers will not respond or will not respond adequately, and the IRS will assess tax that the taxpayers may not owe.

### Recommendation

The National Taxpayer Advocate recommends that Congress pass legislation to make it easier for financially distressed taxpayers to exclude CODI from gross income. As discussed above, Congress established a general rule that CODI is includible in gross income but also created certain exclusions that generally are geared toward providing relief for taxpayers who are experiencing financial difficulties.

We suggest three options for consideration:

1. *Provide that CODI is not includable in gross income unless the total amount of CODI attributable to the taxpayer from all sources exceeds a certain threshold for the taxable year.* This would be the simplest option for taxpayers, because they would be relieved of the burden of learning about and filing Form 982 to claim an exclusion. The IRS could automatically program its computers to ignore CODI if the sum of CODI reported on Forms 1099-C with respect to the taxpayer falls below the threshold. The threshold should be set at a level high enough to provide relief to a majority of the financially distressed taxpayers whom the proposal is designed to assist and low enough to prevent widespread abuses that could undermine the general rule that CODI is taxable.

2. *Provide that taxpayers with CODI below a certain threshold do not need to make adjustments to their tax attributes.* This option is less attractive in that taxpayers would still have to file Form 982, would still have to distinguish between “qualified” and “non-qualified” indebtedness for purposes of the qualified principal residence indebtedness exclusion, and would still have to compute insolvency.<sup>17</sup> But it would create a more limited exception to the general rule that CODI is taxable than would be the case under option 1, while alleviating some taxpayer burden and reducing record-keeping requirements.
3. *Amend the definition of “qualified principal residence indebtedness” to provide that the full amount of canceled mortgage debt qualifies for exclusion, even if a portion of the proceeds was used to pay off non-residential debt like car loans, medical bills, student loans, or credit card balances.*<sup>18</sup> This option would provide complete relief from CODI tax liability attributable to mortgage debt cancellation for most homeowners or persons who have lost their homes. However, it would not relieve taxpayers of the burden of filing Form 982 to claim the exclusion or provide any relief to taxpayers who have CODI from canceled debts (*e.g.*, car loans, medical bills, student loans, or other consumer debt) that are not rolled into a mortgage.<sup>19</sup>

<sup>17</sup> If taxpayers are not required to adjust tax attributes, the National Taxpayer Advocate recommends that the IRS create a simplified Form 982-EZ for their use. The National Taxpayer Advocate also recommends that the IRS develop and provide a worksheet that taxpayers may use for purposes of computing whether and to what extent they are insolvent. For additional detail, see Most Serious Problem: *Understanding and Reporting the Tax Consequences of Cancellation of Debt Income, supra*.

<sup>18</sup> This could be accomplished by redefining “qualified principal residence indebtedness” in IRC § 108(h)(2) as acquisition indebtedness under IRC § 163(h)(3)(B)(i) or home equity indebtedness under IRC § 163(h)(3)(C)(i). Interest on amounts borrowed under home equity lines of credit is currently deductible, so this change would align the tax treatment of interest on the debt with the tax treatment of cancellation of the debt.

<sup>19</sup> Our understanding is that the majority of canceled debts are not mortgage-related, so it may be desirable to combine this option with option (1).

LR  
#7**Eliminate (or Reduce) Procedural Incentives for Lawmakers  
to Enact Tax Sunsets****Problem**

Tax law changes are increasingly subject to sunsets, *i.e.*, they are more often set to expire. The Joint Committee on Taxation (JCT) and Congressional Budget Office (CBO) recently identified more than 100 temporary tax provisions, up from about 21 in 1992.<sup>1</sup> According to government estimates, the cost of extending provisions that expired in 2008 (called “extenders”) into 2009 is about \$100 billion and the ten year cost of extending provisions expiring before 2018 is nearly four trillion dollars.<sup>2</sup> Sunsets burden both taxpayers and the IRS, often for no compelling reason. According to the President’s bipartisan Advisory Panel on Federal Tax Reform:

Frequent changes in the tax code, which often add to or undo previous policies, as well as the enactment of temporary provisions, result in uncertainty for businesses and families. This volatility is harmful to the economy and creates additional compliance costs.<sup>3</sup>

Similarly Peter Orszag, Director of the CBO and President-Elect Obama’s announced nominee to serve as Director of the Office of Management and Budget, co-authored an article on tax sunsets in 2003 with William Gale, co-director of the Tax Policy Center, which observed:

Recent [tax] sunsets have been motivated by the desire to manipulate budget rules and hide the likely cost of new tax cuts... leave policymakers in the future with less flexibility than they would otherwise have... [and have] create[d] needless uncertainty over the future structure of the tax code.<sup>4</sup>

More specifically, tax sunsets make it difficult for both the government and taxpayers to plan ahead, especially when significant questions exist about whether Congress will extend a provision that is set to expire. The complexity and uncertainty caused by sunsets

<sup>1</sup> Compare William G. Gale and Peter R. Orszag, Tax Policy Center, *Sunsets in the Tax Code*, 99 Tax Notes 1553 (June 9, 2003) (describing 21 tax provisions set to expire over a five-year period as of January 1992) with Joint Committee on Taxation, JCX-1-08, *List of Expiring Federal Tax Provisions, 2007-2020* (Jan. 11, 2008) (listing 123 expiring provisions, but not separately listing each provision of the Economic Growth and Tax Relief Reconciliation Act of 2001, which are all scheduled to sunset at the end of 2010) and Congressional Budget Office, *Updated Estimates for Table 4-9, Effects of Extending Tax Provisions Scheduled to Expire Before 2018*, The Budget and Economic Outlook: Fiscal Years 2008 to 2018, 101-106 (Jan. 2008) (hereinafter, “CBO Estimate”) (listing 102 expiring provisions).

<sup>2</sup> Joint Committee on Taxation, JCX-78-08, *Estimated Budget Effects of the Tax Provisions Contained in an Amendment in the Nature of A Substitute to H.R. 1424*, 7-13 (Oct. 1, 2008) (estimating the cost of extenders for 2009 as \$79 billion for extension of the AMT patch, \$6 billion for extensions affecting individuals, \$14 billion for extensions affecting businesses, and about 3 billion for temporary disaster relief); CBO Estimate (estimating the total cost as \$3.9 trillion).

<sup>3</sup> Report of the President’s Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America’s Tax System*, xiii (Nov. 2005).

<sup>4</sup> William G. Gale and Peter R. Orszag, Tax Policy Center, *Sunsets in the Tax Code*, 99 Tax Notes 1553 (June 9, 2003).

reduce the effectiveness of tax incentives, make it harder for taxpayers to estimate their tax liabilities and pay the correct amount of estimated taxes, make it more difficult for the IRS to administer the law, and likely reduce tax compliance.<sup>5</sup>

While any tax law change is burdensome and any change that is set to expire is more so, some changes are scheduled to expire for valid tax policy reasons that justify the burden. For example, these changes may be temporary to address a temporary problem or to allow time to evaluate the effectiveness of a new tax incentive before committing significant resources to it. According to some observers, however, policymakers generally do not review the unique strengths and weaknesses of specific expiring (or expired) provisions before extending them.<sup>6</sup> Moreover, some tax sunsets are adopted solely to reduce the apparent cost to the federal government of providing popular tax benefits by granting the benefit for only a limited period or to avoid some of Congress' procedural rules. These sunsets (which we call "budget-driven" sunsets) cannot be justified based on substantive policy considerations.<sup>7</sup> Procedural rules, such as the Pay-As-You-Go (PAYGO) rules, "section 302 spending allocation" limits, budget scoring rules, and the "Byrd" rule, described below, provide incentives for lawmakers to enact sunsets. However, sunsets may be more costly than lawmakers realize if they increase noncompliance and raise tax administration costs and burdens for both the government and taxpayers.

## Examples

The following examples illustrate how sunsets can make tax planning difficult, confuse taxpayers, and complicate tax administration.

### Example 1: Sunsets increase complexity.

Congress has repeatedly enacted temporary "patches" to keep the alternative minimum tax (AMT), which is not indexed for inflation, from affecting a growing number of taxpayers.<sup>8</sup> The AMT requires taxpayers to compute their (tentative) tax liability twice – once under the regular tax rules and once under special AMT rules. It generally requires taxpayers to modify their computation of regular taxable income by taking into account the addition or subtraction of certain items (called adjustments and preferences), and then applying a basic exemption and special marginal rates to compute the "tentative minimum tax."<sup>9</sup> The taxpayer then compares this "tentative minimum tax" liability to his or her regular tax

<sup>5</sup> As described below, sunsets may reduce compliance by confusing taxpayers, making it more difficult for them to pay sufficient estimated tax payments.

<sup>6</sup> See Pamela J. Jackson and Jennifer Teefy, Congressional Research Service, RL 32367, *Certain Temporary Tax Provisions ('Extenders') Expired in 2007* (Oct. 8, 2008), reprinted as, *CRS Updates Report on Temporary Tax Provisions*, 2008 TNT 203-84, 2 (Oct. 20, 2008) (noting the extension of expiring provisions are generally lumped together as an "extenders" package).

<sup>7</sup> One commentator has argued that sunsets may be justified on the basis that permanent provisions often have unexpected costs that cannot be included in budget estimates, such as costs that extend beyond the applicable budget window. See George Yin, *Temporary-Effect Legislation and Fiscal Responsibility*, Colloquium on Tax Policy and Public Finance (Spring 2007).

<sup>8</sup> For a discussion of the problems created by the AMT, see, e.g., Legislative Recommendation, *Repeal the Alternative Minimum Tax for Individuals*, supra/infra, National Taxpayer Advocate 2001 Annual Report to Congress 166.

<sup>9</sup> See generally, IRC §§ 55, 56, 57, 58, 59.

liability and generally pays the greater of the two. This complexity makes it difficult for many taxpayers to predict how much they will owe.

Tax sunsets exacerbate these difficulties. In 2001, Congress increased the AMT exemption level to partially adjust it for inflation and prevent the AMT from affecting a larger number of taxpayers.<sup>10</sup> However, this so-called AMT “patch” was set to expire for tax years beginning after 2004.<sup>11</sup> On October 4, 2004, Congress extended the patch to tax years beginning in 2005.<sup>12</sup> On May 17, 2006, after the patch expired, Congress retroactively extended it to tax years beginning in 2006.<sup>13</sup> On December 26, 2007, Congress again retroactively extended the patch to tax years beginning in 2007.<sup>14</sup> After this patch expired, Congress retroactively extended it for another one-year period.<sup>15</sup>

The continuing state of uncertainty surrounding the already-complex AMT makes it more difficult for taxpayers to predict and plan to meet their tax obligations. Not only does such uncertainty reduce taxpayers’ ability to plan long-term expenditures, such as where they can afford to live or send their children to school,<sup>16</sup> but the uncertainty also makes it more difficult for taxpayers to comply with existing estimated tax payment requirements.<sup>17</sup> Retroactive AMT patches enacted late in the year further exacerbate these difficulties.

**Example 2: Sunsets promote costly retroactive and late-year tax law changes.**

On December 20, 2006, Congress retroactively extended a number of expiring (and expired) tax provisions, including the research tax credit, the state and local sales tax deduction,

<sup>10</sup> The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), Pub. L. No. 107-16, 115 Stat. 38 § 701 (2001) (codified, as amended, at IRC § 55(d)(1)).

<sup>11</sup> EGTRRA increased the exemption amount from \$45,000 to \$49,000 for married individuals filing joint returns and from \$33,750 to \$35,750 for singles. *Id.* The Job Creation and Worker Assistance Act of 2002 (JCWAA), Pub. L. No. 107-147, 116 Stat. 21 § 601 (2002) extended other temporary provisions that allowed individuals to use personal tax credits against their AMT liability through December 31, 2003. The Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRA), Pub. L. No. 108-27, 117 Stat. 752 § 106(a)(1) (2003) increased the AMT exemption level from \$49,000 to \$58,000 for married individuals filing joint returns and from \$35,750 to \$40,250 for singles for tax years beginning in 2003 and 2004.

<sup>12</sup> Working Families Tax Relief Act of 2004 (WFTRA), Pub. L. No. 108-311, 118 Stat. 1168 § 103 (2004). WFTRA § 312 also retroactively extended the provision allowing personal tax credits to offset AMT liability for tax years 2004 and 2005. On October 22, 2004, the American Jobs Creation Act of 2004 (AJCA), Pub. L. No. 108-357, 118 Stat. 1418 § 314(a) (2004) provided AMT relief to farmers and fisherman so that their use of income averaging rules would not subject them to the AMT.

<sup>13</sup> Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA), Pub. L. No. 109-222, 120 Stat. 345 § 301(a)(1) (2006). TIPRA retroactively increased the exemption amount from \$58,000 to \$62,550 for married individuals filing joint returns and from \$40,250 to \$42,500 for singles for tax years beginning in 2006. *Id.*

<sup>14</sup> Tax Increase Prevention Act of 2007 (TIPA), Pub. L. No. 110-166, 121 Stat. 2461 (2007). TIPA retroactively increased the exemption amount from \$62,550 to \$66,250 for married individuals filing joint returns and from \$42,500 to \$44,350 for singles for tax years beginning in 2007.

<sup>15</sup> IRC § 55(d), as amended by Pub. L. No. 110-343, 122 Stat. 3,765, Division C, § 102 (2008) (retroactively increasing the 2008 AMT exemption amount from \$66,250 to \$69,950 for married individuals filing joint returns and from \$44,350 to \$46,200 for singles for tax years beginning in 2008).

<sup>16</sup> See Manoj Viswanathan, *Sunset Provisions in the Tax Code: A Critical Evaluation and Prescriptions for the Future*, 82 N.Y.U. L. Rev. 656, 675-679 (May 2007) (describing how sunsets reduce a taxpayer’s ability to make economically efficient decisions).

<sup>17</sup> Taxpayers are generally required to make annual estimated tax payment of the lesser of 90 percent of the individual’s current year tax liability or 100 percent of the individual’s tax for the prior year. See IRC § 6654(d).

the higher education deduction, and the educator's classroom expense deduction.<sup>18</sup> These sunsets resulted in late-year tax law changes, as lawmakers worked to extend expiring provisions before the end of the year – too late for the IRS to revise its tax forms, for tax software companies to update their shrink-wrapped software packages, for taxpayers to adjust their withholding, or for taxpayers to adjust their behavior to take advantage of the extended tax incentives. Probably as a result of late-year extenders, taxpayers ultimately claimed these deductions about 1.4 million fewer times in tax year 2006 than in 2005, when the deductions were included in the Form 1040, *U.S. Individual Income Tax Return*, instructions and built into tax software.<sup>19</sup>

### Example 3: Sunsets increase the cost of tax planning.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) gradually increases the estate tax exemption amount, gradually reduces rates, and then eliminates the estate tax in 2010.<sup>20</sup> However, since EGTRRA expires in 2010, the estate tax, including 2001 rates and exemption amounts, is set to return in 2011.<sup>21</sup> Because of the uncertainty created by this sunset, many taxpayers will be advised to set up more complicated and costly estate plans than they would otherwise need.<sup>22</sup>

### Recommendation

The National Taxpayer Advocate recommends that Congress consider ways to ensure that procedural rules, such as PAYGO rules, “section 302 spending allocation” limits, budget scoring rules, and the “Byrd” rule, do not provide an inappropriate incentive for legislators to enact tax laws with sunset provisions.

<sup>18</sup> Tax Relief and Health Care Act of 2006, Pub. L. No. 109-432, 120 Stat. 2,922 (2006). The research credit (codified at IRC § 41), enacted in 1981 as a temporary provision, has been extended 11 times between 1981 and 2004. See Gary Guenther, Congressional Research Service, RL31181, *Research Tax Credit: Current Status, Legislative Proposals in the 109th Congress, and Policy Issues* 10, 18 (Sept. 22, 2006). Section 501 of the American Jobs Creation Act of 2004 (AJCA), Pub. L. No. 108-357, 118 Stat. 1,418 (2004) first enacted the sales tax deduction (codified at IRC § 164) for tax years beginning after December 31, 2003, and before January 1, 2006. Section 431(a) of EGTRRA first enacted the qualified higher education expense deduction (codified at IRC § 222) for payments made after December 31, 2001, for tax years beginning on or before December 31, 2005. Section 406(a) of JCWAA first enacted the educator's classroom expense deduction (codified at IRC § 62(a)(2)(D)) for tax years beginning during 2002 or 2003. On October 4, 2004, § 307(a) of WFTRA retroactively extended the educator's deduction for tax years 2004 and 2005.

<sup>19</sup> See National Taxpayer Advocate 2007 Annual Report to Congress 3, 6-7 (Most Serious Problem: *The Impact of Late-Year Tax-Law Changes on Taxpayers*).

<sup>20</sup> Pub. L. No. 107-16, 115 Stat. 38 §§ 501, 511, 521 (2001).

<sup>21</sup> Pub. L. No. 107-16, 115 Stat. 38 (2001). For a description of related problems, see National Taxpayer Advocate 2005 Annual Report to Congress 442 (Key Legislative Recommendation: *Tracking Cost Basis as a Result of Estate Tax Repeal*).

<sup>22</sup> See, e.g., Testimony of Conrad Teitell, Principal, Cummings & Lockwood, LLC before the United States Senate Committee on Finance, *Federal Estate Tax – Uncertainty in Planning Under Current Law* (Nov. 14, 2007).

## Present Law

### “Pay As You Go” (PAYGO) Rules

Tax legislation may be subject to procedural rules commonly known as “Pay-As-You-Go” (PAYGO).<sup>23</sup> PAYGO generally allows a member of Congress to raise a “point of order” with respect to a provision that would result in a net increase in mandatory spending or revenue reductions (*e.g.*, tax cuts) over various multi-year periods – the current fiscal year plus five years and the current fiscal year plus ten years. If a PAYGO point of order is sustained, the provision is eliminated from the bill unless the Rules Committee in the House or three-fifths of the Senate (whichever is applicable) waives the point of order or exempts the bill from PAYGO.<sup>24</sup> A member of Congress can use a sunset to reduce the apparent cost of a tax cut so that another member cannot challenge it by raising a PAYGO point of order.<sup>25</sup>

### Section 302 Spending Allocations

Tax legislation included in a reconciliation bill – a bill subject to special streamlined procedural rules – may also be subject to “section 302 spending allocation” limits which provide similar incentives for legislators to enact temporary tax provisions. The Congressional Budget Act of 1974 streamlined the process for passing certain legislation.<sup>26</sup> Pursuant to the act, Congress first passes a budget resolution, which sets out Congress’ goals for each category of revenue and spending for at least five fiscal years by assigning “section 302 spending allocations” that limit spending for each category.<sup>27</sup> If tax-writing committees want to include tax cuts in excess of the section 302 allocation, they must also include

<sup>23</sup> Statutory PAYGO rules enacted as part of the Budget Enforcement Act of 1990 (Title XIII of the Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. 1,388) were effective from fiscal year (FY) 1986 through FY 2002. Under these rules, a PAYGO violation could result in sequestration – across the board cuts in nonexempt direct spending programs – if the Office of Management and Budget determined that revenue and direct spending legislation enacted for the immediate fiscal year yielded a net cost. See, *e.g.*, Robert Keith, Congressional Research Service, RL34300, *Pay-As-You-Go Procedures for Budget Enforcement* (Dec. 31, 2007). Today the operative PAYGO rules do not automatically result in across the board cuts. Rather, the House and Senate have adopted non-statutory PAYGO rules that are enforced when individual members raise a PAYGO point of order. *Id.*; S. Con. Res. 21, 110th Cong. (2007); H. Res. 6, 110th Cong. (2007).

<sup>24</sup> See, *e.g.*, Robert Keith, *Congressional Research Service*, RL33850, *The House’s “Pay-As-You-Go” (PAYGO) Rule in the 110th Congress: A Brief Overview*, 5 (Jan. 31, 2007). Three-fifths of the Senate is 60 votes if no seats are vacant. A simple majority is generally all that is required to waive the PAYGO rules in the House. *Id.*

<sup>25</sup> There are a number of similar procedural rules. For example, section 321 of the Conference Report to the Concurrent Resolution on the Budget for Fiscal Year 2008 described a provision that would subject certain tax cuts to a point of order in the House unless they were contingent on a later determination that the government will actually receive revenues projected to offset the tax cuts with surpluses through 2012. H. Conf. Rep. 110-153 (explained on page 121). Another provides for a point of order against increasing the long-term deficit, *i.e.*, increasing the deficit in any of four ten-year periods. See S. Con. Res. 21, 110th Cong. 1st Sess. § 201 (2007); H. Conf. Rep. 110-659, 130 (2008) (describing various budget-related points of order that remain in effect for 2009).

<sup>26</sup> Titles I-IX of the Congressional Budget and Impoundment Control Act of 1974, Pub. L. No. 93-344, 88 Stat. 297 (1974) (as amended and codified at 2 U.S.C. §§ 621-692) are cited as the “Congressional Budget Act of 1974.”

<sup>27</sup> See, *e.g.*, 2 U.S.C §§ 631 (providing a timetable), 632 (describing the content of the concurrent resolution on the budget), 633 (describing spending allocations to committees), 633 (requiring the spending allocations to cover at least five years), 636 (describing procedural limits applicable to concurrent resolutions), 641(a) (describing the reconciliation directives to be included in the concurrent resolution); Robert Keith, Congressional Research Service, RL33850, *The House’s “Pay-As-You-Go” (PAYGO) Rule in the 110th Congress: A Brief Overview 4* (Jan. 31, 2007) (noting that budget resolutions sometimes cover up to ten years, plus the current year). The FY 2008 Senate Budget Resolution prohibits consideration of reconciliation legislation that would increase a deficit or reduce a surplus for the sum of years 1-6 (2007-2012) or the sum of years 1-11 (2007-2017). S. Con. Res. 21, 110th Cong. 1st Sess. (2007). The FY 2009 concurrent budget resolutions did not change the PAYGO rules. See S. Con. Res. 70, 110th Cong. (2008); H. Con. Res. 312, 110th Cong. (2008). These resolutions are sometimes called “nonbinding” because they are not signed by the President and do not have the force of law.

additional revenue-raising measures so the legislation meets the allocation limits on a net basis. Then the Budget Committee generally incorporates provisions drafted by each committee with jurisdiction over the matters covered by the budget resolution into an omnibus budget reconciliation bill. The reconciliation bill is subject to special procedural rules that limit the opportunity for debate (or filibuster) and the opportunity for members to offer amendments that are not “germane” or are “extraneous.”<sup>28</sup>

As with a PAYGO violation, a member can generally raise a “point of order” with respect to any provision in a reconciliation bill that increases spending above or reduces revenue below the section 302 spending allocation levels established by the concurrent budget resolution for years covered by the resolution.<sup>29</sup> Thus, like the PAYGO rules, the section 302 spending allocation limits encourage legislators to use sunsets to reduce the apparent cost of a tax cut over the multi-year budget-scoring period.<sup>30</sup>

### The Byrd Rule

The Byrd Rule virtually requires any tax cut in a reconciliation bill to sunset. It is a statutory rule that generally prevents special-interest provisions, such as those unrelated to the budget, from receiving the benefit of the streamlined reconciliation process in the Senate.<sup>31</sup> The rule allows a senator to raise a point of order against any “extraneous” provision in a reconciliation bill or resolution.<sup>32</sup> However, Congress was also concerned about the use of provisions that increased revenue or reduced spending during the period covered by a reconciliation bill, but had the opposite effect afterwards.<sup>33</sup> In 1987, Congress expanded the definition of “extraneous” to include a provision that “increases... net outlays, or ...decreases... revenues during a fiscal year after the fiscal years covered by such reconciliation bill...”<sup>34</sup> Thus, the Byrd Rule now discourages legislators from accelerating revenue that would otherwise be received outside of the fiscal years covered by the reconciliation bill to meet the section 302 spending allocation limits. However, when tax cut provisions are included in a reconciliation bill, the rule encourages legislators to make them temporary.<sup>35</sup> Because tax cuts that do not sunset decrease revenues “during a fiscal year after the fiscal

<sup>28</sup> See, e.g., 2 U.S.C. §§ 641(d) (describing procedural limits applicable to reconciliation bills) and 641(e) (same). For further discussion of these processes, see, e.g., Robert Keith and Bill Heniff Jr., RL33030, Congressional Research Service, *The Budget Reconciliation Process: House and Senate Procedures* (Aug. 10, 2005); Robert Keith, RL30862, Congressional Research Service, *The Budget Reconciliation Process: The Senate’s “Byrd Rule”* (Apr. 7, 2005); Michael W. Evans, *The Budget Process and the “Sunset” Provisions of the 2001 Tax Law*, 99 Tax Notes 405 (Apr. 21, 2003).

<sup>29</sup> See, e.g., 2 U.S.C. § 642(a).

<sup>30</sup> See, e.g., George Yin, *Temporary-Effect Legislation and Fiscal Responsibility*, Colloquium on Tax Policy and Public Finance (Spring 2007) (noting: “Due to the very gradual phase-in of the repeal and the sunset of the repeal [of certain tax cuts enacted in 2001] as of December 31, 2010, the provision was estimated to cost about \$138 billion over the budget window, or roughly one-fifth of the estimated cost had the repeal been in effect throughout the period.”).

<sup>31</sup> See 2 U.S.C. § 644(a).

<sup>32</sup> See *id.*

<sup>33</sup> Michael W. Evans, *The Budget Process and the “Sunset” Provisions of the 2001 Tax Law*, 99 Tax Notes 405 n. 38 (Apr. 21, 2003) (quoting 1999 statements by the former chair of the Senate Finance Committee, Senator Roth, explaining concerns that prompted the 1987 change to the Byrd rule).

<sup>34</sup> Pub. L. No. 100-119, Title II, § 205 (1987) (codified, as amended, at 2 U.S.C. § 644(b)(1)(E)).

<sup>35</sup> Use of the reconciliation process to enact tax cuts (rather than to raise revenue) was somewhat controversial. See, e.g., Michael W. Evans, *The Budget Process and the “Sunset” Provisions of the 2001 Tax Law*, 99 Tax Notes 405 (Apr. 21, 2003).

years covered by such reconciliation bill," they are considered extraneous. Thus, a member can raise a Byrd Rule point of order to strike tax cuts from a reconciliation bill unless the tax cuts expire during the fiscal years covered by the bill.<sup>36</sup>

### Budget Scoring Rules

Under the PAYGO rules, the House and Senate budget committees determine the budget effect of a provision by using baseline estimates computed in a manner consistent with § 257 of the Balanced Budget and Emergency Deficit Control Act of 1985 (codified at 2 U.S.C. § 907).<sup>37</sup> Similarly, in assessing compliance of a provision with a section 302 spending allocation provided under a budget resolution, the budget committees rely on CBO and JCT estimates, which continue to use the principles of section 257 of the Balanced Budget and Emergency Control Act of 1985 for scoring purposes, even though they are not statutorily required to do so.<sup>38</sup> Pursuant to section 257 of the Balanced Budget and Emergency Deficit Control Act of 1985, these estimates ignore sunsets applicable to programs with estimated current-year outlays greater than \$50 million.<sup>39</sup> However, budget estimates do not ignore sunsets applicable to tax cuts, even if current-year outlays for the tax cut are estimated to represent more than \$50 million. Thus, the scoring methodology does not provide an incentive for legislators to use sunsets to reduce the apparent cost of significant spending programs, but does provide an incentive for them to use sunsets to reduce the apparent cost of significant tax cuts.

### Reasons for Change

Tax law changes are increasingly subject to sunsets. In January 1992, the tax code included 21 provisions that were set to expire.<sup>40</sup> In contrast, the JCT and the CBO recently published lists of more than 100 temporary tax provisions.<sup>41</sup>

<sup>36</sup> As an example, in 1999, H.R. 2488, a reconciliation bill, included tax cuts and two provisions that were crafted in anticipation of a Byrd Rule challenge: (1) section 1501 sunset the tax cuts at the end of 2009, thereby complying with the Byrd Rule; and (2) section 1502 would have reversed the sunset by reinstating all of the tax cuts on the first day of 2010. After a senator raised a Byrd Rule point of order, section 1502 was deleted. See Michael W. Evans, *The Budget Process and the "Sunset" Provisions of the 2001 Tax Law*, 99 Tax Notes 405 (Apr. 21, 2003).

<sup>37</sup> See Section 405 of Title IV of H. Res. 6, 110th Cong. (2007), *reprinted at*, 153 Cong. Rec. H19, H22 (daily ed. Jan. 4, 2007), *adopted at*, 153 Cong. Rec. H82-H83 (daily ed. Jan. 5, 2007) (adopted as new Clause 10 of House Rule XXI); S. Con. Res. 21, 110th Cong. § 201 (2007). In the House, the estimates prepared by the Budget Committee must be "relative to" the most recent baseline estimates supplied by the CBO. Although section 257 of the Balanced Budget and Emergency Deficit Control Act of 1985 expired on September 30, 2006, CBO will continue to follow its procedures. Pub. L. No. 105-33, 111 Stat. 251 § 10212 (1997) (codified at 2 U.S.C. § 900 (note)); Robert Keith, Congressional Research Service, RL33850, *The House's "Pay-As-You-Go" (PAYGO) Rule in the 110th Congress: A Brief Overview*, 5 (Jan. 31, 2007). In adopting and revising section 257, in reconciliation legislation in 1990 and 1997, respectively, the conferees included scorekeeping rules in the joint explanatory statements accompanying the conference reports on those measures. These rules are incorporated into Appendix A of Office of Management and Budget Circular A-11 (July 2007).

<sup>38</sup> See 2 U.S.C. §§ 639, 653, 658b (scoring and other reporting requirements); 2 U.S.C. § 642 (budget resolution limitations).

<sup>39</sup> See 2 U.S.C. § 907(b)(2)(A) (sunset rule).

<sup>40</sup> William G. Gale and Peter R. Orszag, Tax Policy Center, *Sunsets in the Tax Code*, 99 Tax Notes 1553 (June 9, 2003) (describing tax provisions set to expire over a five-year period as of January 1992).

<sup>41</sup> See Joint Committee on Taxation, JCX-1-08, *List of Expiring Federal Tax Provisions, 2007-2020* (Jan. 11, 2008) (listing 123 expiring provisions, but not separately listing each provision of the Economic Growth and Tax Relief Reconciliation Act of 2001, which are all scheduled to sunset at the end of 2010); CBO Estimate (listing 102 expiring provisions).

While any tax law change is burdensome and any change that is set to expire is more so, some sunsets, such as those applicable to temporary disaster relief or one-time economic stimulus initiatives, expire for obvious policy reasons. Since they apply to one-time events, they do not even need to expire to be temporary.<sup>42</sup> Others may expire because Congress would like to see the effect of a provision on taxpayer behavior before making it permanent, a reasonable policy justification. According to some observers, however:

[p]olicymakers have for the most part, considered the extenders [provisions further extending temporary tax provisions] as a group during the enactment process, and have not reviewed the unique strengths and weaknesses of specific provisions.<sup>43</sup>

Moreover, budget-driven tax sunset provisions cannot be justified on the basis of compelling non-procedural tax policy considerations. For example, the EGTRRA reduced tax rates, created a ten percent tax bracket, increased the child tax credit, phased out the estate tax, and provided relief from the AMT and the marriage penalty.<sup>44</sup> All of these changes were set to expire after 2010 or earlier.<sup>45</sup> Some believe there is no good policy justification for allowing these basic tax rule changes to expire.<sup>46</sup>

Legislators reportedly included these sunset provisions in EGTRRA so they could pass tax cuts using the reconciliation process while avoiding a Byrd Rule point of order in the Senate, rather than because the sunsets necessarily made sense from a policy perspective.<sup>47</sup>

### **Sunsets promote burdensome retroactive and late-year tax law changes.**

When legislators enact tax cuts and make them temporary for procedural reasons, they leave future Congresses scrambling to extend the cuts, often late in the year and sometimes after the provisions have expired. Taxpayers and IRS employees need to relearn the law

<sup>42</sup> For example, Section 403 of the Katrina Emergency Tax Relief Act of 2005, Pub. L. No. 109-73, 119 Stat. 2,016 (2005), amended IRC § 7508A, allowing the IRS to provide relief to taxpayers determined to be in a disaster area affected by Hurricane Katrina. This provision did not need to expire because it was limited by the fact that it only allowed relief with respect to a single event.

<sup>43</sup> Pamela J. Jackson and Jennifer Teefy, Congressional Research Service, RL 32367, *Certain Temporary Tax Provisions ('Extenders') Expired in 2007* (Oct. 8, 2008), reprinted as, *CRS Updates Report on Temporary Tax Provisions*, 2008 TNT 203-84, 2 (Oct. 20, 2008).

<sup>44</sup> Pub. L. No. 107-16, 115 Stat. 38 (2001).

<sup>45</sup> Pub. L. No. 107-16, 115 Stat. 38 § 901 (2001) (codified in a note under IRC § 1).

<sup>46</sup> See, e.g., William G. Gale and Peter R. Orszag, Tax Policy Center, *Sunsets in the Tax Code*, 99 Tax Notes 1553 (June 9, 2003). See also Elizabeth Garrett, *Accounting For The Federal Budget And Its Reform*, 41 Harv J. Legis. 187, 196 (Winter 2004) (noting that although “there is no legal commitment that requires Congress to extend these provisions... there is a political commitment.” Thus, sunsets allow lawmakers “to mask the long-term cost of tax reduction bills”); Rebecca M. Kysar, *The Sun Also Rises: The Political Economy of Sunset Provisions in the Tax Code*, 40 Ga. L. Rev. 335 (Winter 2006) (same); Cheryl D. Block, *Pathologies at the Intersection of the Budget and Tax Legislative Processes*, 43 B.C. L. Rev. 863, 912 (July 2002) (quoting Gene Steuerle as stating that “[A]s a matter of tax policy, ... the rules have not worked well, and the tax code is again being made more complex and more unfair with the passage of each new act.”). But see, George Yin, *Temporary-Effect Legislation and Fiscal Responsibility*, Colloquium on Tax Policy and Public Finance (Spring 2007) (arguing that temporary provisions help ameliorate the budget deficit, in part, because permanent provisions sometimes have significant and unexpected costs that are not included in budget estimates). For a description of many of these provisions and recent legislative efforts to extend the provisions, see Maxim Shvedov, Congressional Research Service, *Expiration and Extension of the Individual Income Tax Cuts Enacted in 2001 Through 2007* (Mar. 26, 2008), reprinted as, Maxim Shvedov, *CRS Reviews History of 2001 Tax Cuts, Extensions*, 2008 TNT 62-61 (Mar. 31, 2008).

<sup>47</sup> See, e.g., Maxim Shvedov, *CRS Reviews History of 2001 Tax Cuts, Extensions*, 2008 TNT 62-61 (Mar. 31, 2008). For additional discussion of the history of the Byrd Rule, see Manoj Viswanathan, *Sunset Provisions in the Tax Code: A Critical Evaluation and Prescriptions for the Future*, 82 N.Y.U. L. Rev. 656, 664-668 (May 2007).

any time it changes. However, late-year tax law changes are even more burdensome for both taxpayers and the IRS. As illustrated above, these changes sometimes come too late for the IRS to revise its tax forms, for tax software companies to update their shrink-wrapped software packages, and for taxpayers to adjust their estimated tax payments or take advantage of tax incentives. Because late-year changes degrade the IRS's ability to communicate current rules to taxpayers, many taxpayers remain confused or uninformed about the changes and do not receive the tax benefits that Congress intended.<sup>48</sup> Late-year changes can also degrade the IRS's ability to timely process returns. A delay in processing returns means a delay in issuing refunds to taxpayers, some of whom need the refunds to pay essential bills.<sup>49</sup>

### **Sunsets increase complexity, potentially reducing tax compliance.**

Sunsets may prompt some taxpayers to make mistakes on their returns by inadvertently claiming expired tax benefits when a provision is not renewed. Tax benefits that are allowed to sunset during the year also make it more difficult for taxpayers to estimate their liability ahead of time, potentially leading to estimated tax penalties and noncompliance. According to one study, taxpayers who owe a balance upon filing their returns are more likely than others to understate their liabilities, and more than 20 percent of such taxpayers failed to pay in full with the return.<sup>50</sup> Thus, to the extent that sunsets make it more difficult for taxpayers to estimate their current year tax liability ahead of time, they may reduce tax compliance.

### **Sunsets increase the need for costly tax advice, which may reduce tax compliance.**

For taxpayers who can estimate how sunsets will affect them, sunsets provide planning opportunities. These taxpayers can shift income and deductions from one year to another to avoid sunsets. For example, concern about the extension of the AMT "patch" over the last few years led some tax advisors to recommend bunching expenditures for items that are deductible for regular tax purposes but not for the AMT into a year in which they will be allowed (*e.g.*, a year in which they are sure an AMT patch will apply).<sup>51</sup> As noted above, taxpayers may also feel the need to engage in estate tax planning to take advantage of the ways in which the estate tax law will shift over time. Not only is such planning costly, but taxpayers who choose not to pay a professional to help them plan for sunsets are likely to

<sup>48</sup> As noted above, late year tax law changes may be responsible for taxpayers claiming 1.4 million fewer deductions in tax year 2006 than in 2005. See National Taxpayer Advocate 2007 Annual Report to Congress 3, 6-7.

<sup>49</sup> According to the IRS, due to late year tax law changes, as many as 13.5 million taxpayers who needed to file certain AMT forms had to wait until February 11, 2008 to begin filing them. IR-2007-209 (Dec. 27, 2007).

<sup>50</sup> See Wage and Investment Division, Research Group 5, Project No. 5-03-06-2-028N, *Experimental Tests of Remedial Actions to Reduce Insufficient Prepayments: Effectiveness of 2002 Letters 7* (Jan. 16, 2004), citing District Office of Research & Analysis, Connecticut-Rhode Island and Southwest Districts, Project No. 13.0, *Causes and Potential Treatments for Underwithholding and Insufficient Estimated Payments 44* (June 21, 2000); Charles Christian, Phoenix District Office of Research and Analysis, *The Association Between Underwithholding and Noncompliance 1-2* (July 14, 1995). For the 2006 tax year, 15 percent of all taxpayers who owed a balance upon filing their return failed to pay it in full. Compliance Data Warehouse, Individual Returns Transaction File (IRTF) (Oct. 2008).

<sup>51</sup> See, *e.g.*, Jeff Schnepper, MSN Money, *The Basics: 8 ways to escape the AMT tax sting* (2008), at <http://moneycentral.msn.com/articles/tax/basics/6647.asp?Printer>.

feel they are paying more in taxes than other similarly situated taxpayers. This perception of unequal treatment likely reduces the perceived fairness of the tax system, which may in turn reduce tax compliance at the margins.

### **Sunsets dilute tax incentives and potentially increase recordkeeping burdens.**

Sunsets sometimes prompt lawmakers to allow tax incentives to expire and then retroactively extend them, diluting the effect of incentives for activities that require advance planning. A business is less likely to make a long-term investment in response to a tax incentive such as the research credit if the credit is set to expire.<sup>52</sup> For example, in early 2006 a business might have had difficulty obtaining financing to conduct research based on the potential of obtaining the research and experimentation credit, since the credit expired on December 31, 2005, even though on December 27, 2006, Congress retroactively extended it to apply from January 1, 2006 to December 31, 2007.<sup>53</sup> As a result, Congress is likely getting less for its money – generating less research activity than it otherwise could for the same tax credit dollars.

In addition, if lawmakers routinely allow a temporary tax incentive to expire, as they did with the research credit, businesses that might be eligible for the incentive may feel they should keep records that they hope will be sufficient to qualify them for the credit based on the possibility that it will be extended on a retroactive basis.<sup>54</sup> Such recordkeeping is a waste of resources if lawmakers do not retroactively extend the provision. Other taxpayers may not keep sufficient records to claim the benefit. If it is retroactively extended, they may be tempted to take the credit even though they do not have adequate records of their activities. Burdensome recordkeeping requirements have long been thought to decrease voluntary compliance in this manner.<sup>55</sup>

### **Sunsets increase tax uncertainty and possibly stock market volatility.**

Sunset provisions generate so much uncertainty about the cost of doing business that, pursuant to securities laws,<sup>56</sup> some publicly traded corporations feel the need to warn potential investors that the expiration of certain tax provisions presents a material risk to their businesses. For example, the General Electric Company's annual report warns, in the "risk factors" section:

[A beneficial tax provision] is scheduled to expire at the end of 2008, has been scheduled to expire on four previous occasions, and each time it has been extended

<sup>52</sup> Joint Economic Committee, *The Effects of the Duration of Federal Tax Reductions: Examining the Empirical Evidence* (Feb. 2002) (finding that people respond more strongly to permanent tax incentives than to temporary ones).

<sup>53</sup> Pub. L. No. 109-432, 120 Stat. 2922 § 104(a)(1) (2006) (codified at IRC § 41(h)(1)(B)).

<sup>54</sup> See, e.g., Manoj Viswanathan, *Sunset Provisions in the Tax Code: A Critical Evaluation and Prescriptions for the Future*, 82 N.Y.U. L. Rev. 656, 678 (May 2007).

<sup>55</sup> See, e.g., Deborah H. Schenk, *Simplification for Individual Taxpayers: Problems and Proposals*, 45 Tax L. Rev. 121, 166-67 (1989).

<sup>56</sup> See, e.g., 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5; 15 U.S.C. § 77q(a)(2); 15 U.S.C. § 78r.

by Congress. If this provision is not extended, the current U.S. tax imposed on active financial services income earned outside the United States would increase, making it more difficult for U.S. financial services companies to compete in global markets.<sup>57</sup>

Such uncertainty could potentially increase the volatility of the U.S. stock market, as stock prices fall in anticipation that favorable tax provisions will expire and then recover if Congress later extends them.

### Explanation of Recommendation

It is generally beyond the scope of the National Taxpayer Advocate's authority and institutional competence to recommend specific changes to Congress' procedural rules. Above and in our 2007 report, however, we outlined the significant impact to taxpayers of late-year tax law changes – the cause of which was the routine sunseting of tax provisions.<sup>58</sup> As noted earlier, the number of sunset provisions is increasing. Thus, in looking at the root cause of these and other problems facing taxpayers, the National Taxpayer Advocate believes that a change in these rules would benefit taxpayers.

Ideally, the true costs of sunset provisions, including burden to taxpayers, the tax system, and the IRS, should be taken into account as Congress evaluates them. Because many of these costs cannot be quantified and taken into account as part of the budget scoring process, however, it may be appropriate for Congress to consider ways to reduce or eliminate the incentive for lawmakers to use tax sunsets to circumvent the procedural rules.

Congress should prevent its procedural rules from providing an incentive to enact tax sunsets for which there is no substantive policy justification (*i.e.*, “budget-driven” sunsets). A budget-driven tax sunset could be defined as a tax provision that expires only for procedural reasons. A sunset would not be “budget-driven” if proponents could provide a non-procedural justification for it. For example, a non-procedural justification might include the need to address uniquely challenging economic conditions or natural disasters on a temporary basis. It might also include the need to test a new tax incentive to determine its effectiveness. The same justification could not be used to renew the provision repeatedly, however.<sup>59</sup> As a starting point for discussions, Congress could consider the options listed below.

<sup>57</sup> General Electric Company, Form 10-K, *Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934* (Dec. 31, 2007), at <http://www.sec.gov/Archives/edgar/data/40545/000004054508000011/frm10k.htm#item1a> (last visited Dec. 4, 2008).

<sup>58</sup> See National Taxpayer Advocate 2007 Annual Report to Congress 3, 6-7.

<sup>59</sup> We note that many of the sunset provisions in EGTRRA could probably have been justified on non-procedural grounds. However, it would be more difficult to justify temporarily renewing those provisions on the same basis. According to one review, of the tax provisions that expired in 2005 and were retroactively extended in 2006-2007, one provision was 20 years old, another was ten years old, and nine other provisions had been in existence for five years or more. Pamela J. Jackson and Jennifer Teefy, Congressional Research Service, RL 32367, *Certain Temporary Tax Provisions ('Extenders') Expired in 2007* (Oct. 8, 2008), reprinted as, *CRS Updates Report on Temporary Tax Provisions*, 2008 TNT 203-84, 6 (Oct. 20, 2008).

1. **Consider modifying the Byrd Rule to (a) allow a senator to raise a point of order if a reconciliation bill includes “budget-driven” tax sunset, or (b) allow a reconciliation bill to include tax cuts that extend beyond the fiscal years covered by the bill.<sup>60</sup>**

Either of these changes would eliminate the incentive, created by the current Byrd Rule, to enact temporary tax cuts using a reconciliation bill. If Congress modified the rule to allow a senator to raise a point of order if a reconciliation bill includes a tax sunset provision that could not be explained on any basis other than procedural considerations, the strategy of making tax cuts temporary simply to avoid a Byrd Rule point of order would no longer be effective. As a result, any budget-driven temporary tax cut included in a reconciliation bill would require the support of three-fifths of the Senate (60 votes, if no seats are vacant) to survive a Byrd Rule point of order.

If, instead, Congress modified the Byrd Rule to allow a reconciliation bill to include tax cuts that extend beyond the fiscal years covered by the bill, the strategy of making tax cuts temporary simply to avoid a Byrd Rule point of order would no longer be necessary. Neither of these options would affect the PAYGO or budget scoring rules. Nonetheless, if Congress adopts either of them, any temporary tax cut that lawmakers include in a reconciliation bill will be more likely to be based on policy (or fiscal considerations) rather than procedural maneuvering prompted by the Byrd Rule.

Option 1(b), however, would allow lawmakers to enact permanent tax cuts using the reconciliation process. Some have argued that because the reconciliation process circumvents normal Senate rules, which allow for debate (including potential filibuster) and amendment, it should not be used to pass tax cuts of any kind.<sup>61</sup> While that point is debatable, either option could help reduce the incentive to enact tax sunsets. Especially if Congress does not adopt option 1(a) or 1(b), it may wish to consider option 2.

2. **Consider modifying the Byrd Rule to allow a senator to raise a point of order if a reconciliation bill includes a provision that would extend a previously enacted temporary tax cut that was originally included in a reconciliation bill, provided the extension is budget-driven (as defined above).**

Unlike the first option, this one would not reduce the incentive created by the Byrd Rule to include budget-driven temporary tax cuts in reconciliation bills. It would, however, eliminate the procedural incentive to use the reconciliation process to renew them. As a result, unless proponents could justify another temporary extension of a provision on non-procedural grounds, lawmakers would be more likely to let it expire on schedule. Thus,

<sup>60</sup> For ease of discussion, we use the term “bill” to encompass a bill, amendment, conference report, or resolution. Similarly, we use the term “tax cut” to include not just tax rate reductions, but also any deduction, exemption, credit, adjustment, or other provision that reduces federal tax revenue.

<sup>61</sup> See, e.g., Michael W. Evans, *The Budget Process and the “Sunset” Provisions of the 2001 Tax Law*, 99 Tax Notes 405 (Apr. 21, 2003) (discussing the argument that the reconciliation process should not be used to enact tax cuts).

this option would reduce the incentive for lawmakers to continually extend temporary tax cuts using reconciliation bills rather than making them permanent or letting them expire. However, it would still allow lawmakers to use the reconciliation process to enact temporary tax cuts without getting the support of three-fifths of the Senate needed to allow the provision to survive a Byrd Rule point of order.

**3. Consider revising applicable revenue scoring rules so that any tax cut provision is scored, for purposes of PAYGO and similar rules, as if the provision would remain in effect for the duration of the applicable budget window, at least if its expiration is budget-driven.<sup>62</sup>**

This option would remove the budget-driven incentive created by PAYGO, section 302 spending allocation limitations, and similar rules that encourage legislators to repeatedly extend temporary tax cuts, which are scored as being less expensive than permanent ones. Such a change would be consistent with how section 257 of the Balanced Budget and Emergency Control Act of 1985 treats sunsets applicable to spending for programs with estimated current-year outlays greater than \$50 million.<sup>63</sup> As noted above, such spending sunsets are ignored for scoring purposes under section 257, so budget-driven tax cut sunsets could be ignored as well. Moreover, since taxpayers and legislators often expect temporary tax cuts to be extended, especially if they have been extended in the past, this change would probably make budget estimates more realistic.<sup>64</sup>

<sup>62</sup> Congress could revise the applicable budget scoring rules either by amending section 257 of the Balanced Budget and Emergency Control Act of 1985 or by congressional resolution.

<sup>63</sup> See 2 U.S.C. § 907(b)(2)(A) (sunset rule).

<sup>64</sup> Some commentators, including Peter Orszag, the Director of the CBO, have suggested that the CBO should at least provide, as an alternative baseline, estimates which assume that temporary tax provisions continue. See, e.g., William G. Gale and Peter R. Orszag, Tax Policy Center, *Sunsets in the Tax Code*, 99 Tax Notes 1553 (June 9, 2003) (noting that “[S]ince the assumption that all temporary provisions will expire is unrealistic, the official projections are increasingly biased as a guide to the underlying policy stance”).

## Eliminate (or Simplify) Phase-Outs

### Problem

The Internal Revenue Code (IRC) contains many tax benefits that are phased out at various levels of income.<sup>1</sup> Over 70 million returns are affected each year by one or more phase-outs.<sup>2</sup> As an example, the dependent care tax credit is gradually reduced for taxpayers with incomes between \$15,000 and \$43,000.<sup>3</sup>

Because we could reach a similar result by adjusting marginal rates, phase-outs introduce unnecessary complexity. Phase-outs make it more difficult for taxpayers to determine if they are eligible for a given tax benefit or even to compute their marginal tax rate. Phase-outs use different measures of income to determine whether and how to reduce a given tax benefit as income increases. Some phase-outs use “earned income” from personal services, others use “adjusted gross income” (AGI), and others start with AGI but then apply certain modifications to adjust it in a variety of ways, requiring taxpayers to fill out additional “quasi-returns” (*i.e.*, forms, schedules, and worksheets) to recompute their “income” for purposes of the phase-out.<sup>4</sup> The effect of marital and filing status on the phase-out range also varies from phase-out to phase-out.<sup>5</sup> Since some phase-outs are adjusted for inflation and others are not, the combination of ways that multiple phase-outs affect a taxpayer may change every year, even if the taxpayer’s filing status and income stay the same.<sup>6</sup>

Such complexity is burdensome for taxpayers, reduces the effectiveness of tax incentives, and makes it more difficult for taxpayers to estimate their tax liability and pay the correct amount of withholding or estimated taxes, possibly reducing tax compliance.<sup>7</sup> Phase-outs

<sup>1</sup> See National Taxpayer Advocate 2006 Annual Report to Congress 470, 473. For purposes of this discussion, we use the term “phase-out” to include phase-downs, which reduce (but do not eliminate) tax benefits as income increases.

<sup>2</sup> This data is compiled from the Individual Return Transaction File (IRTF) for Tax Year (TY) 2006 from the Compliance Data Warehouse (CDW).

<sup>3</sup> IRC § 21(a)(2).

<sup>4</sup> For example, the dependent care tax credit phase-out is based on AGI. IRC § 21(a). The earned income tax credit (EITC) phase-out is based on the greater of earned income or AGI. IRC § 32. The Hope credit phase-out is based on a modified computation of AGI, which starts with AGI and then adds amounts excluded from AGI under IRC §§ 911, 931, or 933. IRC § 25A(d).

<sup>5</sup> See National Taxpayer Advocate 2006 Annual Report to Congress 470, 473.

<sup>6</sup> See *id.* For example, the phase-out range for the Dependent care tax credit is not indexed for inflation, but the phase-out range for the Hope credit is. IRC §§ 21(a) and 25A(h).

<sup>7</sup> According to one research study, taxpayers who owe a balance upon filing their return are more likely than others to understate their liabilities, and more than 20 percent of such taxpayers with a balance due failed to pay it in full. See Wage and Investment Division, Research Group 5, Project No. 5-03-06-2-028N, *Experimental Tests of Remedial Actions to Reduce Insufficient Prepayments: Effectiveness of 2002 Letters 7* (Jan. 16, 2004), citing District Office of Research & Analysis, Connecticut-Rhode Island and Southwest Districts, Project No. 13.0, *Causes and Potential Treatments for Underwithholding and Insufficient Estimated Payments* 44 (June 21, 2000). See also Charles Christian, Phoenix District Office of Research and Analysis, *The Association Between Underwithholding and Noncompliance* 1-2 (July 14, 1995) (finding: “On average, understated tax on balance due returns is ten times as large as understated tax on other returns.”). For the 2006 tax year, 15 percent of all taxpayers who owed a balance upon filing their return failed to pay it in full. Compliance Data Warehouse, Individual Returns Transaction File (IRTF) (Oct. 2008).

may also reduce tax compliance by creating the perception that the tax code is unfair. Unlike an increase in marginal rates, phase-outs often tax an additional dollar earned by a low or middle income taxpayer more heavily than an additional dollar earned by a high income taxpayer.<sup>8</sup> Since such marginal rate “bubbles” produce unexpected deviations from our otherwise progressive rate structure, some taxpayers probably feel that phase-outs are unfair. Studies have found that the perception that the code is unfair may reduce voluntary compliance.<sup>9</sup> Although policymakers may sometimes adopt phase-outs to reduce the cost to the federal government of providing popular tax benefits, they may be more costly than policymakers realize if they increase noncompliance.

### Example

A 63-year-old retiree with \$15,000 in Social Security benefits, \$15,000 in wage income, \$20,000 in taxable pension income, and two children in college received a \$500 bonus in 2007. He has an effective marginal income tax rate of about 70 percent with respect to the bonus as a result of just two phase-outs.<sup>10</sup> Because the nontaxable portion of his Social Security benefits is phased out as his income increases, the \$500 bonus increases his taxable income by \$925.<sup>11</sup> Since he is in the 15 percent tax bracket, the additional income would increase his federal income tax by \$143 (approximately 15 percent x \$925).<sup>12</sup> Because the bonus pushes the taxpayer into the phase-out range for the Hope credit for educational expenses, it would reduce his Hope credit by about \$214 (from \$3,300 to about \$3,086).<sup>13</sup> Thus, at the end of the year, after completing an additional worksheet and tax form, the taxpayer would discover that his \$500 bonus increased his income tax liability by about \$357 (\$143 + \$214) so he would only get to keep the remaining \$143 (or approximately 29 percent).<sup>14</sup> In contrast, if the \$500 bonus were paid to someone in the highest 35 percent income tax bracket, he or she would typically get to keep \$325 (\$500 – (\$500 x 35

<sup>8</sup> We have no position regarding whether marginal rates should be higher or lower for all taxpayers or for any particular group of taxpayers. Our concern is with tax administration.

<sup>9</sup> See, e.g., National Taxpayer Advocate 2007 Annual Report to Congress vol. II, 138, 149-150 (Marjorie E. Kornhauser, Normative and Cognitive Aspects of Tax Compliance: Literature Review and Recommendations for the IRS Regarding Individual Taxpayers); Kim M. Bloomquist, *Income Inequality and Tax Evasion: A Synthesis*, Second Edition of the OECD Jan Francke Tax Research Award (Mar. 20, 2003) (citing studies suggesting that growing dissatisfaction with the tax system, perception of unfair treatment, and perception with the value received is less than taxes paid may be causes of noncompliance).

<sup>10</sup> This analysis assumes that before computing the Hope credit phase-out, each child would qualify for the full credit. It also ignores employment taxes, which would increase the taxpayer's marginal tax rate by another 7.65 percent, as well as state income taxes and college financial aid computations based on income. See, e.g., IRC § 3101. Such taxes and aid reductions could easily mean that the bonus generates liabilities that exceed 100 percent of the bonus.

<sup>11</sup> The phase-out range for the Social Security benefit exclusion begins when modified adjusted gross income plus one-half of the Social Security benefits exceed \$32,000 for joint filers and \$25,000 for single and head of household filers. IRC § 86(b), (c).

<sup>12</sup> See Instructions to Form 1040, *U.S. Individual Income Tax Return* (2007) (tax tables). The amount is not exactly 15 percent of \$925 because the figure comes from the tax tables.

<sup>13</sup> The phase-out range for the Hope credit begins at \$94,000 for joint filers and \$47,000 for single or head of household filers for TY 2007. See IRC § 25A(h); Form 8863, *Education Credits (Hope and Lifetime Learning Credits)* (2007).

<sup>14</sup> The taxpayer would have to fill out the Social Security Benefits Worksheet in Form 1040, the worksheet in Publication 915, *Social Security Benefits and Equivalent Railroad Retirement Benefits*, or the worksheets in Publication 590, *Individual Retirement Arrangements (IRAs)*, to determine how the bonus would affect the tax treatment of his Social Security benefits. He would also need to fill out Form 8863, *Education Credits*, to determine the amount of his Hope credit.

percent)) – more than twice as much. Moreover, if the taxpayer did not anticipate the effect of these phase-outs on his tax liability, he could be unexpectedly under-withheld.

### Recommendation(s)

The National Taxpayer Advocate recommended in her 2006 annual report that Congress eliminate or at least simplify phase-outs, and reiterates those recommendations again this year as Congress considers tax reform options.<sup>15</sup> Although in most instances outright repeal would improve tax administration, the National Taxpayer Advocate recommends policymakers consider the questions below with respect to each phase-out. Congress should analyze these issues as well as the effect of phase-outs on marginal rates.<sup>16</sup>

1. Can we identify a tax policy reason (other than revenue scoring) for each phase-out? Do those tax policy benefits outweigh the cost of complexity and noncompliance that the phase-out will generate? If so, do such policy reasons suggest a particular income level at which a phase-out makes sense?
2. Is it feasible to use a single measure of income for each phase-out, such as “adjusted gross income?” Is there a good policy reason to deviate from the existing measures of income that outweighs the complexity such deviation will create? Will those policy reasons justify increasing the number of computations and quasi-returns (*i.e.*, additional forms, schedules, and worksheets) that taxpayers have to fill out each year and the noncompliance that such complexity will generate?
3. Are there important tax policy reasons not to index each phase-out for inflation? Unless phase-outs are indexed for inflation, the real income level set by policymakers to trigger them will drift downward each year until the tax benefit affects only a few of the lowest income taxpayers while burdening all taxpayers with a needlessly complex tax code. Unindexed phase-outs might also begin to overlap with other phase-outs that are indexed for inflation, producing unexpectedly high effective marginal tax rates at certain income levels.
4. Should phase-outs create penalties for married or unmarried taxpayers or otherwise affect taxpayers differently based on filing status?
5. Should phase-out ranges be wide or narrow? Phase-out ranges that eliminate tax benefits gradually (*e.g.*, ratably) over a reasonably wide phase-out range are less likely to create unexpectedly high effective marginal tax rates. When phase-outs result in unexpectedly high effective marginal tax rates they make it difficult for taxpayers to predict their liability ahead of time, reduce the incentive to work, and

<sup>15</sup> National Taxpayer Advocate 2006 Annual Report to Congress 470.

<sup>16</sup> Commentators have recently recommended that the JCT and Treasury's Office of Tax Analysis provide a detailed analysis of effective marginal tax rates for both current law and all major tax proposals. See Alan D. Viard and Alex Brill, *Effective Marginal Tax Rates, Part 2: Reality*, 121 Tax Notes 327 (Oct. 20, 2008). For example, the Urban-Brookings Tax Policy Center analyzed the implications of the McCain and Obama tax proposals on marginal rates. See Katherine Lim and Jeffrey Rohaly, *The Impact of the Presidential Candidates' Tax Proposals on Effective Marginal Tax Rates* (Sept. 30, 2008), at [http://www.taxpolicycenter.org/UploadedPDF/411759\\_candidates\\_tax\\_proposals.pdf](http://www.taxpolicycenter.org/UploadedPDF/411759_candidates_tax_proposals.pdf) (last visited Dec. 4, 2008).

create planning opportunities for taxpayers who are able to shift income from one year to the next or to related individuals or entities. They also increase the perception of the tax law as unfair and arbitrary, which may reduce voluntary compliance.<sup>17</sup> However, phase-outs with wider phase-out ranges generally affect more taxpayers directly.

6. Is there any tax policy reason for phase-out formulas to differ as widely as they do? Uniform and simple phase-out formulas might make it easier for taxpayers to figure out how additional income will affect their tax benefits. They might also allow the IRS to reduce the number of forms, worksheets, and schedules that taxpayers need to fill out.
7. Is there a good policy reason for phase-out ranges to overlap? On one hand, overlapping phase-outs can create unexpectedly high effective marginal income tax rates for taxpayers in those ranges. On the other hand, creating standard phase-out ranges, as proposed by some practitioner groups, could have the advantage of increasing the transparency of the tax code because taxpayers may be more likely to know what the phase-out range is and whether they are likely to be subject to it.<sup>18</sup> Uniform ranges might also enable the IRS to reduce the number of forms, worksheets, and schedules required to administer phase-outs.

<sup>17</sup> See, e.g., National Taxpayer Advocate 2007 Annual Report to Congress vol. II 138, 149-150 (Marjorie E. Kornhauser, Normative and Cognitive Aspects of Tax Compliance: Literature Review and Recommendations for the IRS Regarding Individual Taxpayers); Kim M. Bloomquist, *Income Inequality and Tax Evasion: A Synthesis*, Second Edition of the OECD Jan Francke Tax Research Award (Mar. 20, 2003) (citing studies suggesting that growing dissatisfaction with the tax system, perception of unfair treatment, and perception with the value received is less than taxes paid may be causes of noncompliance).

<sup>18</sup> See American Bar Association, American Institute of Certified Public Accountants, and Tax Executives Institute, Inc., *Recommendations of the AICPA/ABA/TEI Task Force on Tax Simplification* (Sept. 13, 2002) (Attachment B: Simplification of Phase-Outs Based on Income Levels), at <https://www.abanet.org/tax/pubpolicy/2002/020913lt-atb.pdf> (last visited Dec. 4, 2008) (proposing three standard phase-out ranges: one for benefits targeted to low income taxpayers, one for benefits targeted to middle income taxpayers, and one for benefits targeted to high income taxpayers).

LR  
#9**Reforming the Penalty Regime<sup>1</sup>**

The number of civil tax penalties has increased from about 14 in 1954 to more than 130 today.<sup>2</sup> The last comprehensive penalty reform was enacted in 1989, after careful study by an IRS task force, Congress, and others.<sup>3</sup> Since then, legislative and administrative changes to the penalty regime have continued piecemeal with a focus on deterring tax cheating, but without the kind of careful analysis the government conducted in 1989.<sup>4</sup>

Penalties are important because of their potential to increase voluntary tax compliance and reduce the \$345 billion annual tax gap.<sup>5</sup> If structured improperly, however, penalties can *reduce* voluntary compliance, potentially endangering collection of the 84 percent of all taxes due that come in timely and voluntarily each year without any direct effort on the part of the government.<sup>6</sup> Perhaps for this reason, in 1989 both Congress and the IRS reached the conclusion that the purpose of civil tax penalties should be to enhance voluntary compliance.<sup>7</sup>

The IRS task force rejected other purposes, such as raising revenue, punishing noncompliant behavior, and reimbursing the government for the cost of compliance programs, because policies designed to fulfill other purposes may conflict with the goal of enhancing voluntary compliance.<sup>8</sup> Penalties may deter noncompliance for some taxpayers by imposing costs on it. However, if such deterrence were the only consideration, penalty reform

<sup>1</sup> For a more detailed discussion of this topic and the recommendations, see *A Framework for Reforming the Penalty Regime*, vol. II, *infra*.

<sup>2</sup> See IRM 20.1.1.1.1 (Feb. 22, 2008). For a list of current law penalties, see *A Framework for Reforming the Penalty Regime*, vol. II, Appendix A, Table 4, The Number of FY 2007 Assessments for Selected Civil Tax Penalties by Internal Revenue Code Section, *infra*. We use the term “penalty” to refer to civil monetary penalties and “additions to tax,” exclusive of interest charges and loss of tax benefits, for violating federal tax rules. For purposes of this report, a penalty does not include an increase in tax liabilities resulting from the failure to satisfy substantive requirements to obtain a tax benefit. For example, it excludes the so-called penalties for premature distributions from annuity contracts or individual retirement accounts. See, e.g., IRC §§ 72(q), (t).

<sup>3</sup> See Omnibus Budget Reconciliation Act of 1989 (OBRA), Pub. Law No. 101-239 §§ 7701-7743 (Dec. 19, 1989). OBRA incorporated penalty reform legislation entitled the “Improved Penalty Administration and Compliance Tax Act” (IMPACT). See H.R. Conf. Rep. No. 101-386 at 647-665 (1989).

<sup>4</sup> See Executive Task Force for Internal Revenue Commissioner’s Penalty Study, *A Philosophy of Civil Tax Penalties* (Discussion Draft), reprinted in 111 DTR L-1 1988 (June 9, 1988) (hereinafter “IRS Task Force Report I”); Executive Task Force for the Commissioner’s Penalty Study, *Report on Civil Tax Penalties* (Working Draft of Chapters 1-4 and 8), reprinted in 237 DTR L-10 (Dec. 9, 1988) (hereinafter “IRS Task Force Report II”); Executive Task Force for the Commissioner’s Penalty Study, *Report on Civil Tax Penalties*, reprinted in 89 TNT 45-36 (Feb. 27, 1989) (hereinafter “IRS Task Force Report III”). See also Joint Committee on Taxation, JCS-9-88, *Description of Tax Penalties* (Mar. 24, 1988).

<sup>5</sup> See Internal Revenue Service U.S. Department of the Treasury, *Reducing the Federal Tax Gap, A Report on Improving Voluntary Compliance*, 10 (Aug. 2, 2007), at [http://www.irs.gov/pub/irs-news/tax\\_gap\\_report\\_final\\_080207\\_linked.pdf](http://www.irs.gov/pub/irs-news/tax_gap_report_final_080207_linked.pdf) (last visited Dec. 4, 2008). The \$345 billion figure represents the “gross” tax gap, before accounting for late payments and enforced collections. *Id.*

<sup>6</sup> When the IRS last measured compliance, it found that taxpayers voluntarily and timely pay about 84 percent of all federal taxes due each year – about \$1.767 trillion out of \$2.112 trillion in 2001 – without any action by the government. See Internal Revenue Service U.S. Department of the Treasury, *Reducing the Federal Tax Gap, A Report on Improving Voluntary Compliance*, 10 (Aug. 2, 2007), at [http://www.irs.gov/pub/irs-news/tax\\_gap\\_report\\_final\\_080207\\_linked.pdf](http://www.irs.gov/pub/irs-news/tax_gap_report_final_080207_linked.pdf) (last visited Dec. 4, 2008). Only about one percent are collected via enforcement (*i.e.*, \$24.3 billion). *Id.*

<sup>7</sup> See, e.g., IRS Task Force Report I 8-9; H.R. Conf. Rep. No. 101-386 at 661 (1989) (stating in connection with significant civil tax penalty reform: “[T]he IRS should develop a policy statement emphasizing that civil tax penalties exist for the purpose of encouraging voluntary compliance.”).

<sup>8</sup> See IRS Task Force Report I at 9-10.

would be easy – we could simply increase the severity of all civil tax penalties and work to impose them in every instance of noncompliance. But, severe civil and criminal penalties already apply to intentional tax evasion.<sup>9</sup> Even very high penalties may not improve compliance if the likelihood that the IRS will detect noncompliance and impose the penalty is small.

Moreover, severe penalties that are not well designed could reduce compliance if they provide a disincentive for noncompliant taxpayers to step forward, are so disproportionate or arbitrarily imposed that taxpayers feel they are unjust, or result in protracted disputes that leave the IRS with few resources to impose them.<sup>10</sup> Even seemingly moderate penalties may be seen as disproportionately severe and arbitrary if they apply (or the IRS proposes them) in situations where taxpayers reasonably believe they have done nothing wrong or have done their best to comply. Therefore, any legislative changes to the penalty regime need to be based on research, rather than a reflexive reaction to the abuse of the day.

### The Need for Better Data

Before we begin serious penalty reform, we need better data about whether and how penalties promote voluntary compliance. As early as 1989, Congress recommended that the IRS “develop better information concerning the administration and effects of penalties.”<sup>11</sup> In addition, the IRS’s official policy is to collect information

to determine the effectiveness of penalties in promoting voluntary compliance... [and recommend] changes when the Internal Revenue Code or penalty administration does not effectively promote voluntary compliance...<sup>12</sup>

However, the government still has no significant quantitative data to show how penalties affect voluntary compliance.<sup>13</sup> The IRS either does not assess or does not track assessments of many current law penalties, much less study them in a comprehensive manner.<sup>14</sup> As a result, policymakers lack the information they need to structure and administer tax

<sup>9</sup> See, e.g., IRC § 6651(f) (fraudulent failure to file); IRC § 6663 (fraudulent underpayment); IRC § 7201 (criminal sanction for willful tax evasion); IRC § 7203 (criminal sanction for willful failure to file, report, or pay).

<sup>10</sup> One survey found that the strongest factors influencing compliance was personal integrity. See Roper ASW, *IRS Oversight Board 2005 Taxpayer Attitude Survey 7* (Feb. 21, 2006), at <http://www.ustreas.gov/irsob/releases/2006/02212006.pdf> (last visited Dec. 4, 2008) (finding that for 95 percent of the respondents personal integrity was somewhat of an influence or a great deal of influence on their compliance decision). Accord Marjorie E. Kornhauser, *Tax Compliance and the Education of John (and Jane) Q. Taxpayer*, 121 Tax Notes 737 (Nov. 10, 2008) (suggesting personal integrity and tax morale drive voluntary compliance). When a taxpayer feels the government (or the tax system) has become unjust, this sense of personal integrity may no longer require tax compliance – he or she may feel justified in evading the tax rules.

<sup>11</sup> H.R. Conf. Rep. No. 101-386, 101st Cong., 1st Sess. 661 (1989).

<sup>12</sup> Policy Statement 20-1 (June 29, 2004).

<sup>13</sup> See Treasury Inspector General for Tax Administration, Ref. No. 2001-40-069, *Management Advisory Report: Ineffective Administration of the Individual Taxpayer Penalty Program Creates Inequity* 9 (Apr. 2001) (stating “[T]he IRS does not know if the individual taxpayer penalty program is achieving its objective of encouraging voluntary compliance;” and finding that the IRS lacked systems to assess whether it was assessing and abating penalties consistently or following up on recommended improvements).

<sup>14</sup> See *A Framework for Reforming the Penalty Regime*, vol. II, Appendix A, Table 4, The Number of FY 2007 Assessments for Selected Civil Tax Penalties by Internal Revenue Code Section, *infra* (showing many penalties for which the IRS either has no specific assessment data or did not assess in FY 2007).

penalties to maximize voluntary compliance or even to accurately estimate the budget effect of changes to the penalty rules.<sup>15</sup>

### Analytical Framework

In the absence of better data, any penalty reform should consider the following principles, which the IRS penalty task force first identified in 1989 after extensive dialogue with stakeholders:<sup>16</sup>

- *Perceptions of Fairness.* Fairness has at least three components, as follows:
  - ◇ Horizontal equity – “treating similarly situated taxpayers similarly.” A horizontally equitable penalty applies only to similarly situated taxpayers – those who fail to comply and also fail to put forth the expected level of effort to comply (*i.e.*, the taxpayer has no reasonable cause for the failure).
  - ◇ Proportionality – “the punishment should fit the crime.” A proportionate penalty bears some relation to the culpability of the taxpayer and the harm caused by the infraction.
  - ◇ Procedural fairness – don’t “shoot first and ask questions later.” Procedural fairness requires the government to avoid asserting penalties against taxpayers that have not violated the rule.<sup>17</sup> It may also require the IRS to provide taxpayers with an effective process for administratively appealing penalty assessments.<sup>18</sup>
- *Comprehensibility.* Penalties cannot promote voluntary compliance if taxpayers do not understand them.
- *Effectiveness.* To be effective, a penalty must be severe enough to eliminate non-compliance without being so severe as to be difficult to enforce or perceived as disproportionate or unfair. A penalty may be more effective in encouraging remedial action if it is graduated (or reduced) based on the taxpayer’s efforts to correct any initial noncompliance, provided such graduations do not produce excessive complexity.

<sup>15</sup> Revenue generated directly from new penalties can be taken into account in connection with the federal budget “scoring” process, but any resulting effect on voluntary compliance can probably not be taken into account given the lack of quantitative research in this area. Because the scoring process takes the IRS’s tendency not to enforce an unduly harsh penalty into account, a focus on budget scoring may provide an incentive for legislators to enact penalties that cannot be waived by the IRS even if such penalties might ultimately reduce voluntary compliance and tax revenues in ways that are difficult to measure. See Joint Committee on Taxation, JCX-1-05, *Overview of Revenue Estimating Procedures and Methodologies Used by the Staff of the Joint Committee on Taxation* (Feb. 2, 2005) (stating: “the effectiveness of the applicable penalty regime and the IRS enforcement posture (*i.e.*, whether the IRS routinely waives penalties for a particular issue and how frequently they audit an issue) that would be associated with a proposal are also taken into account.”). However, as one commentator has observed: “[t]he best penalties are those that don’t raise any revenue [directly] because they encourage the conduct that the penalty is designed to encourage.” Jeremiah Coder, *Tax Shelter Penalties Are Unclear and Weakly Enforced, Panelists Say*, 2008 TNT 145-3 (July 28, 2008) (quoting N. Jerold Cohen).

<sup>16</sup> The discussion in this section is drawn, in large part, from the IRS Task Force Reports.

<sup>17</sup> See IRS Task Force Report II at L-18 (noting “the Task Force believes that, at the fringes, penalizing those who should not be penalized creates more negative attitudes and more problems than providing a slight tilt toward allowing some taxpayers who have violated a standard of behavior to avoid penalties”).

<sup>18</sup> See Task Force Report II at L-19 and L-20; Task Force Report III at 13-15. According to the Supreme Court, “taxes are the lifeblood of government, and their prompt and certain availability an imperious 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. U.S.*, 295 U.S. 247, 259-260 (1935).

- *Ease of administration.* A penalty is administrable if it is easy for the IRS to determine when it should be imposed while still allowing the IRS to exercise discretion in determining whether to waive the penalty. IRS employees may find reasons not to enforce penalties perceived to be unfairly harsh. Such penalties are also difficult to administer, in part, because they lead to controversy, which drains IRS resources, limiting the number of taxpayers the IRS will be able to impose the penalty against.

These four principles – fairness, comprehensibility, effectiveness, and ease of administration – are not always consistent with one another. Nonetheless, in the absence of quantitative data on the characteristics of penalties that best promote voluntary compliance, these considerations represent a sensible starting point for evaluating potential penalty reforms.

### Recommendations<sup>19</sup>

Our primary recommendation is for Congress to have the IRS (1) collect and analyze more detailed penalty data on a regular basis, and (2) conduct an empirical study to quantify the effect of each penalty on voluntary compliance. This quantitative research should also identify changes to penalty laws and penalty administration that would improve voluntary compliance. Congress should appropriate additional funds for this research, as necessary.

Without such research, any penalty analysis will be somewhat subjective and superficial. Nonetheless, the limited data and analysis that are available, as discussed in greater detail in volume II of this report,<sup>20</sup> suggest the following changes to the major penalty provisions would promote voluntary compliance based on the principles described above:

1. Prevent IRS systems from automatically assessing accuracy-related penalties without considering all of the facts and circumstances;
2. Consider the feasibility of clarifying the definition of a “tax shelter” for purposes of the substantial understatement penalty;
3. Restructure the penalty for failure to file a “reportable transaction” information disclosure;
4. Improve the proportionality and effectiveness of the failure to file penalty for those who are more than six months late;
5. Reduce the penalty for late filers who timely pay within a period of extension;
6. Reduce the number of failure to pay penalty rates and eliminate interaction with the failure to file penalty;
7. Simplify the prior year estimated tax payment safe harbor and encourage taxpayers to use it;

<sup>19</sup> For a more detailed discussion of this topic and each of the recommendations, see *A Framework for Reforming the Penalty Regime*, vol. II, *infra*.

<sup>20</sup> *Id.*

8. Simplify the estimated tax penalty computation and provide an automatic waiver of *de minimis* estimated tax penalties;
9. Allow the IRS to abate estimated tax penalties for first-time estimated tax payers who have reasonable cause;
10. Make the trust fund recovery penalty more effective by clarifying that it covers third party payers; and
11. Reduce the penalty for failure to make tax deposits in the prescribed manner.

LR  
#10**Modify Internal Revenue Code Section 6707A to Ameliorate Unconscionable Impact****Problem**

Section 6707A of the Internal Revenue Code imposes a penalty of \$100,000 per individual and \$200,000 per entity for each failure to make special disclosures with respect to a transaction that the Treasury Department characterizes as a “listed transaction” or “substantially similar” to a listed transaction.<sup>1</sup> Consider the following:

- The penalty imposes strict liability – it applies without regard to whether the taxpayer has knowledge that the transaction has been listed and without regard to whether the transaction is reported correctly on the taxpayer’s return.<sup>2</sup>
- The penalty applies even if the taxpayer derived no tax savings from the transaction.<sup>3</sup>
- The penalty must be imposed by the IRS and cannot be rescinded under any circumstances.<sup>4</sup>
- The penalty may not be appealed in court.<sup>5</sup>
- The taxpayer’s disclosure must initially be made twice – once with the IRS Office of Tax Shelter Analysis and again with the tax return for the year in which the transaction is first required to be disclosed.<sup>6</sup> A disclosure included with the taxpayer’s filed return, no matter how detailed, will not suffice by itself to avoid the penalty. After the first year in which the transaction must be disclosed, the taxpayer must continue to make disclosures with each filed return that reflects the transaction.
- A taxpayer that discloses a transaction may be subject to the penalty if the IRS deems the disclosure to be incomplete.<sup>7</sup>
- If a transaction is not “listed” at the time the taxpayer files a return but it becomes listed years later, the taxpayer becomes responsible for filing a disclosure statement and will be liable for this penalty for failing to do so. This is true even if the taxpayer has no knowledge that the transaction has been listed.<sup>8</sup>

<sup>1</sup> IRC § 6707A. For the definition of a “listed transaction,” see Treas. Reg. § 1.6011-4(b)(2).

<sup>2</sup> IRC § 6707A; Joint Explanatory Statement of the Committee of Conference accompanying H.R. 4520, 108th Cong. at 373 (2004).

<sup>3</sup> *Id.*

<sup>4</sup> IRC § 6707A(a) & (d)(1). Section 6707A(a) provides that “[a]ny person who fails to [make the required disclosures] shall pay [the] penalty” (emphasis added). This language seems absolute, and the IRS to date has interpreted the provision as requiring it to impose the penalty in all circumstances described in the statute. There is a minority view that the Commissioner has broad authority in determining whether to impose penalties and that the Commissioner could refrain from imposing penalties in cases where he believes that doing so promotes effective tax administration.

<sup>5</sup> IRC § 6707A(d)(2).

<sup>6</sup> Treas. Reg. § 1.6011-4(a) & (e).

<sup>7</sup> Treas. Reg. § 1.6011-4(d).

<sup>8</sup> Treas. Reg. § 1.6011-4(e)(2). The requirement will cease to apply after the period of limitations for the final return reflecting the transaction has expired.

- The penalty applies to each tax return the taxpayer files.<sup>9</sup>
- The usual three-year statute of limitations does not apply.<sup>10</sup>

Thus, an individual who does business through a wholly owned S corporation may enter into a ten-year transaction that he does not believe is improper and that produces little or no tax savings – only to end up owing a penalty of \$3 million (*i.e.*, a penalty of \$200,000 on the S corporation and a penalty of \$100,000 on the individual taxpayer for each of the ten years).<sup>11</sup>

A taxpayer who has entered into a transaction that is a “reportable transaction other than a listed transaction” fares only slightly better.<sup>12</sup> The penalty amount is \$10,000 per individual and \$50,000 per entity.<sup>13</sup> The penalty may be rescinded by the Commissioner of Internal Revenue, but only if a finding is made that rescinding the penalty would “promote compliance with the requirements of this title and effective tax administration.”<sup>14</sup> This means the IRS must first assess the penalty and the taxpayer must then prepare a rescission request. The taxpayer may not seek judicial review of the final IRS determination.<sup>15</sup>

Section 6707A was added to the Code in 2004 in an effort to combat tax shelters.<sup>16</sup> The tax-writing committees were concerned that the IRS in some cases did not learn of the existence of tax shelters until it conducted audits after the fact, and in other cases, the IRS probably did not learn about the shelters at all. The purpose of imposing a harsh

<sup>9</sup> IRC § 6707A; Treas. Reg. § 1.6011-4(e)(1); Joint Explanatory Statement of the Committee of Conference accompanying H.R. 4520, 108th Cong. at 373 (2004).

<sup>10</sup> IRC § 6501(c)(10) (providing that the statute of limitations will remain open with respect to an undisclosed listed transaction until at least one year after the earlier of (i) the date on which the taxpayer provides the required disclosure or (ii) the date on which a material advisor provides the name of the taxpayer to the Treasury Department in response to a request made under IRC § 6112(b).).

<sup>11</sup> As a general matter, the National Taxpayer Advocate believes that the IRS has broad authority to provide relief in cases where the application of a law to a taxpayer’s circumstances produces egregious results. Section 7122 of the Code gives the IRS broad authority to compromise tax liabilities. Prior to 1998, the IRS considered offers in compromise only if they were based on doubt as to the taxpayer’s liability or doubt as to collectibility. In 1998, Congress amended IRC § 7122, directing the Secretary to prescribe guidelines for IRS employees to use in determining whether an offer-in-compromise is adequate and should be accepted to resolve a dispute. See Internal Revenue Service Restructuring and Reform Act, Pub. L. No. 105-206, § 3462 (1998); IRC § 7122(c). The conference report accompanying the legislation stated:

[T]he conferees 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 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.

H.R. Rep. No. 105-599, at 289 (1998) (Conf. Rep.). We believe that imposing enormous penalties on taxpayers who either had no awareness of the Section 6707A disclosure requirements or who realized little or no tax savings is inequitable, imposes undue hardship, and contravenes public policy by undermining public respect for the fairness of the tax system. In the case of the Section 6707A penalty, however, it appears that Congress may have intended to override the Commissioner’s general authority to compromise tax liabilities. Section 6707A(d) specifically limits to reportable transactions that are not listed transactions the Commissioner’s authority to take into account “effective tax administration” considerations. Thus, the statute arguably excludes listed transactions from compromise. For additional perspective on “effective tax administration” offers in compromise, see National Taxpayer Advocate 2004 Annual Report to Congress 433-450 (Legislative Recommendation, *Offers in Compromise: Effective Tax Administration*).

<sup>12</sup> For the definition of a “reportable transaction,” see Treas. Reg. § 1.6011-4(b)(1).

<sup>13</sup> IRC § 6707A(b)(1).

<sup>14</sup> IRC § 6707A(d)(1).

<sup>15</sup> IRC § 6707A(d)(2).

<sup>16</sup> American Jobs Creation Act, Pub. L. No. 108-357, 118 Stat. 1418 § 811(a) (2004); H.R. Rep. No. 108-548, pt. 1, at 261 (2004).

penalty on taxpayers who fail to provide information was to increase the likelihood that the IRS could analyze questionable transactions and challenge transactions it thought were improper. Section 6707A also requires publicly traded companies to report the penalty to the Securities and Exchange Commission, which was also thought to serve as a deterrent to abusive transactions.<sup>17</sup>

Notwithstanding the underlying congressional intent in enacting Section 6707A, the statute as written can impose unconscionable hardship on taxpayers. Even the penalty for proven cases of civil fraud is capped at 75 percent of the tax underpayment.<sup>18</sup> Yet this statute allows penalties of up to \$300,000 per year to be imposed on taxpayers with no underpayment of tax and no knowledge that they entered into transactions that the IRS has “listed.” It is rare that a tax provision is found to violate the United States Constitution, but we believe the imposition of such a large penalty on a taxpayer who entered into a transaction that produced little or even no tax savings and without regard to the taxpayer’s knowledge or intent raises significant constitutional concerns, including possible violation of the Eighth Amendment’s prohibition against excessive government fines and due process protections.

In practice, the requirement that this penalty be imposed without regard to culpability may have the effect of bankrupting middle class families who had no intention of entering into a tax shelter – an outcome that has dismayed even hardened IRS enforcement personnel. For example, an Appeals Officer seeking advice from the IRS Office of Chief Counsel on whether he had any grounds to remove a Section 6707A penalty wrote:

All the IRS employees involved in this case agree that the taxpayer (and the taxpayer’s CPA) had no knowledge or reason to suspect that the transaction violated IRC 6011 and was a listed transaction requiring disclosure.... I am both an attorney and CPA and in my 29 years with the IRS I have never [before] worked a case or issue that left me questioning whether in good conscience I could uphold the government’s position even though it is supported by the language of the law.<sup>19</sup>

TAS currently has about 40 cases in its inventory involving taxpayers who are facing this penalty,<sup>20</sup> and we understand that the IRS is considering the penalty in hundreds of additional cases.

<sup>17</sup> IRC § 6707A(e); H.R. Rep. No. 108-548, pt. 1, at 261 (2004). The House committee report stated: “[T]he Committee believes that a penalty for failing to make the required disclosures, when the imposition of such penalty is not dependent on the tax treatment of the underlying transaction ultimately being sustained, will provide an additional incentive for taxpayers to satisfy their reporting obligations under the new disclosure provisions.”

<sup>18</sup> IRC § 6663(a).

<sup>19</sup> E-mail from Appeals Officer to a senior attorney in the IRS Office of Chief Counsel (Dec. 17, 2008).

<sup>20</sup> Taxpayer Advocate Service, Taxpayer Advocate Management Information System (keyword and history search performed in December 2008).

### Example

In 2004, an individual doing business through a wholly owned S corporation purchased a life insurance policy. Like many insurance policies, this one was touted as having certain tax benefits, which were worth about \$45,000 over three years. Although the taxpayer was reasonably diligent in evaluating the transaction, he was unaware that it was substantially similar to a listed transaction and subject to special reporting requirements. On audit, the IRS was persuaded that neither the taxpayer nor his advisors knew the transaction was a listed transaction. Because the transaction was listed and was not disclosed, however, the IRS imposed a \$900,000 penalty, consisting of three \$200,000 penalties at the entity level and three \$100,000 penalties at the individual level. The IRS cannot rescind the penalty, and the taxpayer is prohibited from challenging it in court.

### Recommendation

The National Taxpayer Advocate recommends that the amount of the penalty imposed by Section 6707A be revised so that it bears a proportional relationship to the amount of tax savings. We understand that the purpose of the penalty is to promote disclosure, but the benefits of disclosure must be balanced against the burdens the penalty imposes on taxpayers. A transaction, even if tax-motivated, does not present significant compliance concerns if a taxpayer receives little or no tax savings. To the contrary, compliance concerns generally increase in direct proportion to the amount of the claimed tax savings. We recommend that the penalty be restructured to reflect this proposition.

The National Taxpayer Advocate is also concerned about the absence of a “reasonable cause” exception, the “stacking” of multiple Section 6707A penalties, and the potential imposition of the Section 6707A penalty on taxpayers who derived no tax benefit whatsoever. If the IRS concludes, for example, that neither the taxpayer nor his advisors had any knowledge that a transaction was questionable, we believe the IRS should have the authority to waive the penalty. For a discussion of these concerns and related penalty issues, see *A Framework for Reforming the Penalty Regime*, volume 2, *infra*, and Legislative Recommendation, *Reforming the Penalty Regime*, *supra*.

LR  
#11**The Time Has Come to Regulate Federal Tax Return Preparers****Problem**

For most Americans, the annual ritual of preparing and filing tax returns represents their most significant contact with the U.S. government. Thus, the importance of making the return preparation process run smoothly cannot be overstated. More than 60 percent of individual taxpayers and most business taxpayers pay practitioners to prepare and file their returns.<sup>1</sup> In addition, in fiscal year 2006, nearly 73 percent of taxpayers who claimed the Earned Income Tax Credit (EITC) used preparers.<sup>2</sup> Accordingly, tax return preparers are an essential component of taxpayer rights and tax compliance. The IRS relies on preparers to educate taxpayers about tax laws, facilitate efficient electronic filing, and reduce the stress and anxiety often associated with the tax filing season.<sup>3</sup> Despite the vital role return preparers play in effective tax administration, anyone can prepare a tax return for a fee — with no training, licensing, or oversight required. Attorneys, certified public accountants, and enrolled agents are all licensed by state or federal authorities, and are subject to censure, suspension, or disbarment from practice before the IRS in the event of wrongdoing.<sup>4</sup> Yet there is virtually no federal oversight over “unenrolled” preparers, who constitute the majority of tax return preparers today.

A 2006 study by the Government Accountability Office (GAO) underscores the significant problems in the tax return preparation industry. GAO auditors posing as taxpayers made 19 visits to several national tax preparation chains in a large metropolitan area. Using two carefully designed fact patterns, they sought assistance in preparing tax returns. The tax preparation chains made errors on all 19 returns. In 17 instances, the preparers computed the wrong refund amounts, with variations of several thousand dollars. In five of ten applicable cases, preparers failed to ask relevant probing questions, and as a result, they prepared returns claiming ineligible children for the EITC. Perhaps the most troubling finding was that preparers failed to report business income in ten of the 19 cases. Several preparers even advised the GAO “taxpayers” that reporting certain income was unnecessary because the IRS would have no way of knowing about it.<sup>5</sup>

<sup>1</sup> IRS, Tax Year 2006 Taxpayer Usage Study, Report No. 16 (Returns received from Jan. 1, 2007 to Oct. 26, 2007).

<sup>2</sup> IRS Compliance Data Warehouse, Individual Returns Transaction File (Tax year 2006).

<sup>3</sup> See Leslie Book, *The Need to Increase Preparer Responsibility, Visibility and Competence*, *infra*; National Taxpayer Advocate 2007 Annual Report to Congress, vol. 2, 44-74 (Leslie Book, *Study of the Role of Preparers in Relation to Taxpayer Compliance with Internal Revenue Laws*).

<sup>4</sup> Circular 230, 31 C.F.R. § 10.50.

<sup>5</sup> Government Accountability Office, GAO-06-563T, *Paid Tax Return Preparers: In a Limited Study, Chain Preparers Made Serious Errors 2* (Apr. 4, 2006) (Statement of Michael Brostek, Director Strategic Issues, before the Committee on Finance, U.S. Senate).

The Treasury Inspector General for Tax Administration (TIGTA) conducted a similar study in 2008 and also found troubling results. TIGTA auditors posing as taxpayers visited 12 commercial chains and 16 small, independently owned tax return preparation offices in a large metropolitan area. All of the preparers visited were unlicensed and unenrolled. Of the 28 returns prepared, 17 (61 percent) were prepared incorrectly. Sixty-five percent of the inaccurate returns contained mistakes or omissions deemed to be caused by human error and/or misinterpretation of the tax laws. However, 35 percent of the inaccurate returns contained misstatements or omissions that TIGTA deemed willful or reckless. Finally, all of the business returns were prepared inaccurately.<sup>6</sup>

Since 2002, the National Taxpayer Advocate has proposed a plan for the IRS to register, test, and certify unenrolled federal income tax preparers. Given the role that preparers play in guiding taxpayers through our complex tax laws, it is incumbent on the IRS to register and identify unenrolled preparers and administer a basic examination to ensure at least a minimal level of competency among paid preparers. Moreover, an ongoing continuing professional education (CPE) requirement would keep preparers current on tax law changes and help them learn from the most common mistakes.<sup>7</sup>

Several states have experience in regulating return preparers. Oregon and California have requirements that preparers must meet before preparing tax returns in those states.<sup>8</sup> The GAO evaluated the two programs and determined the program in Oregon seemed to increase the accuracy of returns prepared in that state as compared to the rest of the country. Oregon has a two-tiered licensing program, with the first tier requiring qualifying education, an examination, and continuing education, and the second tier requiring work experience and a second examination. California's program requires qualifying education and the completion of continuing education.<sup>9</sup> However, the GAO review found the returns filed in California were *less* likely to be accurate than those filed elsewhere in the country.

<sup>6</sup> Treasury Inspector General for Tax Administration, Ref. No. 2008-40-171, *Most Tax Returns Prepared by a Limited Sample of Unenrolled Preparers Contained Significant Errors* (Sept. 3, 2008).

<sup>7</sup> See National Taxpayer Advocate 2006 Annual Report to Congress 197-221; National Taxpayer Advocate 2005 Annual Report to Congress 223-37; National Taxpayer Advocate 2004 Annual Report to Congress 67-88; National Taxpayer Advocate 2003 Annual Report to Congress 270-301; National Taxpayer Advocate 2002 Annual Report to Congress 216-30; *Fraud in Income Tax Return Preparation: Hearing Before the Subcomm. on Oversight of the H. Comm. on Ways & Means*, 109th Cong. (2005) (statement of Nina E. Olson, National Taxpayer Advocate). In her 2003 Annual Report to Congress, the National Taxpayer Advocate further encouraged Congress to enact a more stringent compliance and penalty regime to deter reckless disregard of the rules and/or negligence by paid preparers. National Taxpayer Advocate 2003 Annual Report to Congress 270-301. Based on continual discussions with internal and external stakeholders, the National Taxpayer Advocate's recommendation has evolved since originally proposed. The initial proposal required an initial exam and annual refresher exams. After discussing the issue with various stakeholder groups, we still firmly believe that an initial examination is essential to an effective program. However, rather than require annual refresher exams, we believe preparers should be required to periodically prove, upon renewing registration, the completion of either a continuing education or an examination requirement. Thus, preparers would be able to choose between an examination and CPE.

<sup>8</sup> Maryland recently enacted legislation to regulate paid preparers. The Maryland Individual Tax Preparers Act establishes an eight-person Board of Income Preparers, and, effective June 2010, requires all preparers not specifically exempted to register, pay a fee, and take an examination modeled after the Special Enrollment Examination prepared by the IRS. The preparer must renew the registration every two years, at which time the preparer must pay a renewal fee and provide evidence of completion of continuing education requirements. Maryland Individual Tax Preparers Act, Senate Bill 817, Md. Code Business Regulation and Occupations, chap. 623 (May 22, 2008).

<sup>9</sup> GAO, GAO-08-781, *Tax Preparers: Oregon's Regulatory Regime May Lead to Improved Federal Tax Return Accuracy and Provides a Possible Model for National Regulation* (Aug. 2008).

Thus, GAO's findings appear to support the need to require preparers to pass an initial examination in addition to continuing education.

Based on many discussions with a wide variety of external stakeholders, including commercial tax preparation chains and national professional trade associations, we believe there is general agreement that such legislation is necessary to protect the best interests of taxpayers. At a House subcommittee hearing held in 2005, the American Bar Association, the American Institute of Certified Public Accountants, the National Association of Enrolled Agents, the National Society of Accountants, and the National Association of Tax Professionals all testified in favor of the proposal in principle.<sup>10</sup> While there are remaining logistical issues to be addressed, the overriding goal must be to advance the long-term best interests of taxpayers and tax administration.

In the 110th Congress, proposals to regulate return preparers were included in two separate bills – S.1219, the Taxpayer Protection and Assistance Act of 2007, and H.R. 5716, the Taxpayer Bill of Rights Act of 2008.<sup>11</sup> Both bills include provisions to ensure unenrolled preparers are equipped with the necessary knowledge and skills to accurately prepare tax returns.

### Recommendation

The National Taxpayer Advocate recommends that Congress enact a registration, examination, certification, and enforcement program for unenrolled tax return preparers. This program should consist of the following components:

- Any tax return preparer as defined in IRC § 7701(a)(36) other than an attorney, certified public accountant, or enrolled agent must register with the IRS, and Congress should authorize the IRS to impose a per-return penalty for failure to register, absent reasonable cause.
- All registered preparers must pass an initial examination designed by the Secretary to test the technical knowledge and competency of unenrolled return preparers to prepare federal tax returns. The exam can be administered in two separate parts. The first part would address the technical knowledge required to prepare relatively less complex Form 1040-series returns. The second part would test the technical knowledge required to prepare business returns, including complex sole proprietorship schedules.
- All registered preparers must complete CPE requirements as specified by the Secretary. The Secretary should have the authority to permit preparers to satisfy such requirements by instead passing a specified examination.

<sup>10</sup> *Fraud in Income Tax Return Preparation: Hearing Before the Subcomm. on Oversight of the H. Comm. on Ways & Means*, 109th Cong. (2005)

<sup>11</sup> S.1219, § 4, 110th Cong. (2007); H.R. 5716, § 4, 110th Cong. (2008).

- All registered preparers must renew their registration every three years, at which point they must show evidence of completion of CPE requirements.
- The Secretary should be authorized and directed to conduct a public awareness campaign to inform the public about the registration requirements and offer guidelines about what taxpayers should look for in choosing a qualified tax return preparer.

LR  
#12**Refund Delivery Options****Problem**

With the current downturn in the economy, federal tax refunds are an important source of funds for many individual taxpayers. As a result, the Department of Treasury and the IRS need to provide all taxpayers with the ability to receive refunds as quickly as possible and at minimal cost. The following measures would serve the best interests of taxpayers as well as tax administration:

- *Minimizing Refund Turnaround Time.* A significant number of taxpayers purchase commercial refund delivery products, such as refund anticipation loans (RALs), to receive their refunds quickly. Refunds for returns processed through the IRS Customer Account Data Engine (CADE) are released in five to seven days, while those processed through the Individual Master File (IMF) require nine to 15 days. The IRS should convert to CADE as quickly as possible and should evaluate all refund processes with the ultimate goal of minimizing the time it takes to release refunds.<sup>1</sup>
- *Revenue Protection Indicator.* The IRS e-file program is not designed to provide taxpayers with the reasonably accessible information necessary to make informed decisions about purchasing commercial refund delivery products. The IRS acknowledgement file, which is sent to taxpayers who e-file, includes the Debt Indicator but does not inform taxpayers whether compliance screens will delay the release of or reduce the amount of refunds. The IRS runs these compliance screens after it releases the acknowledgement file, and after taxpayers purchase RALs and potentially spend the loan proceeds. Thus, by including a Revenue Protection Indicator (RPI) in the acknowledgement file to notify taxpayers of compliance-related issues, the IRS could prevent avoidable defaults on RALs.
- *Debit Cards.* The quickest and cheapest way to distribute tax refunds is electronically.<sup>2</sup> However, a significant number of taxpayers, including Earned Income Tax Credit (EITC) recipients, are unbanked (*i.e.*, do not have an established relationship with a

<sup>1</sup> Treasury Inspector General for Tax Administration (TIGTA), Ref. No. 2008-40-170, *Many Taxpayers Who Obtain Refund Anticipation Loans Could Benefit from Free Tax Preparation Services*, (Aug. 29, 2008); IRS, Debt Indicator Report to Congress 27 (Oct. 31, 2006), as requested by H.R. Rep. No. 109-307 (2005) (Conf. Rep.). For a discussion of Treasury and the IRS's concerns regarding RALs, see Department of Treasury, *Advanced Notice of Proposed Rulemaking, Guidance Regarding Marketing of Refund Anticipation Loans (RALs) and Certain Other Products in Connection with the Preparation of a Tax Return*, REG-136596-07 (Jan. 8, 2008); Government Accountability Office (GAO), GAO-08-800R, *Refund Anticipation Loans* (June 5, 2008).

<sup>2</sup> The U.S. Treasury Department estimates that by converting the 10.5 million people who still get a paper Social Security check once a month to electronic payments, it could save the federal government up to \$42 million a year. Lori Montgomery, *Washington Post*, *Treasury Dept. Rolling Out Social Security Debit Card* (June 10, 2008) at D3.

financial institution) or need their money quickly.<sup>3</sup> The Department of Treasury and the IRS should develop a program to enable unbanked taxpayers to receive refunds on stored value cards (SVCs). Such a program would support the Financial Literacy and Education Commission's National Strategy for Financial Literacy by providing unbanked taxpayers with a government-sponsored refund delivery option that serves as a steppingstone to ultimately open bank accounts.<sup>4</sup> The IRS needs to evaluate the experience of the existing SVC program administered by the Financial Management Service (FMS) to distribute Social Security benefits, as well as other government-administered SVC programs, with the ultimate goal of developing a similar program for individual taxpayers.<sup>5</sup>

- *Public Awareness Campaign.* Taxpayers need accurate information to make informed decisions regarding refund delivery options. It is in the best interest of taxpayers and tax administration for the IRS to conduct a public awareness campaign rather than relying primarily on private industry to disseminate information.

### Example

An EITC recipient with no relationship with any financial institution visits a commercial return preparer early every February to have his federal income tax return prepared. The taxpayer's average refund is \$3,000 per year. Because he needs his refund to pay his bills within the week, he purchases a refund anticipation loan product from Bank A. He receives the loan proceeds on a commercial debit card, which has high transactional fees. After he has spent all of the proceeds downloaded onto the debit card, the taxpayer learns he has defaulted on his loan because the IRS froze his refund.

### Recommendation

The National Taxpayer Advocate recommends that Congress require the Department of Treasury and the IRS to:

- Evaluate the entire refund process to determine opportunities to shorten the turn-around time;
- Develop a pilot program to determine how the inclusion of a Revenue Protection Indicator in the acknowledgement file will impact tax administration. Evaluate the feasibility of including such information in the current "Where's My Refund" online application;

<sup>3</sup> Financial Literacy and Education Commission, *Taking Ownership of the Future: The National Strategy for Financial Literacy* 67 (2006); GAO, GAO-08-800R, *Refund Anticipation Loans* (June 5, 2008). The average Adjusted Gross Income (AGI) for taxpayers filing tax year 2004 individual income tax returns with RAL indicators was \$22,400. IRS Staff of Research, Analysis, and Statistics, *The Relationship between Bank Products and Individual Taxpayer Compliance*, Slide 4 (Nov. 2008).

<sup>4</sup> Financial Literacy and Education Commission, *Taking Ownership of the Future: The National Strategy for Financial Literacy* (2006).

<sup>5</sup> Eleanor Laise, *Treasury Plans Social Security Debit Card*, Wall Street Journal (Jan. 4, 2008).

- Evaluate existing stored value card programs to distribute government benefits, with particular emphasis on the experience of FMS's Direct Express Program to distribute Social Security benefits;
- Incorporating lessons learned from existing programs, develop a SVC program to distribute refunds to individual taxpayers before the 2010 tax filing season; and
- Conduct an annual public awareness campaign to provide accurate information to taxpayers regarding available refund delivery alternatives, associated turnaround times, and any other pertinent information.

### Present Law

Section 6402 of the Internal Revenue Code (IRC) authorizes the IRS to make credits or refunds. Other than the requirement that a taxpayer file a timely claim for refund,<sup>6</sup> and the requirement for the IRS to pay interest on the overpayment in certain circumstances,<sup>7</sup> nothing in the Code or the Treasury Regulations specifies the timing of the refund delivery process. There are, however, many nontax laws that would apply to the electronic payment of tax refunds onto SVCs. These laws include:

- Electronic Funds Transfer Act (Regulation E);<sup>8</sup>
- Federal Deposit Insurance Act;<sup>9</sup>
- U.S. Patriot Act ;<sup>10</sup>
- Bank Secrecy Act;<sup>11</sup>
- Gramm-Leach-Bliley Act;<sup>12</sup> and
- State consumer protection laws.

### Reasons for Change

#### The Refund Delivery Process

An electronically filed return passes through three distinct organizations that process the return and deliver the refund electronically.<sup>13</sup> First, the IRS receives e-filed returns from transmitters on a daily basis. Once received, the returns are analyzed and accepted for

<sup>6</sup> IRC §§ 6402(a), 6511.

<sup>7</sup> IRC § 6611.

<sup>8</sup> 15 U.S.C. 1693 et seq.; 12 C.F.R. § 205.1 et seq.

<sup>9</sup> Federal Deposit Insurance Act, 12 U.S.C. 1813. FDIC coverage only applies to SVCs if funds are "deposited" in insured financial institutions. Federal Deposit Insurance Corporation (FDIC), General Counsel's Opinion No. 8, 61 Fed. Reg. 40489 (Aug. 2, 1996).

<sup>10</sup> Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA PATRIOT Act) Act of 2001, Pub. L. No. 107-56, 115 Stat. 272 (2001).

<sup>11</sup> The Bank Secrecy Act, 12 U.S.C. 1818, 1829b, 1951-59, and 31 U.S.C. 5311 et seq.

<sup>12</sup> Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999).

<sup>13</sup> IRS, Debt Indicator Report to Congress (Oct. 31, 2006), as requested by H.R. Rep. No. 109-307 (2005) (Conf. Rep.).

further processing or rejected back to the transmitter for correction and resubmission. Accepted returns undergo “pipeline” processing and additional analysis. Returns can “fall out” of the processing flow due to errors on the return or processing issues that require correspondence with the taxpayer, and result in refund delays. Compliance checks, such as the Dependent Database and Criminal Investigation (CI) screens, also take place on all returns. If the compliance screens spot an issue, the refund can be delayed for a potential fraud investigation or pre-refund examination. After passing through the compliance screens, returns are routed to either the CADE or IMF for processing by analyzing the return data within the context of the taxpayer’s account, posting taxes due, and determining the amount of the refund. CADE returns are processed and posted daily, so it takes only a day and a half to process e-filed returns from receipt to posting. IMF returns are processed weekly, resulting in a processing range of five and a half to 11 and a half days. At the completion of posting, the IRS sends to the FMS of the Department of Treasury a file containing refund information and bank numbers.<sup>14</sup>

The FMS processing takes a half a day. Once FMS receives the refund file, it performs validations, processes the files through the Treasury Offset Program, and creates origination files that are transmitted to the Automated Clearinghouse (ACH) Network for settlement. The clearinghouse performs settlement services, transferring funds electronically from the Treasury to the designated bank account. The process takes two days and the refund is deposited the next day after the ACH processing cycle is complete.<sup>15</sup>

Total refund turnaround depends on when the return is submitted and whether it posts to CADE or IMF. Direct deposit of refunds for problem-free returns processed through CADE take five to seven days from the time of submission. In comparison, direct deposit refunds for returns processed through IMF take nine to 15 days. Each year, the IRS shifts more types of returns from IMF to CADE, including returns with the EITC, which moved to CADE in the 2008 filing season.<sup>16</sup>

TIGTA recently conducted a survey of 350 taxpayers who had RAL indicators on their IRS accounts. Of the 250 respondents who stated they received a RAL, 55 percent indicated they would be willing to wait seven or more days to receive their tax refunds from the IRS. In addition, approximately 64 percent of the respondents were banked, which indicates speed may play an important factor in the decision-making process. Sixty-three percent of the respondents received the EITC, and they paid ten to 39 percent of this amount for tax

<sup>14</sup> FMS provides central payment services for federal program agencies, operates the federal government’s collections and deposit systems, provides government-wide accounting and reporting services, and manages the collection of delinquent debt. IRS, Debt Indicator Report to Congress 26 (Oct. 31, 2006), as requested by H.R. Rep. No. 109-307 (2005) (Conf. Rep.).

<sup>15</sup> *Id.*

<sup>16</sup> *Id.* See also TIGTA, Ref. No. 2008-40-170, *Many Taxpayers Who Obtain Refund Anticipation Loans Could Benefit from Free Tax Preparation Services* (Aug. 29, 2008); TIGTA, Ref. No. 2008-20-151, *Customer Account Data Engine Project Management Practices Have Improved, but Continued Attention is Needed to Ensure Future Success* (Sept. 11, 2008).

return preparation and RAL fees. Thus, by minimizing the refund turnaround time, the IRS could steer taxpayers away from more expensive refund delivery options.<sup>17</sup>

TIGTA reviewed the processing of the respondents' refunds and found interesting results. The IRS processed approximately 18 percent of the respondents' returns through CADE and released their refunds in five to ten days.<sup>18</sup> Considering that the overwhelming majority of respondents indicated a willingness to wait up to nine days to receive refunds, it appears a significant number of respondents might have chosen a different refund delivery method had they been well-informed.

### RAL Defaults

Taxpayers suffer significant harm when they default on RALs. To minimize RAL defaults, the National Taxpayer Advocate has previously recommended that the IRS include a Revenue Protection Indicator in the acknowledgment file.<sup>19</sup> The acknowledgement file currently includes the Debt Indicator, which provides information about whether the taxpayer owes any delinquent debts to federal or state agencies pursuant to the Treasury Offset Program (TOP).<sup>20</sup> The DI can only distinguish between IRS and FMS debt. The IRS has information about tax debts, but for other federal debts, it directs taxpayers to the TOP call center, which can confirm the existence of a debt and refer taxpayers to the specific agency to which the debt is owed for further information.<sup>21</sup>

If the DI shows the taxpayer owes a federal or state debt, FMS has the authority to offset those debts against federal tax refunds.<sup>22</sup> Thus, the IRS will deduct the amount of the delinquent debt from the refund before releasing any remaining amount. If the taxpayer took out a RAL, it will default when the bank does not receive the full amount of the anticipated refund. While the DI certainly benefits taxpayers by reducing RAL defaults, the IRS and Treasury can provide taxpayers additional information to further minimize the default rate. Accordingly, the acknowledgement file should also address whether the IRS plans to hold a portion of the refund due to compliance activity.

<sup>17</sup> While the TIGTA report stated that 85 percent of respondents would be willing to wait up to nine days to receive their information, based on TIGTA's reported findings, we believe it is more accurate to state that 55 percent would be willing to wait seven or more days. Forty percent stated they would be willing to wait seven to nine days and 15 percent stated they would be willing to wait greater than nine days. TIGTA Ref. No. 2008-40-170, *Many Taxpayers Who Obtain Refund Anticipation Loans Could Benefit from Free Tax Preparation Services* 2-3, 29 (Aug. 29, 2008).

<sup>18</sup> TIGTA, Ref. No. 2008-40-170, *Many Taxpayers Who Obtain Refund Anticipation Loans Could Benefit from Free Tax Preparation Services* 8 (Aug. 29, 2008).

<sup>19</sup> For a detailed discussion of the negative consequences of default, see National Taxpayer Advocate Fiscal Year 2007 Objectives Report to Congress, Vol. II (June 30, 2006).

<sup>20</sup> FMS manages liabilities owed by taxpayers to federal or state agencies through the Treasury Offset Program (TOP). FMS has statutory authority to offset such debts against federal income tax refunds. IRC § 6402(d).

<sup>21</sup> For more information on the Debt Indicator, see National Taxpayer Advocate Fiscal Year 2007 Objectives Report to Congress, Vol. II (June 30, 2006).

<sup>22</sup> FMS manages liabilities owed by taxpayers to federal agencies through the TOP. FMS has the authority to offset such debts against federal income tax refunds and provides weekly information to the IRS. The IRS updates its system to reflect such debts in the form of the Debt Indicator. For more information on the TOP, see IRC § 6402(d); <http://www.fms.treas.gov/news/factsheets/benefitoffset.html> (last visited June 17, 2008).

## Stored Value Cards

### *National Strategy to Improve Financial Literacy*

Approximately ten million households in the United States are unbanked.<sup>23</sup> A significant number of taxpayers do not have an established relationship with a financial institution for a variety of reasons, including personal choice, poor credit history, or immigration status. Unbanked individuals may experience the following negative consequences:

- High fees for check cashing and bill payment;
- Higher risk of theft and robbery due to carrying cash;
- Inability to establish a credit history; and
- Difficulty in building assets.

Title V of the Fair and Accurate Credit Transactions Act of 2003 established the Financial Literacy and Education Commission and required the Commission to “improve the financial literacy and education of persons in the United States through development of a national strategy.”<sup>24</sup> A section of the national strategy developed by the Commission encourages the use of public-private partnerships to assist the unbanked in establishing relationships with financial institutions.<sup>25</sup>

The establishment of an SVC program to distribute tax refunds, EITC benefits in particular, would further the national strategy to improve financial literacy. Because SVCs function similarly to traditional checking accounts, introducing these cards to the unbanked or underbanked will provide them with a steppingstone to a relationship with a financial institution with the ultimate goal of converting such accounts into traditional deposit accounts. In addition, access to funds through a debit card provides many tangible benefits, such as:

1. Elimination of the need to stand in line or pay high fees associated with check cashers and commercial refund products;
2. Quick access to funds;
3. Greater safety, as taxpayers do not have to carry as much cash;
4. Reduced risk of stolen paper checks;
5. Branded cards limit cardholder liability for lost or stolen cards;
6. A sense of personal empowerment for cardholders because they can make purchases directly with the card, shop or pay bills online; and
7. Potential to build credit (if the card provider reports accounts to credit bureaus).<sup>26</sup>

<sup>23</sup> Financial Literacy and Education Commission, *Taking Ownership of the Future: The National Strategy for Financial Literacy* 67 (2006).

<sup>24</sup> Section 513(b), Title V, Fair and Accurate Credit Transactions Act of 2003, Pub. L. No. 108-159, 111 Stat. 1952 (2003).

<sup>25</sup> Financial Literacy & Education Commission, *Taking Ownership of the Future: The National Strategy for Financial Literacy* 72 (2006).

<sup>26</sup> Comptroller of the Currency, Community Developments, *Payroll Cards: An Innovative Product for Reaching the Unbanked and Underbanked* (June 2005).

Income tax refunds, and EITC benefits in particular, are significant amounts for many taxpayers and should be a prime focus for asset building initiatives. For example, in 2006, approximately 80 percent of individual income tax returns claimed a refund and the average amount was \$2,689. For EITC returns with refunds, the average EITC claimed was \$2,022 with an average AGI of \$15,873.<sup>27</sup> Thus, considering the amounts in question, it is safe to assume that many individual taxpayers, especially EITC recipients, count on tax refunds and would prefer to receive their funds quickly and at low or no cost. Thus, refunds and EITC benefits are prime candidates for delivery on an SVC. In addition, in the above-discussed recent TIGTA survey of taxpayers with RAL indicators on their accounts, approximately 63 percent stated they would have preferred to receive a debit card from the IRS instead of purchasing a RAL.<sup>28</sup>

Finally, Congress has expressed interest in the development of a debit card program to deliver refunds to unbanked taxpayers. Section 10(g) of H.R. 5717, the Taxpayer Bill of Rights Act of 2008, directs Treasury to conduct a study, in consultation with the National Taxpayer Advocate, on payment opportunities to deliver tax refunds to unbanked taxpayers through electronic means, with a focus on debit cards.<sup>29</sup>

### ***Increase Electronic Delivery of Refunds***

FMS has stated that one of its 2009 priorities is to “[p]rovide federal payments timely and accurately, and continue to move toward an all-electronic Treasury for payments.”<sup>30</sup> The private sector already offers open and closed loop debit cards to receive income tax refunds.<sup>31</sup> However, to realize the advantages of this electronic delivery method, taxpayers must pay the associated transaction fees over which the Department of Treasury has no control. By developing a government-sponsored SVC program, FMS could maintain the level of control necessary to best serve the interests of taxpayers and tax administration. Such a program will allow the IRS to steer taxpayers away from paper refund checks and toward electronic benefit transfers (EBT) because the IRS can endorse its own product. Furthermore, FMS could control the pricing and distribution plans of the product to serve the best interests of taxpayers.

It is important to note that the federal government has a strong incentive to provide an SVC for EITC benefits, because it is analogous to other government benefit programs. Census data illustrate that in 2003, the EITC lifted 4.4 million people out of poverty, including 2.4 million children. The EITC moves more children out of poverty than any other

<sup>27</sup> IRS Compliance Data Warehouse, Individual Returns Transaction File (IRTF) for Tax Year 2006.

<sup>28</sup> TIGTA, *Many Taxpayers Who Obtain Refund Anticipation Loans Could Benefit from Free Tax Preparation Services*, 2008-40-170, 7 (Aug. 29, 2008).

<sup>29</sup> H.R. 5716, 110th Cong. §10(g) (April 8, 2008).

<sup>30</sup> Financial Management Service, Mission Statement, Program Summary by Budget Activity and FY 2009 Priorities, available at [http://74.125.47.132/search?q=cache:3aq49izp\\_0YJ:www.ustreas.gov/offices/management/budget/budget-documents/cj/09/CJ%2520FY09.FMS.pdf+financial+management+service+mission+statement+program+summary+by+budget+activity&hl=en&ct=clnk&cd=1&gl=us](http://74.125.47.132/search?q=cache:3aq49izp_0YJ:www.ustreas.gov/offices/management/budget/budget-documents/cj/09/CJ%2520FY09.FMS.pdf+financial+management+service+mission+statement+program+summary+by+budget+activity&hl=en&ct=clnk&cd=1&gl=us) (last visited on Dec. 4, 2008).

<sup>31</sup> Chase Issuing Debit Cards for Income Tax Refunds (Mar. 6, 2006), available at [http://www.paymentnews.com/2006/03/chase\\_issuing\\_d.html](http://www.paymentnews.com/2006/03/chase_issuing_d.html); H&R Block Press Release, H&R Block Adds Mobile Phone Banking to Emerald Card Platform (May 28, 2008).

single program or category of programs.<sup>32</sup> Unbanked EITC recipients should not have to pay a fee to receive their benefit when they do not incur costs to access Social Security, food stamps, and other governmental benefits.<sup>33</sup>

The need for debit cards became increasingly evident when the IRS distributed economic stimulus payments in 2008. In general, the IRS issued the payments electronically if bank account routing information appeared on the taxpayer's 2007 tax return. Because RAL and RAC accounts are temporary and not controlled by the taxpayer, stimulus payments deposited into those accounts would not reach the taxpayer. Fortunately, the IRS receives an electronic indicator when a RAL or RAC is associated with a return and was able to program its systems to send paper checks to all taxpayers whose 2007 returns were accompanied by one of these indicators.<sup>34</sup>

According to IRS data, approximately 20.4 million taxpayers purchased RALs and Refund Anticipation Checks (RACs) during the 2008 filing season (as of June 10, 2008).<sup>35</sup> These taxpayers received their stimulus payments according to the schedule established for the release of paper checks – with some coming as late as mid-July – instead of receiving their payments electronically in May. Thus, more than 20 million taxpayers who purchased RALs and RACs waited up to 2-1/2 months longer to receive their stimulus payments than taxpayers who did not purchase those products. Considering that the AGI for taxpayers who purchased a RAL or RAC is substantially lower than the AGI for taxpayers who did not purchase a bank product, it is clear that the delay affected taxpayers at the lowest income levels.<sup>36</sup> These taxpayers would not have experienced this delay if they had SVCs to receive their refunds.

### Taxpayer Awareness of Refund Delivery Options

Taxpayers need to have access to accurate information to make informed decisions about how to receive their refunds. Reducing the refund turnaround time and providing additional electronic delivery options will only impact taxpayer behavior if taxpayers know about all the options, as well as the consequences associated with each one. The information the IRS provides directly to taxpayers about refund delivery options is limited. For

<sup>32</sup> Robert Greenstein, Center on Budget and Policy Priorities, *The Earned Income Tax Credit: Boosting Employment, Aiding the Working Poor* (Aug. 17, 2005).

<sup>33</sup> Any such SVC program would likely be put out to bid and administered by a private company, similar to the Direct Express program for Social Security benefits, as discussed below.

<sup>34</sup> In February 2008, one tax-preparation company notified the IRS that it had failed to include RAL indicators on approximately 450,000 electronically filed returns. The company and the bank providing the RALs were able to provide the routing transit numbers (RTNs) used for the RALs. The company provided this information early enough so that the IRS was able to include in its programming a requirement to convert returns bearing those RTNs to paper checks. The IRS reports that the taxpayers whose returns were involved generally did not experience delay in receiving their stimulus payments. IRS response to TAS information request (June 13, 2008).

<sup>35</sup> IRS response to TAS information request (June 12, 2008) (Information as of June 10, 2008).

<sup>36</sup> For tax year 2004 individual returns, the average AGI for taxpayers with no bank product was \$55,200, and the average for RAL and RAC taxpayers was \$22,400 and \$32,200, respectively. IRS Staff of Research, Analysis, and Statistics, *The Relationship between Bank Products and Individual Taxpayer Compliance*, Slide 4 (Nov. 2008).

example, the IRS website offers a three week refund turnaround time for e-filed returns.<sup>37</sup> In addition, before the 2008 filing season began, the IRS issued a news release stating that taxpayers could receive direct deposited refunds associated with e-filed returns “in as little as ten days.”<sup>38</sup> While the information is correct, taxpayers would benefit greatly by receiving more detailed information, such as the average refund turnaround time in the previous filing season for each filing method, broken down by the type of return. Because ten days is a conservative figure, especially when CADE processes the return, the IRS is not conveying a clear picture to the taxpayer and does not equip the taxpayer with enough knowledge to make a well-informed decision in the filing season.

Further, regardless of what information the IRS releases directly, many taxpayers receive information on refund delivery options from their return preparer or software package. It is unclear whether the IRS effectively monitors the accuracy of the information conveyed by these sources.

## Explanation of Recommendation

### Faster Refunds

The IRS needs to perform an end-to-end analysis of refund processing to identify opportunities for reducing refund turnaround time. This includes the migration to CADE, the ability to run certain processes and compliance screens concurrently rather than sequentially, and external processes (FMS and ACH).

### Revenue Protection Indicator in the Acknowledgement File

The IRS should include an RPI in its e-file acknowledgement file. To provide this additional beneficial information, the IRS would need to run further compliance screens, such as the Dependent Database and CI screens, before releasing the acknowledgement file. The proposed reordering of the return processing pipeline would delay the release of the acknowledgement file.

The National Taxpayer Advocate is aware that the IRS considers the quick release of the acknowledgement file to be an incentive to e-file.<sup>39</sup> However, the IRS should also consider the inclusion of additional compliance information in the acknowledgement file as an incentive to e-file. Some taxpayers will learn very early in the process whether they have potential problems on their returns.<sup>40</sup> This knowledge could prevent them from spending

<sup>37</sup> See <http://www.irs.gov/taxtopics/tc152.html> (last visited Nov. 30, 2008).

<sup>38</sup> IRS News Release, *Tax Packages Arrive in Mail; IRS Reminds Taxpayers to e-file and Watch for Tax Law Changes*, IR-2008-1 (Jan. 2, 2008).

<sup>39</sup> IRS, *Advancing E-File Study (Phase 1 Report)* 120 (Draft dated June 6, 2008).

<sup>40</sup> The Revenue Protection Indicator (RPI) will only alert taxpayers to problems detected by initial compliance screens. The RPI will not alert taxpayers to problems detected by the IRS after the release of the refund. However, the fact that it detects only some, but not all, compliance issues should not justify abandoning the program. Taxpayers benefit from the information provided, such as by avoiding a RAL default, even if the RPI does not detect all compliance issues.

their anticipated refunds on credit, whether in the form of RAL proceeds or credit card charges. Taxpayers may even have the opportunity to correct errors before the problem escalates.

The IRS needs to weigh the benefits of such a program against the risks. For example, it is unclear how such a delay in the release of the acknowledgement file would impact the e-file rate. In addition, there is risk involved in providing quick information regarding the results of compliance screens. Such information should be general in nature so as not to provide a roadmap for the unscrupulous to work the system. Accordingly, it would be wise to develop a pilot program to test the impact of the RPI on tax administration.

The IRS also can expand the use of the indicator by modifying the current “Where’s My Refund” program by including RPI information. The resulting system would have the ability to provide more customized information regarding the timing of that particular taxpayer’s refund based on IRS screens as well as the DI.

Including the RPI in the acknowledgement file could potentially affect the commercial market for refund delivery products in a significant manner. First, the delay of the acknowledgement file would decrease the attractiveness of RALs because financial institutions would not approve the loans until the IRS releases the acknowledgement file, unless they are willing to assume greater risk. Thus, the difference in refund turnaround times between RALs and e-file/direct deposit delivery options would become that much smaller. Second, inclusion of the RPI would affect the industry’s risk assessment calculations for RALs. Financial institutions would factor the resulting lower loan default rates into their risk analysis and price their products accordingly.

### **Stored Value Cards**

The Department of Treasury needs to assess the feasibility of establishing a SVC program to deliver the EITC portion of federal income tax refunds. Such cards would allow taxpayers to receive their benefits as quickly as direct deposit while avoiding fees associated with many commercial delivery products, such as RALs, RACs, and commercial debit cards.

SVCs use a magnetic stripe to store information about funds prepaid to the card. There are two main categories: (1) single-purpose or “closed-loop” cards and (2) “open-loop” cards. Closed-loop cards, such as mass transit fare cards and college-issued cards, can only be used to buy goods at particular retailers. Open-loop SVCs can make debit transactions at a wide variety of retail locations, and can also receive direct deposits and withdraw cash at ATMs. Some of the open loop cards are branded by Visa or MasterCard and can be used wherever those brands are accepted.<sup>41</sup>

<sup>41</sup> Federal Reserve Bank of New York, *Stored Value Cards: An Alternative for the Unbanked?* (July 2004); Katy Jacob, The Center for Financial Services Innovation, *Stored Value Cards: A Scan of Current Trends and Future Opportunities* (July 2004).

Reloadable multipurpose open-loop cards are essentially one step away from a traditional checking account. Users can make payments to a wide variety of merchants and service providers and, most importantly, they can load additional funds to the cards.

Taxpayers can either apply for a government sponsored SVC or utilize an existing commercial card to receive tax refunds. As long as the taxpayer inputs the SVC's routing and account number on the tax return, the IRS can direct deposit the refund onto the card.

The IRS and Treasury need to evaluate existing SVC programs to understand the benefits and disadvantages of such programs. In addition, Treasury should consider merging programs or at least informing taxpayers of the possibility of designating an existing SVC as the refund delivery mechanism. Once the IRS and Treasury have studied this issue, they should apply lessons learned to design and develop an SVC program before the 2010 filing season, including a government-sponsored SVC for EITC recipients.<sup>42</sup>

### Existing Electronic Benefit Transfer Programs

EBT programs are well established in a variety of state, federal, and foreign governments. Treasury and the IRS need to evaluate the experience of the programs discussed below to develop an optimal program for tax refunds.

#### Direct Express for Social Security Payments

In a program designed to encourage approximately 3.9 million unbanked Social Security and Supplemental Security Income (SSI) recipients to switch to electronic payments, FMS has established Direct Express debit cards. The cards are MasterCard-branded and offered by the Department of Treasury's financial agent, Comerica Bank. FMS deposits benefits directly into a prepaid account accessed through the open-loop stored value card, which can be used anywhere a MasterCard debit card can be used (to make purchases or cash withdrawals).<sup>43</sup>

Direct Express cardholders can withdraw an amount up to the entire balance at a teller window at any MasterCard member bank. There is no fee for the first ATM withdrawal per deposit at any Comerica bank or any of the approximately 50,000 ATMs in the Direct Express network. Users pay a \$0.90 fee for all subsequent ATM withdrawals. Other charges include \$0.50 per bill for online bill payment and a \$4.00 replacement card fee, and out-of-network ATMs may impose additional charges. There are no fees for purchases at retail establishments where MasterCard is accepted, overdrafts, declined transactions,

<sup>42</sup> The New America Foundation has developed an interesting proposal to distribute tax refunds on SVCs. A summary of this proposal can be found at [http://www.newamerica.net/publications/articles/2008/tax\\_refunds\\_deposited\\_prepaid\\_cards\\_could\\_provide\\_financial\\_access\\_unbanked\\_8028](http://www.newamerica.net/publications/articles/2008/tax_refunds_deposited_prepaid_cards_could_provide_financial_access_unbanked_8028) (last visited on Dec. 5, 2008).

<sup>43</sup> Lori Montgomery, Washington Post, *Treasury Dept. Rolling Out Social Security Debit Card* (June 10, 2008) at D3.

inactive accounts, ATM inquiries, bank teller withdrawals, customer service, the first annual replacement card, or text/e-mail/phone alerts of deposits and low balances.<sup>44</sup>

Direct Express offers the following protections to cardholders:

- Funds deposited on Direct Express cards are FDIC-insured;
- Electronic Funds Transfer Act protections apply to limit the cardholder's liability to \$50.00 in the case of unauthorized withdrawals or purchases upon the loss or theft of the card (as long as the holder reports the loss, theft or unauthorized charge within two business days of learning about it; but no more than 90 days after it occurred);
- MasterCard's "Zero Liability" policy protections; and
- Social Security and SSI benefits deposited on the Direct Express card are not subject to garnishment or freezing, except as authorized by federal law, although the government can collect its own debts from the card.<sup>45</sup>

### State Food Stamp Programs

All 50 states, the District of Columbia, the U.S. Virgin Islands, and Guam have food stamp EBTs. Once an application is accepted, most states mail a debit card to the recipient, who can access a food stamp EBT account at authorized food retail outlets. Food stamp benefits are automatically deposited into the food stamp EBT account for each month the recipient is eligible.<sup>46</sup>

### Maryland Unemployment Benefits Disbursed on Prepaid Debit Cards

Maryland recently introduced a Visa branded prepaid debit card program for unemployment insurance benefits, contracting with Citigroup to provide the cards and manage the program. New applicants no longer have the option of receiving their unemployment insurance benefits on paper checks. The program costs the state nothing and Citigroup takes a percentage of the fees paid to Visa by retailers. Card users are not charged fees for the first four in-network cash withdrawals or for purchases wherever Visa cards are accepted. The cards have a two-year expiration date and can be used again even after the user temporarily discontinues receiving benefits.<sup>47</sup>

### Payroll Cards

Employers and employees are increasingly realizing the benefits of distributing payroll onto SVCs. In 2004, 1.8 million unbanked households used prepaid payroll cards and the

<sup>44</sup> FMS, *Direct Express Card, Common Questions*, available at <http://fms.treas.gov/directexpress2007/questions3.html> (last visited June 17, 2008); National Consumer Law Center, *Consumer Concerns for Older Americans: Prepaid Debit Cards for Social Security and SSI Benefits* (June 2008), available at [http://www.nclc.org/issues/seniors\\_initiative/content/CC\\_Prepaid\\_Debit\\_Cards.pdf](http://www.nclc.org/issues/seniors_initiative/content/CC_Prepaid_Debit_Cards.pdf) (last visited Dec. 17, 2008).

<sup>45</sup> *Id.*

<sup>46</sup> Department of Agriculture, Food Stamp Program, *Electronic Benefits Transfer (EBT) Highlights*, available at [http://www.fns.usda.gov/fsp/ebt/ebt\\_status\\_highlights.htm](http://www.fns.usda.gov/fsp/ebt/ebt_status_highlights.htm) (last visited June 17, 2008); United States Department of Agriculture, *Food Stamp Electronic Benefit Transfer Systems: A Report to Congress* (Oct. 2003).

<sup>47</sup> Gus G. Sentementes, *Debits In, Checks Out*, Baltimore Sun (Dec. 1, 2008).

trend seems to indicate increased use of such cards. The cards reduce payroll processing costs for employers, provide quick and inexpensive access to payroll funds for unbanked employees, and aid cardholders in the transition to more traditional bank accounts. Banks find these arrangements profitable as well. Besides the obvious reason to move more cardholders to bank accounts, banks earn a portion of the transactional fees charged to retail merchants. They may also charge the employer or employee monthly or service fees, but these fees are often waived.<sup>48</sup>

#### United Kingdom's Post Office Card Account

The United Kingdom has established the Post Office Card Account (POCA) as a simple way to distribute benefits, state pensions, and tax credit payments. No other money can be paid into the account, including wages. While withdrawals are free, citizens can only make such withdrawals over the counter in post office branches. The response to the POCA was much greater than expected, with approximately 4.3 million customers regularly collecting benefits through a POCA as of April 2006.<sup>49</sup>

#### Australia's Welfare Card

The Australian government recently announced a new welfare debit card that will contain a portion of a family's welfare payment, which the family can only spend on necessities such as food and clothing. However, the program is considered controversial because it is designed to prevent recipients from using the funds on alcohol, drugs and gambling.<sup>50</sup>

#### *Impact of Government Issued SVCs on Private Industry*

Low income taxpayers would likely use the SVC accounts to pay bills, frequently draining the accounts soon after receiving the funds. These frequent transactions and average low balances would not allow the banks to earn much interest revenue. However, banks could view the program as a long-term initiative to establish relationships with potential future account holders and borrowers.<sup>51</sup>

Critics of the debit card proposal are concerned the IRS would be seen as endorsing particular industry products. Yet the IRS already accepts payments on commercial credit cards

<sup>48</sup> Comptroller of the Currency, Consumer Affairs Department, *Community Developments, Insights: Payroll Cards: An Innovative Product for Reaching the Unbanked and the Underbanked 2* (June 2005). Some of the employers offering such cards include McDonalds, FedEx, Sears, Roebuck, Dairy Queen, and Subway. Jennifer Bayot, *To Cash This Paycheck, Find the Nearest A.T.M.*, *New York Times* (Feb. 24, 2003).

<sup>49</sup> The House of Commons, Treasury Committee, *Banking the Unbanked: Banking Services, the Post Office Card Account and Financial Inclusion*, 13th Report of Session 2005-2006, HC 1717 (Nov. 19, 2006), at 50, available at <http://www.publications.parliament.uk/pa/cm200506/cmselect/cmtreasy/1717/1717.pdf> (last visited Dec. 17, 2008); see also <http://www.postoffice.co.uk/portal/po/content1?catId=19400181&mediald=19900206&campaignid=PI0038&intcampaignid=PI0038> (last visited Dec. 17, 2008).

<sup>50</sup> The Daily Telegraph, *Rudd Defends Welfare Card* (May 10, 2008), available at <http://www.news.com.au/dailytelegraph/story/0,,23673204-5001021,00.html> (last visited on Nov. 30, 2008); ABC News, *ACOSS Rejects Welfare Card Scheme* (May 9, 2008), available at <http://www.abc.net.au/news/stories/2008/05/09/2239888.htm> (last visited June 17, 2008).

<sup>51</sup> Daniel M. Leibsohn, Community Development Finance, South Shore Bank of Chicago, *Southern New Hampshire University Roundtable 3, Case Study No. 5* (March 2002).

(MasterCard, VISA, American Express, and Discover), which include the same associations branding the open-loop SVCs.<sup>52</sup>

### Improving Taxpayer Awareness

The IRS should conduct a public awareness campaign to give all taxpayers accurate information about refund delivery options. This information should include details of average costs and turnaround times, as well as any additional pertinent information. The IRS itself would control the content and media distribution of this campaign rather than relying primarily on tax return preparers or software providers to convey this information as the IRS does now.

Finally, once Treasury studies and determines the feasibility of distributing tax refunds on SVCs, it needs to get the word out to taxpayers about this additional refund delivery option. The IRS should inform taxpayers both directly and through their preparers how to apply for government-sponsored cards. In addition, taxpayers need to understand that they can utilize the direct deposit option on their returns by inputting the routing number and account number for an existing SVC, whether it is government sponsored or not.<sup>53</sup>

In addition to the public awareness campaign, the IRS should impose strict requirements on authorized IRS e-file providers to convey information to their customers about refund options.<sup>54</sup> The IRS can accomplish this by including communication requirements in Publication 1345, *Handbook for Authorized IRS e-file Providers of Individual Income Tax Returns*.

### Conclusion

To serve the best interests of taxpayers and tax administration, the IRS needs to evaluate current refund processes with an eye toward reducing the refund turnaround time. If the IRS can shorten the time it takes to release refunds, taxpayers would be less inclined to purchase more expensive commercial products.

The IRS should also include an RPI in the e-file acknowledgement file. This additional information regarding IRS compliance activity would benefit taxpayers by allowing them to correct errors early on, as well as avoid additional expenses or debt, based on an anticipated tax refund that the IRS has flagged. The IRS could also incorporate the indicator information in the existing “Where’s My Refund” program to provide more customized and accurate information to users.

<sup>52</sup> IRS, *Pay Taxes by Credit or Debit Card*, available at <http://www.irs.gov/efile/article/0,,id=101316,00.html> (last visited on June 17, 2008).

<sup>53</sup> At the same time, the IRS should caution taxpayers to review applicable fees for SVCs not sponsored by the federal government.

<sup>54</sup> The IRS should require preparers, in conjunction with the National Taxpayer Advocate’s proposal to regulate return preparers, to ask their clients if they have an existing SVC to receive the refund and inform the client of the availability of the direct deposit option by using the routing and account numbers of the SVC. In addition, the IRS could include this requirement in IRS Publication 1345, *Handbook for Authorized IRS e-file Providers of Individual Income Tax Returns*.

The IRS should enable unbanked taxpayers, especially EITC recipients, to receive tax refunds on debit cards. The IRS can learn from the experiences of existing programs, including the FMS Direct Express program, and engage in discussions with the debit card industry to understand the costs of development and issues specific to tax administration. Ideally, the Social Security Administration program would merge with the IRS program in the future to allow both agencies to load benefits onto the same card. The IRS and Treasury should complete their review, design, and implement a program before the 2010 filing season. Taxpayers would either use existing SVCs or apply for and receive new debit cards before the filing season, and the IRS could load refunds onto cards as quickly as if direct deposit was used. Government-sponsored debit cards would have minimal fees and could be reloaded in the future. Through the government debit card program, unbanked taxpayers could familiarize themselves with the banking system and ultimately open bank accounts.

Finally, the IRS needs to increase taxpayer awareness of refund delivery alternatives. First, the IRS should conduct a public awareness campaign to reach taxpayers directly. Second, the IRS should require tax preparers to communicate this information.

LR  
#13**Crediting an Overpayment Against an Unassessed, Outstanding Tax Liability****Problem**

In August 2007, the IRS issued Revenue Ruling 2007-51, permitting the IRS to (1) offset refunds pursuant to Internal Revenue Code (IRC) § 6402(a) against unassessed liabilities, or (2) credit a decrease in tax resulting in a carryback adjustment against an unassessed liability.<sup>1</sup> Permitting the IRS to offset a refund to an unassessed liability allows collection prior to assessment.

The examples described in the Revenue Ruling were limited to corporations, and the Office of Chief Counsel has advised Congress that it is only applying the ruling to corporations.<sup>2</sup> Revenue Ruling 2007-51 undermines taxpayers' right under IRC § 6212 to challenge a proposed deficiency before assessment and payment of the tax. Absent compelling public policy, taxpayers, particularly low income taxpayers who rely on refunds to help pay for basic living expenses, should be protected from this type of premature collection. If Congress shares the IRS's concern that large refunds or credits are being issued when corporations have significant unassessed liabilities, the National Taxpayer Advocate recommends that Congress carve out a specific exception in the Code for these circumstances.

**Example**

Pam, a single mother, filed her return for tax year 2007, anticipating a \$2,500 refund. She received a statutory notice of deficiency for \$2,000 for tax year 2006, which she was planning to dispute in the United States Tax Court. Instead of receiving a refund of \$2,500, Pam received only \$500 because the IRS offset her 2007 refund against her proposed 2006 liability, even though she was planning to dispute the 2006 liability and the window of time for filing a petition to the Tax Court was still open.

**Recommendation**

Amend IRC § 6402 to change the term "liability" to "assessed liability," thereby permitting the IRS to credit any overpayment only against an assessed tax liability.

<sup>1</sup> 2007-2 C.B. 573.

<sup>2</sup> Letter from Deborah Butler, Associate Chief Counsel (Procedure and Administration), IRS Office of Chief Counsel, to U.S. House of Representatives, Committee on Ways and Means (Nov. 9, 2007).

## Present Law

Under IRC § 6212, the IRS is authorized to send a notice to the taxpayer when it is determining a tax deficiency. Once the IRS issues a statutory notice of deficiency, the IRS may not assess the income tax liability for at least 90 days.<sup>3</sup> If the taxpayer does not agree with the notice, he or she generally has 90 days to petition the Tax Court.<sup>4</sup> If the taxpayer does not petition the court within those 90 days, the IRS will assess the tax. If the taxpayer files a petition, the tax is not assessed until the decision of the Tax Court is final. Collection of the liability cannot begin until the liability has been assessed.<sup>5</sup> However, the IRS may assess and collect tax under jeopardy procedures before the issuance of the statutory notice of deficiency, if the IRS determines that delay will jeopardize collection<sup>6</sup> (such as when a taxpayer's solvency is imperiled or if a taxpayer has intentionally attempted to place property out of the IRS's reach).<sup>7</sup>

Under IRC § 6402(a), the IRS may credit any overpayment against an outstanding tax liability, providing the IRS with another alternative for collecting past due liabilities. The statute, however, does not define liability. The IRS addressed this issue in Revenue Ruling 2007-51, which concludes that a liability is determined with specificity no later than the date the IRS sends a statutory notice of deficiency to the taxpayer.<sup>8</sup>

## Reason for Change

In response to concerns raised outside the IRS<sup>9</sup> as well as by the National Taxpayer Advocate, the IRS Office of Chief Counsel reaffirmed its position that credits can be offset against an unassessed tax liability,<sup>10</sup> relying on several cases<sup>11</sup> in which the courts have held that crediting an overpayment is proper when a taxpayer's liability for the year of an underpayment is "then due," and that underpayments are "then due" when the IRS has issued a statutory notice of deficiency. Given the strong statutory support for a prepayment forum

<sup>3</sup> IRC § 6213(a).

<sup>4</sup> IRC § 6213. Within 90 days from the time the notice of deficiency is mailed, the taxpayer may file a petition with the Tax Court for redetermination of the deficiency.

<sup>5</sup> IRC §§ 6502 and 6215(a).

<sup>6</sup> IRC § 6861. The IRS may, if the collection of any tax is jeopardized by delay, immediately assess such tax, and interest and penalties, and the assessment will be due and payable upon notice and demand. However, the taxpayer can still petition the Tax Court after the jeopardy assessment.

<sup>7</sup> See IRC § 6861. See also Treas. Reg. §§ 301.6861-1(a) and 1.6851-1(a)(1)(ii) and (iii).

<sup>8</sup> Rev. Rul. 2007-51, 2007-2 C.B. 573. See also IRC § 6212 (requiring the IRS to send taxpayers a statutory notice of deficiency prior to assessment).

<sup>9</sup> Letter from Carlton M. Smith, Director of the Cardozo Tax Clinic, Benjamin N. Cardozo School of Law, to Hon. Charles B. Rangel Chairman, House Ways and Means Committee and Hon. Max Baucus Chairman, Senate Finance Committee (Sept. 20, 2007), published in, *Associate Professor Calls IRS Ruling Harmful to Low-Income Taxpayers*, Tax Notes Today, 2007 TNT 185-70 (Sept. 24, 2007).

<sup>10</sup> Letter from Deborah Butler, Associate Chief Counsel (Procedure and Administration), to Carlton M. Smith, Director of the Cardozo Tax Clinic, Benjamin N. Cardozo School of Law, (Dec. 31, 2007), published in, *IRS Maintaining Legality of Revenue Ruling on Refund Offsets in Letter to Law Professor*, Tax Notes Today, 2008 TNT 5-9 (Jan. 8, 2008).

<sup>11</sup> See *McCarl v. United States*, 42 F.2d 346 (D.C. Cir. 1930), cert. denied, 284 U.S. 839 (1930) (interpreting § 284(a) of the Revenue Act of 1926); *Cole v. Helvering*, 78 F.2d 852 (D.C. Cir. 1934) (interpreting § 322(a) of the Revenue Act of 1928); *Standard Oil Co. v. United States*, 5 F. Supp. 976 (Ct. Cl. 1934), cert. denied, 293 U.S. 599 (1934). See also *Smith v. Director of Internal Revenue*, 77-2 U.S.T.C. (CCH) ¶ 9599 (S.D. Fla. 1977) (taxpayer's suit for a refund of 1975 tax that had been credited to deficiencies pending before the Tax Court was dismissed without prejudice).

in the Tax Court, the National Taxpayer Advocate is concerned that this interpretation of the term “liability” in IRC § 6402 will vitiate the concept of the prepayment forum, even though the Tax Court retains jurisdiction over the disputed liability. Offsetting a refund against an unassessed liability before going to Tax Court erodes the prepayment forum and eliminates an important check on the substantial power of the IRS to propose, assess, and collect taxes. This longstanding prepayment forum principle, coupled with the congressional limitation on collection prior to assessment (in most circumstances), indicates that Congress believes tax liabilities should be assessed prior to collection, including collection through refund offset under IRC § 6402(a). Therefore, IRC § 6402(a) should be amended to reverse the IRS interpretation and clarify that “liability” means “assessed liability.”

The IRS’s actual concern appears to be with the corporate net operating loss and the desire to offset an unassessed liability against a refund arising from the loss. If jeopardy authority is not sufficient to justify such action, then IRS should make its case to Congress – providing data to justify abridging the taxpayer’s statutory right to a prepayment forum.

One explanation for why the IRS is moving to offset corporate refunds against liabilities that have not yet been assessed is the IRS’s concern that the liability will go unpaid. However, if delay will jeopardize collection of tax, the IRS can assess such deficiency immediately using jeopardy assessment procedures.<sup>12</sup> The IRC allows for jeopardy assessments when a taxpayer’s solvency is imperiled or if a taxpayer has intentionally attempted to place property out of the IRS’s reach.<sup>13</sup> Collecting the liability prior to its assessment is unnecessary, since the IRS already has the authority under jeopardy proceedings to assess and collect on a liability before issuance of the statutory notice of deficiency, if collection is at risk. Outside these special circumstances, Congress has provided taxpayers with the opportunity to dispute their liabilities prior to assessment and collection.

### Explanation of Recommendation

This recommendation to amend IRC § 6402(a) prevents the IRS from offsetting a legitimate refund against an uncertain, unassessed liability. This change preserves the prepayment forum established by Congress, so taxpayers will not face the burden of having to satisfy the liability before challenging a liability in court. This approach reflects the basic principle of our tax system – that taxpayers only have to pay what they owe, and only after their liabilities have been determined to a high degree of certainty. Offsetting a refund to a disputed liability before that liability is assessed, and while the taxpayer still has the opportunity to challenge the notice of deficiency in the Tax Court, undermines a fundamental right of taxpayers. If the IRS is concerned about the collection of tax in situations involving unassessed liabilities, it should use its existing jeopardy assessment and collection powers. Where jeopardy assessment powers are inadequate and compelling public policy concerns

<sup>12</sup> IRC § 6861. The IRS may, if the collection of any tax is jeopardized by delay, immediately assess such tax, and interest and penalties, and the assessment will be due and payable upon notice and demand. However, the taxpayer can still petition the Tax Court after the jeopardy assessment.

<sup>13</sup> See IRC § 6861. See also Treas. Reg. §§ 301.6861-1(a) and 1.6851-1(a)(1)(ii) and (iii).

warrant offset of a tax refund against an unassessed liability, Congress should explicitly authorize such collection.

LR  
#14**Waiver of Levy Prohibition Under Internal Revenue Code Section 6331(k)****Problem**

Section 6331(k) of the Internal Revenue Code (IRC) generally provides that the IRS cannot levy on a taxpayer's assets while an offer in compromise (OIC) is pending or an installment agreement (IA) is pending or in effect. This prohibition does not apply, however, if the taxpayer files a written notice with the IRS waiving the levy restriction.<sup>1</sup> This aspect of the law creates the risk that the IRS will make such a waiver a necessary condition to obtain an IA or OIC.

**Example**

A husband and wife who own their home owe federal income tax, interest, and penalties for a number of tax years. They cannot fully pay their liability before the statutory period of limitations for collection will expire, and thus seek to enter into a partial payment installment agreement (PPIA) with the IRS. The IRS initially determines that seizure of the taxpayers' home would impose an economic hardship on the taxpayers and their family. Four months later, however, the IRS determines the taxpayers qualify for a PPIA but nonetheless refuses to allow them to enter into such an agreement unless they agree to waive the levy prohibition so the IRS can seize and sell their home.

**Recommendation**

Amend IRC § 6331 to prohibit the IRS from requiring the taxpayer to waive the IRC § 6331(k) prohibition on levies as a condition precedent to the IRS's consideration or acceptance of installment payments or an OIC.

**Present Law**

IRC § 6159 authorizes the IRS to enter into written agreements to allow the taxpayer to pay any liability in installments if the IRS determines that such agreement will facilitate the full or partial collection of such liability. IRC § 7122 provides that the IRS can compromise the taxpayer's liability through an OIC. Paragraphs (1) and (2) of IRC § 6331(k) provide that no levy may be made during:

- The period that a taxpayer's OIC or offer for an IA is pending;
- The 30 days after such an offer has been rejected;

<sup>1</sup> IRC §§ 6331(k)(3)(A) and 6331(i)(3)(A)(i).

- The timely filed appeal of such a rejection;
- The period when an IA is in effect; and
- The 30 days after any termination of an IA.

IRC § 6331(k)(3)(A) states that rules similar to IRC § 6331(i)(3) and (4) shall apply for purposes of IRC § 6331(k). Section 6331(i) generally prohibits levies while proceedings for the refund of divisible tax are pending in federal court.<sup>2</sup> Section 6331(i)(3)(A), however, provides that the levy prohibition shall not apply if the taxpayer files a written notice with the IRS waiving this restriction. Thus, by a cross-reference to IRC § 6331(i)(3), IRC § 6331(k)(3)(A) gives taxpayers the ability to waive the ban on levies during the consideration of an IA or OIC and while an IA is in effect.

The prohibitions on levy during the pendency of proceedings for the refund of a divisible tax and while IAs are in effect, and the accompanying provision for taxpayer waiver of such prohibitions, were added to the Code by the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98).<sup>3</sup> The Conference Report for RRA 98 suggests Congress gave taxpayers the ability to waive the levy prohibition to allow them to determine when a levy on a particular asset or assets would be in their best interest. Such collection would stop the running of interest and penalties as to the portion of the liability satisfied by the levy. In explaining the prohibition of levies during the pendency of refund proceedings, the Conference Report stated that, “Collection by levy would be withheld unless jeopardy exists or the taxpayer waives the suspension of collection in writing (**because collection will stop the running of interest and penalties on the tax liability**)” (emphasis added).<sup>4</sup>

### Reasons for Change

Congress has given taxpayers the unconditional right to waive the prohibition of levies during the consideration of and after the rejection of IAs or OICs, and while IAs are in effect. Without specific direction or any limitations from Congress, the IRS may enter into IAs and OICs by making taxpayers waive the prohibition on levies as a precondition to considering or accepting such agreements. Because Congress intended that taxpayers would control the prohibition on levies to reduce penalties and interest by waiving their rights, any requirement by the IRS to require a waiver before considering or accepting IAs or OICs abrogates Congress’ intent with respect to IRC § 6331(k)(3)(A).

The IRS enters IAs and OICs to facilitate full or partial collection of tax liabilities. Congress has not conditioned IAs or OICs on the IRS using intrusive and forced collection measures

<sup>2</sup> A divisible tax is one in which the assessment may be divided into portions or separate transactions, such as employment taxes, Trust Fund Recovery Penalties, certain excise taxes and abusive tax shelter penalties. See IRM 1.2.14.1.4, *Policy Statement 5-16* (Mar. 1, 1984) and 5.11.1.3.10 (July 1, 2004).

<sup>3</sup> Pub. L. No. 105-206, § 3462(b) (July 22, 1998).

<sup>4</sup> H.R. Rep. No. 105-599, at 279 (1998) (Conf. Rep.).

to make additional collections. Rather, the conference report mentioned above makes clear that Congress believes collection by IAs or OICs enhances taxpayer compliance.<sup>5</sup>

Taxpayers have a right to decide when to waive the prohibition on levies, and the IRS should not condition the acceptance of an IA or OIC on the taxpayer waiving the collection restrictions. Yet the National Taxpayer Advocate has witnessed occasions when the IRS has attempted to require a waiver in exchange for agreeing to an IA.

### Explanation of Recommendation

To protect taxpayers from IRS overreaching, the National Taxpayer Advocate recommends that Congress amend IRC § 6331(k)(3)(A) to clarify that the IRS is prohibited from making a waiver of the levy prohibition a condition for considering or approving an IA or OIC.

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<sup>5</sup> H.R. Rep. No. 105-599, at 289 (1998) (Conf. Rep.)

LR  
#15**Mailing Duplicate Notices to Credible Alternate Addresses****Problem**

IRS notices often trigger the legal rights and obligations of taxpayers to do many things, such as contest a liability, challenge a deficiency notice, or contest a lien filing. The IRS mails these notices to the taxpayer's last known address.<sup>1</sup> However, with a population that is mobile and transitory, the last known address contained in the IRS's Master File may not reflect the taxpayer's current residence. As a result, taxpayers who are between return filing seasons and have not updated their addresses with the U.S. Postal Service (USPS) may not receive notices from the IRS that provide crucial legal rights and obligations, such as specific time limits on taking some required action. Between 2006 and 2007, about 13 percent of the U.S. population over the age of 16 moved, demonstrating the large number of taxpayers who potentially may not update their addresses with the IRS in any given year.<sup>2</sup> For example, in fiscal years 2007 and 2008 more than five percent of all audit correspondence mailed to taxpayers was returned as undeliverable.<sup>3</sup>

**Example**

A taxpayer timely files an income tax return for 2005 in 2006. For years beginning in 2006 and beyond, his income consists only of Social Security and minimal interest payments and is below the filing threshold so the taxpayer does not file a return. In 2007, the taxpayer falls ill and moves into a nursing home. Because of the illness, the taxpayer did not update his address with the USPS. The IRS discovers an issue with the taxpayer's last filed return and in early 2008 mails a letter to the taxpayer's last known address as contained in the Master File. The taxpayer no longer lives at this address and does not receive the letter. Had the IRS checked a third party database, it may have discovered a better address for the taxpayer through department of motor vehicle records, credit card billing addresses, or Social Security payment records.

**Recommendation**

The National Taxpayer Advocate recommends that Congress amend IRC § 7701 to add a definition of "last known address" that incorporates case law and current regulations. Congress also should direct the Secretary of Treasury to:

<sup>1</sup> Treas. Reg. § 301.6212-2.

<sup>2</sup> U.S. Census Bureau, *Geographical Mobility: 2006 to 2007 Detailed Tables*, at <http://www.census.gov/population/www/socdemo/migrate/cps2007.html> (last visited Dec. 15, 2008).

<sup>3</sup> Audit Information Management System (AIMS Database) IRS Compliance Data Warehouse. In fiscal year 2007 5.6 percent of audit correspondence was returned and 5.1 percent returned in fiscal year 2008.

- (1.) Develop procedures for checking third party databases for credible alternate addresses prior to sending notices that establish legal rights and obligations (*i.e.*, Statutory Notices of Deficiency, Collection Due Process notices, notices of Federal tax lien filing, *etc.*); and
- (2.) When there is a credible alternate address, require the IRS to mail the notice simultaneously to the last known address and to the credible alternate address (as defined by the Secretary).

### Present Law

Many provisions of the Internal Revenue Code (IRC) require the IRS to mail notices to the taxpayer's last known address.<sup>4</sup> However, there is no statutory definition of the term "last known address." Treasury Regulations define "last known address" as the address on the taxpayer's last filed return, his or her address as reported to the USPS, or the address provided by clear and concise notice to the IRS.<sup>5</sup> No law or regulation requires the IRS to use third party sources, other than the USPS, to ascertain a credible alternate address for a taxpayer, even when notices that have been mailed to a last known address are returned to the IRS as undeliverable.

### Reasons for Change

Taxpayers who move, and who do not update their addresses with the IRS or the USPS, may never receive notices that trigger crucial legal rights and obligations. The burden is on the taxpayer to keep the IRS informed of the taxpayer's whereabouts. The IRS can meet the letter of the law by mailing notices to the last known address, even if it may be many years old and the IRS has had no correspondence from the taxpayer, including filed tax returns, in the intervening years.

If a collection notice comes back as undeliverable, the IRS feeds the taxpayer's previous address into third party software to ascertain if a new address might exist. If it finds a new address, the Collection function mails a letter seeking confirmation that this is the taxpayer's present address, and includes a change of address form for the taxpayer to file if indeed the taxpayer has moved. This is known as an "Are you there?" letter. The IRS Collection function mails a similar letter in cases where the USPS returns mail with a change of address notification. Between Jan. 1, 2008, and Dec. 15, 2008, the IRS mailed over 100,000 Undeliverable Mail - New Address Verification letters, representing only letters sent by the Collection function to taxpayers whose undeliverable mail was returned with change of address notifications.<sup>6</sup> This figure does not include the number of "Are you there?" letters sent to addresses obtained through third party databases. The letter simply asks if the

<sup>4</sup> See, e.g., IRC §§ 6212, 6320, 6330, 6303.

<sup>5</sup> Treas. Reg. § 301.6212-2.

<sup>6</sup> Wage & Investment Division, Office of the Notice Gatekeeper, *L 2788C Undeliverable Mail-New Address Verification*, at <http://gatekeeper.web.irs.gov/snip-Detail.aspx?pCP=2788C> (last visited Dec. 15, 2008). A total of 111,044 of these letters were sent between January 1, 2008, and December 15, 2008.

taxpayer is at the new address, and includes a change of address form for the taxpayer to file if indeed the taxpayer has moved. However, any time period triggered by the initial notice that spurred the “Are you there?” letter continues to run and may expire before the taxpayer responds with an updated address.

Requiring the IRS to perform an address search and to mail a duplicate notice to a credible alternate address (if one exists) simultaneously with the statutorily required notice mailed to the last known address will increase the possibility of reaching that taxpayer at the beginning of the process. Reaching the taxpayer at an earlier juncture would in turn allow the taxpayer to resolve or try to resolve the situation before the time for doing so expires and before further fees and penalties accumulate.

### Explanation of Recommendation

Providing a statutory definition of the “last known address” that includes a provision for checking third party databases for credible alternate addresses and sending a duplicate notice will increase the likelihood the taxpayer receives actual notice and reduce the volume of undeliverable mail. The IRS currently uses third party databases to check addresses in the collection context and can develop rules for what constitutes a “credible alternate address” such that the IRS is comfortable mailing a duplicate notice to the taxpayer at that address.<sup>7</sup> This approach will help to protect the taxpayer’s privacy as well as increase responsiveness to correspondence.

By requiring the IRS to mail a duplicate notice to a credible alternate address simultaneously with the required notice to the taxpayer’s last known address, the IRS would have a better chance of resolving the taxpayer’s case early in the process, saving the time and expenditure associated with unnecessary appeals, audit reconsideration, litigation, and collection. Early intervention on the part of the IRS would reduce burden to both the IRS and the taxpayer.

<sup>7</sup> In issuing regulations, the Secretary will need to define what constitutes a credible alternate address, what constitutes a third party database, and what a notice with significant legal effect is.

LR  
#16**Health Insurance Deductions for Self-Employed Individuals****Problem**

In her 2001 and 2004 Annual Reports to Congress, the National Taxpayer Advocate recommended that Congress repeal Internal Revenue Code (IRC) § 162(l)(4) to afford sole proprietors the same tax treatment as their wage-earning counterparts.<sup>1</sup> Self-employed individuals cannot deduct health insurance costs when determining net earnings for self-employment tax purposes. While wage-earners can participate in benefit plans that allow them to exclude their contributions from gross income,<sup>2</sup> thereby avoiding Social Security and Medicare taxes, self-employed taxpayers must pay both the employee and employer shares of Social Security and Medicare taxes on their health insurance costs.<sup>3</sup> Further, C corporations can deduct the health insurance premiums paid on behalf of their employees as ordinary and necessary business expenses, and are not subject to Social Security or Medicare taxes on those amounts for either the employer or employee.<sup>4</sup>

**Example**

Mr. Smith, who is self-employed, spends \$7,000 every year on health insurance premiums for himself and his family. At a tax rate of 15.3 percent, Mr. Smith must pay \$1,071 in self-employment tax on what he spends for his family's health insurance. Mr. Smith must pay both the employer and employee shares of the Medicare and Social Security taxes associated with his health insurance premiums. In contrast, a wage earner who participates in his employer's cafeteria plan and incurs the same health insurance costs (\$7,000) is not required to pay Social Security and Medicare taxes on his premiums. Because Mr. Smith is self-employed, he pays \$1,071 more than his wage-earning counterpart. Additionally, the employer of the wage-earning individual can deduct payments made to cover employee health insurance from gross income, thus avoiding Social Security or Medicare taxes on those premiums.

**RECOMMENDATION**

Congress should repeal IRC § 162(l)(4) to place self-employed taxpayers on an equal footing with their wage-earning counterparts.

<sup>1</sup> See National Taxpayer Advocate 2004 Annual Report to Congress 388; National Taxpayer Advocate 2001 Annual Report to Congress 223.

<sup>2</sup> See IRC § 106(a).

<sup>3</sup> IRC § 1401. Partners in partnerships and two percent owners in "S" Corporations also must file an IRS Form 1040, Schedule E, which does not allow for the deduction of self-employment tax on insurance premiums paid.

<sup>4</sup> IRC § 162(a) and Treas. Reg. § 1.162-10(a).

LR  
#17**Mileage Deduction for Charitable Activities****Problem**

Section 162(a) of the Internal Revenue Code (IRC) generally allows a trade or business to take a deduction for ordinary and necessary expenses paid or incurred during the taxable year in connection with the trade or business. For trade or business expenses associated with operating a passenger automobile, taxpayers have the option of deducting actual expenses or taking the standard mileage deduction.<sup>1</sup>

The IRS annually adjusts the standard mileage rate for business expenses. For 2008, the IRS initially set the rate at 50.5 cents per mile.<sup>2</sup> However, due to the rapidly increasing cost of fuel, the IRS increased the standard mileage rate to 58.5 cents per mile for business expenses incurred during the last six months of 2008.<sup>3</sup>

For passenger automobiles driven for charitable activities, the allowable mileage deduction is governed by IRC § 170,<sup>4</sup> which sets the standard mileage deduction for vehicle expenses associated with a charitable activity at 14 cents per mile. Unlike the standard mileage deduction for business expenses, the mileage deduction for charitable activities is specified in the Code, with no provision to allow the IRS or the Secretary of the Treasury to adjust the rate. As a result, the IRS does not have the discretion to adjust the standard mileage deduction for charitable activities from year to year.

**Example**

John Doe has been volunteering at his local church for the past six years. The church organizes a food drive each Thanksgiving, collecting groceries from its congregation for volunteers to distribute to needy families. John has a large sport utility vehicle that can hold many bags of groceries and seat several other volunteers. John does not receive reimbursement from the church for his fuel expenditures (which have increased significantly over the years), but is allowed to deduct 14 cents per mile driven for this charitable activity.

John recalls receiving reimbursement at a much higher rate on the few occasions that he has had to drive his car for his company. Upon checking his records, John learns that his company reimbursed him 36 cents a mile in 2003, and each year the mileage rate increased,

<sup>1</sup> See Rev. Proc. 2007-70, 2007-2 C.B. 1162.

<sup>2</sup> See *id.*

<sup>3</sup> See Announcement 2008-63, 2008-28 I.R.B. 114.

<sup>4</sup> IRC § 162(b) provides that no deduction is allowed under IRC § 162(a) for any charitable contribution or gift.

reaching 58.5 cents a mile in 2008. John wonders why the church is only reimbursing him 14 cents a mile this year, the same as in 2003.

### Reasons for Change

Many U.S. residents felt the effect of the cost of gasoline reaching all-time highs in 2008. The IRS has recognized this fact and has increased the standard mileage rate for business expenses for the latter part of the year. Each year, the IRS adjusts the standard mileage deduction for business expenses. However, the standard mileage rate for providing services for charitable organizations may not be adjusted without a change in legislation.

Several bills have been introduced in Congress in recent years addressing this concern, including:

- H.R. 2020 introduced April 24, 2007, by Rep. Todd Platts (PA);
- H.R. 6283 introduced June 17, 2008, by Rep. John Lewis (GA); and
- S. 3246 introduced July 10, 2008, by Sen. Benjamin Cardin (MD).

Providing this adjustment will assist charities, especially in difficult times when taxpayers are unable to make cash donations but would make in-kind donations or volunteer their time.

### Recommendation

The National Taxpayer Advocate recommends that Congress amend IRC § 170(i) to allow the Secretary of the Treasury to determine the standard mileage rate for charitable activities.