## INTRODUCTION

The National Taxpayer Advocate has a statutory requirement that is unique within the Internal Revenue Service. The Advocate is directed by Section 7803 (c)(3)(B)(viii) of the Internal Revenue Code to formulate and present in the Annual Report to Congress, proposals for legislative action that will ameliorate or eliminate problems affecting Taxpayers. Frequently, these difficulties impede a taxpayer's ability to comply with federal law. Our mandate is to identify actual and potential barriers confronting taxpayers, and to propose viable legislative options.

The following recommendations arose from a variety of sources, including those internal to the Taxpayer Advocate Service, and the Internal Revenue Service. Suggestions and comments from external groups, including tax professionals, Taxpayer Advocacy Panels, the IRS Oversight Board, and Low Income Taxpayer Clinics were an invaluable source of ideas. We also analyzed data and commentary compiled through customer satisfaction surveys, research projects, and academic treatises.

Our discussion is grouped into two categories: Key Legislative Recommendations, and Additional Legislative Issues. The former details proposed changes in six areas of tax law, and provides an issue summary, practical example of its impact, and a description of our proposal as it relates to current law. We have included information about the impact on taxpayers, and the potential administrative requirements each proposal imposes upon the IRS. As with other sections of this Report, the issue of taxpayer rights figure prominently in our discussion.

The section on Additional Legislative Issues contains five areas which are worthy of mention, but require further development. These issues will be explored by the Taxpayer Advocate Service during the next year, and evaluated for possible inclusion in our formal legislative proposals. We note that the majority of these recommendations were proposed by employees of IRS Operating Divisions and functions other than the Taxpayer Advocate Service.

The Key Recommendations meet the criteria identified in our "Most Serious Problems" section. There are linkages, for example, between the discussion related to Math Error Authority and oversight of EITC return preparers, and the legislative proposals that follow. Several of the issues that surface in the "Most Litigated" section are also subsequently addressed by a suggested legislative remedy. For example, the inconsistent tax treatment of attorney fee awards and settlements in civil rights or similar cases was first identified in our analysis of litigation about deductions or unreported income.

Several of the Key Legislative Recommendations in our 2001 Annual Report received serious consideration by legislators, and were introduced in proposed bills. Provisions related to the uniform definition of a qualifying child struck a particularly responsive chord among both taxpayers and their elected representatives. Although the Alternative Minimum Tax did not receive the level of attention that we believe the problem warrants, its inclusion in last year's report heightened both legislators' and taxpayers' awareness of a looming tax administration debacle.

This legislative activity emphasizes that one of the primary functions of our report is to intensify the scrutiny of problems in either the complexity of the Code or the implementation of the tax law by the Internal Revenue Service. Although the TAS organization works to resolve these issues administratively, often a legislative solution is required. We believe that the submissions which follow are among that group.

RECOMMENDATIONS

LEGISLATIVE RECOMMENDATIONS

## STATUS OF 2001 LEGISLATIVE RECOMMENDATION WITH CONGRESSIONAL ACTION

| RECOMMENDATION | BILL NO. | SPONSOR | DATE | CURRENT STATUS |
|---|---|---|---|---|
| **Family Issues** | | | | |
| Uniform Definition of a Qualifying Child | HR 5166 | Portman | 7/18/2002 | referred to the Ways & Means Committee |
| | HR 5505 | Houghton | 10/1/2002 | referred to the Ways & Means Committee |
| Means Tested Public Assistance Benefits | HR 5505 | Houghton | 10/1/2002 | referred to the Ways & Means Committee |
| Credits for the Elderly or the Permanently Disabled | S 2131 | Bingaman | 4/15/2002 | referred to the Senate Finance Committee |
| **Alternative Minimum Tax** | | | | |
| Repeal | HR 437 | English | 2/6/2001 | referred to the Ways & Means Committee |
| | S 616 | Hutchinson | 3/26/2002 | referred to the Senate Finance Committee |
| | HR5166 | Portman | 7/18/2002 | referred to the Ways & Means Committee |
| Index AMT exemption | HR 5505 | Houghton | 10/1/2002 | referred to the Ways & Means Committee |
| **Penalties & Interest** | | | | |
| Interest Abatement on Erroneous Refunds | HR 586 | Lewis | 2/13/2001 | 4/18/02 passed the House w/ an amendment - referred to Senate |
| | HR 3991 | Houghton | 3/19/2002 | defeated in House |
| First Time Penalty Waiver | HR 586 | Lewis | 2/13/2001 | 4/18/02 passed the House w/ an amendment - referred to Senate |
| | HR 3991 | Houghton | 3/19/2002 | defeated in House |
| Federal Tax Deposit (FTD) Avoidance Penalty | HR 586 | Lewis | 2/13/2001 | 4/18/02 passed the House w/ an amendment - referred to Senate |
| | HR 3991 | Houghton | 3/19/2002 | defeated in House |
| **Home-based Service Workers** | | | | |
| | S 2129 | Bingaman | 4/15/2002 | referred to the Senate Finance Committee |
| **Joint & Several Liability** | | | | |
| Community Property | HR4070 | Shaw | 3/20/2002 | 11/18/02 as amended passed by the Senate |

SECTION TWO

| RECOMMENDATION | BILL NO. | SPONSOR | DATE | CURRENT STATUS |
|---|---|---|---|---|
| **IRS Collection Procedures** | | | | |
| Return of Levy or Sale Proceeds | HR 586 | Lewis | 2/13/2001 | 4/18/02 passed the House w/ an amendment - referred to Senate |
| | HR 3991 | Houghton | 3/19/2002 | defeated in House |
| Reinstatement of Retirement Accounts | HR 586 | Lewis | 2/13/2001 | 4/18/02 passed the House w/ an amendment - referred to Senate |
| | HR 3991 | Houghton | 3/19/2002 | defeated in House |
| Partial Payment Installment Agreements | HR 586 | Lewis | 2/13/2001 | 4/18/02 passed the House w/ an amendment - referred to Senate |
| | HR 3991 | Houghton | 3/19/2002 | defeated in House |
| **Employment Tax Issues** | | | | |
| Health Insurance Deduction for Self-Employed Individuals | S 2130 | Bingaman | 4/15/2002 | referred to the Senate Finance Committee |
| **Small Business Issues** | | | | |
| Income Averaging for Commercial Fisherman | S 312 | Grassley | 2/13/2001 | referred to the Senate Finance Committee |
| | HR 2347 | Nussle | 6/27/2001 | referred to the Ways & Means Committee |
| | S 1676 | Kerry | 11/13/01 | referred to the Senate Finance Committee |
| **Other Issues** | | | | |
| Disclosure Regarding Suicide Threats | HR 586 | Lewis | 2/13/2001 | 4/18/02 passed the House w/ an amendment - referred to Senate |
| | HR 3991 | Houghton | 3/19/2002 | defeated in House |
| Tolling the Statute of Limitations 7811(d) | HR 586 | Lewis | 2/13/2001 | 4/18/02 passed the House w/ an amendment - referred to Senate |
| | HR 3991 | Houghton | 3/19/2002 | defeated in House |
| Low-Income Taxpayer Clinics | HR 586 | Lewis | 2/13/2001 | 4/18/02 passed the House w/ an amendment - referred to Senate |
| | HR 3991 | Houghton | 3/19/2002 | defeated in House |
| | HR 7 | Baucus | 7/16/2002 | reported by Chairman Baucus, with an amendment referred to the Senate Finance Committee |

RECOMMENDATIONS

LEGISLATIVE RECOMMENDATIONS

## 1 ATTORNEY FEES IN NONPHYSICAL PERSONAL INJURY CASES

### DID YOU KNOW?

- Nonphysical personal injury cases are filed by victims of employment, race, sex, or age discrimination, breach of contract, or wrongful termination.
- Contingent attorney fees and attorney fee awards are treated differently depending on where the taxpayer lives and which court hears the case.
- The United States Courts of Appeal for the Fifth, Sixth, and Eleventh Circuits now exclude the fees from income.
- The First, Third, Fourth, Seventh, Ninth, Tenth, and Federal circuits hold that the fees are includible in income.
- The United States Tax Court generally considers the fees includible in gross income unless the case can be appealed to the Fifth, Sixth, or Eleventh Circuit Courts.
- The United States Supreme Court has declined to accept cases that might resolve this conflict.
- The current IRS position is that the fees are includible in income.
- If the fees are includible in income, they may be deductible on Schedule A, Itemized Deductions, as a miscellaneous deduction subject to the limitation of two percent of adjusted gross income.
- Miscellaneous deductions on Schedule A, Itemized Deductions, are reduced if adjusted gross income exceeds certain amounts (for 2002: $137,300 or 68,650 if married filing separately).
- Miscellaneous deductions on Schedule A, Itemized Deductions, are subject to the Alternative Minimum Tax (AMT) because they are not deductible for AMT purposes.
- The treatment of miscellaneous deductions under the AMT may result in the combined attorney fees and tax on the settlement or award consuming the majority, or possibly all, of the damages received by the taxpayer. Indeed, it is possible that the tax liability of a prevailing party may **exceed** the damages awarded, resulting in a **reduction** in the individual's assets.

### PROBLEM

Nonphysical personal injury cases are usually filed by victims of employment, race, sex, or age discrimination, breach of contract, or wrongful termination. In such cases, contingent attorney fees and attorney fee awards are treated differently depending on where the taxpayer lives and which court hears the case. The United States Courts of Appeal for the Fifth, Sixth, and Eleventh Circuits now exclude the fees from the taxpayer's gross income. The First, Third, Fourth, Seventh, Ninth, Tenth, and Federal circuits hold that the fees are includible in gross income. The United States Tax Court generally considers the fees includible in gross income unless the case can be appealed to the Fifth, Sixth, or Eleventh Circuit Courts. The United States Supreme Court has declined on at least four occasions to accept cases that might resolve this conflict.[1] The current IRS position is that the fees are includible in gross income.[2]

The disparate treatment of attorney fee awards or settlements in nonphysical personal injury cases results in some taxpayers being able to completely exclude these legal fees from gross income while other taxpayers must include them. If the fees are includible in gross income, the taxpayer may be able to deduct them as a miscellaneous itemized deduction subject to the limitation of two percent of adjusted gross income (AGI). However, miscellaneous itemized deductions are not deductible for alternative minimum tax (AMT) purposes and may be subject to the Internal Revenue Code section 68 limitation on itemized deductions for high-income taxpayers.[3] The treatment of miscellaneous deductions under the AMT may result in the combined attorney fees and tax on the settlement or award consuming the majority, or possibly all, of the damages received by the taxpayer.[4]

### EXAMPLES

- A New York Times article stated that a police officer who sued her employer for sex discrimination and harassment prevailed in court and was awarded $300,000 in damages and almost $950,000 in attorneys' fees and costs. Her state falls under the jurisdiction of the U.S. Court of Appeals for the Seventh Circuit, so she must include almost $1,250,000 in taxable income on her federal return. Her tax liability will consume the entire $300,000 of the damage award, *and she will owe an additional $99,000 in federal taxes*. The net effect of her successful lawsuit against her

[1] Benci-Woodward v. Commissioner, 121 S. Ct. 855 (2001); Coady v. Commissioner, 121 S. Ct. 1604 (2001); Hukkanen-Campbell v. Commissioner, 122 S. Ct. 1915 (2002); Sinyard v. Rossotti, 122 S. Ct. 2357 (2002).

[2] Internal Revenue Service Market Segment Specialization Program (MSSP) Audit Guide, *Lawsuit Awards and Settlements*, Chapter 3, Other Related Topics, Deduction for Attorneys' Fees.

[3] The effect of the IRC § 68 limitation is such that, as a taxpayer's adjusted gross income exceeds the threshold level, the amount of itemized deductions that can be claimed is reduced. For tax years beginning in 2002, the applicable amount is $137,300 (or $68,650 if married filing separately).

[4] Timothy R. Koski, *Should Clients Escape Tax on Lawsuit Proceeds Retained by Attorneys?*, 2001 Tax Notes Today, 126-42.

employer will be to leave her worse off financially than before she filed the discrimination claim.[5]

- A different result would occur if the police officer lived in a state under the jurisdiction of the U.S. Court of Appeals for the Fifth Circuit. In this circuit, the taxpayer could exclude the $950,000 in attorney fees and costs from her taxable income and would only owe tax on the $300,000 damage award. Assuming her total award would be taxed at the maximum tax rate of 38.6 percent for 2002, she would owe $115,800 in federal income tax, leaving her with $184,200.

The above examples represent a $283,200 difference in tax liabilities between identically situated taxpayers, solely as a consequence of the judicial district in which the taxpayer resides. The result would be the same whether the attorney's fee arose from a contingent fee agreement or a court-ordered award.

### RECOMMENDATION

The following three recommendations eliminate the unequal treatment under current law of legal fees in cases involving nonphysical personal injury. The first recommendation is the easiest for taxpayers to understand and requires less computational ability in preparing the tax return. Recommendations two and three achieve the same result but with greater complexity than the first proposal. They would, however, enable the IRS to track whether taxpayers are reporting attorney fees and taxable awards correctly.

1. Amend IRC § 104(a)(2) to exclude from gross income legal fees agreed upon or awarded in nonphysical personal injury settlements and judgments.
2. Include legal fees agreed upon or awarded in nonphysical personal injury settlements and judgments in gross income, and amend IRC § 62 to allow an adjustment to income for such fees in calculating adjusted gross income (AGI).
3. Include legal fees agreed upon or awarded in nonphysical personal injury settlements and judgments in gross income but allow an itemized deduction that is not subject to the two percent of AGI limitation of IRC § 67(a). In addition, an exception should be included in IRC § 68 regarding the limitation rules for itemized deductions and a deduction should be allowed for AMT purposes under IRC § 56.

The National Taxpayer Advocate recommends the second alternative.

[5] Adam Liptak, *Tax Bill Exceeds Award to Officer in Sex Bias Suit*, The New York Times, Because of the restrictions against public disclosure of confidential taxpayer records, none of the information in the above example was verified against official IRS records or sources. Aug. 11, 2002, page 18.

## PRESENT LAW

### INCLUSION OF LEGAL FEES IN GROSS INCOME

Internal Revenue Code section 61(a) defines gross income as including "all income from whatever source derived" unless otherwise excluded under the Internal Revenue Code. In general, non-punitive damages received in a personal injury case are excludable from income only if the payments are received on account of injury or sickness and the injury or sickness is physical in nature.[6] Punitive damages are not excludible from income.[7] Damages received for emotional distress are not excludable, except to the extent that amounts received are attributable to medical expenses incurred as a result of the emotional distress.[8]

Nonphysical personal injury may result from employment, race, sex, or age discrimination, breach of contract, or wrongful termination. Prior to 1996, the Internal Revenue Code did not distinguish between physical and nonphysical injury and allowed damages from both types of injury to be excluded from income.[9] However, courts reached differing conclusions about whether discrimination resulted in personal injury and thus came within the scope of IRC § 104(a)(2).[10] The Small Business Job Protection Act of 1996[11] amended IRC § 104(a)(2) to exclude from gross income the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal *physical* injuries or *physical* sickness.[12] Therefore, a claimant who pays legal fees to pursue damages for other than personal physical injuries or physical sickness and who receives reimbursement of these fees pursuant to a settlement or judgment is required to include the reimbursement in gross income.[13]



[6] IRC § 104(a)(2).

[7] *Id.*

[8] *Id.*

[9] IRC § 104(a)(2) prior to the 1996 amendment read as follows: "(2) the amount of any damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injuries or sickness;"

[10] Robert H. Scarborough, *NYSBA Tax Section Analyzes Civil Damages Legislation*, 2001 Tax Notes Today 36-18, footnote 7.

[11] Pub. L. No. 104-188.

[12] IRC § 104(a)(2), as amended by the Small Business Job Protection Act of 1996, Pub. L. No. 104-188, section 1605(a).

[13] S. Rep. No. 104-281, at 115 (1996); H.R. Rep. No. 104-586, Part II, Revenue Offsets, section 5, reprinted at 1996-3 C.B. at 480-81.

Federal courts are divided regarding the treatment of legal fees paid out of a settlement or judgment awarded to the claimant.[14] In most cases involving nonphysical personal injury, an attorney is hired on a contingent fee basis and agrees to represent the client in return for a specified percentage of the recovery, if any. In other cases, the court may award a specified amount to cover the attorneys' fees and court costs incurred in prosecuting the claim. At the end of the case, the attorney usually receives the full amount of the recovery, retains an amount equal to the contingent fee or the award made by the court, and transfers the balance to the client.

There are two predominant legal theories governing the inclusion in or exclusion from the plaintiff's income of the attorney fee portion of settlement proceeds. The United States Court of Appeals for the Fifth, Sixth, and Eleventh Circuits have held that the legal fees may be excluded from a claimant's income if, under state law, the attorney has an equitable interest in the cause of action or recovery to the extent of the agreed upon fee.[15] This theory is based on state law in those jurisdictions that grant attorneys lien rights (or ownership rights) to income attributable to a settlement or judgment award that the attorneys' efforts brought into existence. Thus, those courts have held that, since the attorney had a right to the income, the plaintiff may exclude that portion of the award from gross income.[16] See Table 2.1.1, Legal Fee Cases by Federal Circuit Court, to review a listing of U.S. Circuit Court rulings.

The U.S. Court of Appeals for the First, Third, Fourth, Seventh, Ninth, Tenth, and Federal Circuits have held that attorney fees in nonphysical personal injury cases must be included in a claimant's income under the assignment of income doctrine, regardless of the attorney's interest in the award.[17] This doctrine holds that a taxpayer who is entitled to income cannot avoid being taxed on that income by assigning it to another.[18]

[14] For a detailed discussion of the treatment of these legal fees, *see* Paul M. Jones, Jr., *Nonphysical Personal Injury Settlements and Judgements: Amending the Internal Revenue Code to Exclude Attorney Fees,* 35 Ind. L. Rev. 245 (2001).

[15] See, e.g., Cotnam v. Commissioner, 263 F.2d 119 (5th Cir. 1959) (reviewing Alabama statute creating lien on the cause of action); Clarks Estate v. United States, 202 F.3d 854 (6th Cir. 2000) (relied on Michigan state statute giving an attorney a lien on a portion of a client's judgment); Srivastava v. Commissioner, 220 F.3d 353 (5th Cir. 2000) (allowing for excludability of contingency fees in Texas because court stated they were bound by Cotnam); Davis v. Commissioner, 210 F.3d 1346 (11th Cir. 2000) (court followed Cotnam and held fees were not income to client).

[16] Jones, *supra* note 14, at 247.

[17] See, e.g., Baylin v. United States, 43 F.3d 1451 (Fed. Cir. 1995) (fees paid directly from the settlement to the attorney benefited the client by discharging his obligation to the attorney); Coady v. Commissioner, 213 F.3d 1187 (9th Cir. 2000) (because the taxpayers received benefit from the full amount of judgment, the entire amount was income); Kenseth v. Commissioner, 114 T.C. 399 (2000) (fees are income under IRC § 61; no specific exclusion from income found); O'Brien v. Commissioner, 38 T.C. 707 (1962) (it made no difference whether under a state attorneys' lien statute the attorney had a lien or the taxpayer irrevocably assigned a portion of his claim to the attorney).

[18] Lucas v. Earl, 281 U.S. 111 (1930).

The United States Supreme Court has declined to grant certiorari to resolve the conflict between the circuits.[19] The IRS takes the position that attorney fees in nonphysical personal injury cases are includible in the claimant's gross income.[20] The United States Tax Court, in numerous cases, has upheld the IRS's position, although there has been disagreement among the judges.[21] The Tax Court has held that taxable recoveries in lawsuits are gross income in their entirety to the party-client and that associated legal fees – contingent or otherwise – are to be treated as miscellaneous itemized deductions.[22]

### DEDUCTION OF LEGAL FEES

Under current law, legal fees paid or incurred by a claimant are deductible to the extent they are allocable to amounts received in a settlement or judgment that are included in the claimant's gross income.[23] The fees are treated as miscellaneous itemized deductions to the extent that the claimant's total miscellaneous itemized deductions exceed two percent of the claimant's adjusted gross income (AGI).[24] Thus, a taxpayer often will not be entitled to deduct some or all of the amount of attorney fees includible in gross income. In addition, any amount allowable as a deduction is subject to reduction under the overall limitation of itemized deductions if the claimant's AGI exceeds a threshold amount.[25] Finally, no deductions are allowed for any miscellaneous itemized deductions in computing the claimant's alternative minimum taxable income (*AMTI*).[26]



[19] Benci-Woodward v. Commissioner, 121 S. Ct. 855 (2001); Coady v. Commissioner, 121 S. Ct. 1604 (2001); Hukkanen-Campbell v. Commissioner, 122 S. Ct. 1915 (2002); Sinyard v. Rossotti, 122 S. Ct. 2357 (2002).

[20] Market Segment Specialization Program (MSSP) Audit Guide, *Lawsuit Awards and Settlements*, Chapter 3, Other Related Topics, Deduction for Attorneys' Fees.

[21] Kenseth v Commissioner, 114 T.C. 399 at 421 (2000) (Beghe, J., dissenting). The disagreement was with the assignment of income doctrine on which the court decided the case and whether the full amount of the settlement proceeds was Kenseth's to assign, given the lien held by his attorneys.

[22] Benci-Woodward v. Commissioner, T.C. Memo. 1998-395 at *1; Biehl v. Commissioner, 118 T.C. No. 29 at *3 (2002); Hukkanen-Campbell v. Commissioner, T.C. Memo. 2000-180 at *20; Kenseth v. Commissioner, 114 T.C. 399 at 407 (2000).

[23] IRC § 212 (deduction for ordinary and necessary expenses paid or incurred for the collection or production of income); Benci-Woodward v. Commissioner, T.C. Memo. 1998-395 at *1; Biehl v. Commissioner, 118 T.C. No. 29 at *3 (2002); Hukkanen-Campbell v. Commissioner, T.C. Memo. 2000-180 at *20; Kenseth v. Commissioner, 114 T.C. 399 at 407 (2000).

[24] IRC § 67(a) and (b). Benci-Woodward v. Commissioner, T.C. Memo. 1998-395 at *1; Biehl v. Commissioner, 118 T.C. No. 29 at *3 (2002); Hukkanen-Campbell v. Commissioner, T.C. Memo. 2000-180 at *20; Kenseth v. Commissioner, 114 T.C. 399 at 407 (2000).

[25] IRC § 68.

[26] IRC § 56(b)(1).

The Tax Court in Kenseth v. Commissioner agreed that including the attorney fee in income without a dollar-for-dollar offset is harsh and inequitable, but noted that it is Congress' responsibility to remedy the situation. In his dissenting opinion in Kenseth, Judge Renato Beghe stated,

> Although this case is not the most egregious recent example, the mechanical interplay of the itemized deduction rules with the AMT can result – in cases in which the contingent fee exceeds 50 percent of the recovery – in an overall effective rate of federal income tax and AMT on the net recovery exceeding 50 percent; in cases in which the aggregate fees exceed 72-73 percent of the recovery, the tax can exceed the net recovery, resulting in an overall effective rate of tax that exceeds 100 percent of the net recovery.[27]

## REASONS FOR CHANGE

Legislation is needed to resolve the split among the circuit courts of appeals regarding the taxation of attorney fees. A change would bring about a fair result for plaintiffs in nonphysical personal injury cases. Currently, plaintiffs are subjected to unpredictable tax consequences as well as reduced settlement proceeds.

Under current law, taxpayers who are complainants in nonphysical personal injury suits are subject to disparate tax treatment regarding any attorney fees awarded or received in settlement of those suits. Depending on where a taxpayer-complainant resides, such attorney fees may be subject both to a reduction under IRC § 68 and to the Alternative Minimum Tax under IRC § 55.

The AMT consequences of the approach adopted by the IRS and the majority of the federal circuit courts deviates from the concept of taxing net income. By treating these fees as a miscellaneous itemized deduction and prohibiting a deduction of itemized deductions for AMTI purposes, plaintiffs must pay tax on the full amount of their settlement without a corresponding deduction for the costs of the litigation.[28] On the other

[27] Kenseth v. Commissioner, 114 T.C. 399 at 425 (2000).

[28] Jones, *supra* note 14, at 254.

hand, full exclusion or deductibility of these legal fees, whether contingent or awarded by the court, requires taxpayers to pay tax on only the net amounts actually received from the litigation, a result that more accurately reflects the taxpayers' actual economic circumstances.[29]

The full exclusion or deductibility of attorney fees relating to nonphysical personal injury awards or settlements would promote consistency and predictability of tax consequences on two levels. First, the tax treatment of settlement and judgment income would be consistent regardless of where the taxpayer-claimant resides in the United States. Second, the tax treatment of such income would be consistent despite differences in state attorney lien statutes.[30]

Finally, the full exclusion or deductibility of attorney fees in nonphysical personal injury cases would eliminate significant litigation over this issue.[31] Consistent resolution of this issue will enable taxpayer-claimants to determine clearly what the tax consequences of any such award or settlement may be.



## EXPLANATION OF RECOMMENDATION

There are several alternatives available for clarifying the tax treatment of attorney fee payments in nonphysical personal injury awards or settlements. Although each proposal results in the consistent treatment of these attorney fee payments, each has different consequences in terms of taxpayer burden, compliance monitoring, and effects on related tax calculations.

### Amend the Definition of Gross Income

One possible solution is to amend IRC § 104(a)(2) to exclude legal fees from gross income in nonphysical personal injury cases. This approach would eliminate the disparate treatment that plaintiffs now experience based solely on the place where they live or the jurisdiction in which the cases are heard. It would eliminate situations in which successful plaintiffs finish their journeys through the court system with a tax burden that may consume most, if not all, of their settlements. Indeed, as discussed above, some plaintiffs may even owe more in tax than they received from their settlements or judgments.[32]

[29] *Id. at 256.*

[30] *Id.*

[31] See Table 2.1.1, Legal Fee Cases by Federal Circuit Court.

[32] *See* Adam Liptak, *Tax Bill Exceeds Award to Officer in Sex Bias Suit*, The New York Times, Aug. 11, 2002, at 18; *see also* 146 Cong. Rec. S7160-03 at *S7162-64 (2000) (statement of Sen. Grassley discussing a letter sent by an attorney representing a client who owed more in tax than the damages he received).

The exclusion from gross income of the legal fee portion of the settlement or award would be the easiest approach to implement for both the IRS and the taxpaying public. The taxpayer would simply report the amount of the settlement received, net of the legal fees. Although this proposal would not require a change to the Form 1040, the IRS would have to alter its instructions to provide a worksheet and guidance for calculating the net amount of the award or settlement. This proposal would not enable the IRS to track the full amount of the settlement.[33]

### Allow an Above-the-Line Deduction for Legal Fees

An alternative solution is to retain the present law's inclusion in gross income of the legal fee portion of a nonphysical personal injury settlement or award and amend IRC § 62 to allow those legal fees to be deducted from gross income in calculating Adjusted Gross Income.

Under this alternative, the legal fees would be treated as an adjustment to income ("above-the-line"). Thus, they would not be subject to the Alternative Minimum Tax. Further, the fees would not be subject to the limitation on itemized deductions under IRC § 68. The proposal would have the same net effect as the first recommendation, but it would require a forms change by the IRS and additional work on the part of the taxpayer or return preparer.

This proposal would enable the IRS to track the amounts of damages received by taxpayers and the associated legal fee adjustments for compliance purposes. Under current law, attorneys are required to file Forms 1099 reporting payments received by business clients for legal services.[34] The IRS could modify that reporting requirement to require identifying the fees and costs received by attorneys in nonphysical personal injury cases in a separate box on the form. The IRS would then have the ability to conduct document matching to ensure that the taxpayer-complainant was deducting the correct amount from the gross award.

### Allow Itemized Deduction (Not Subject to 2% or IRC § 68 Limitations) and AMT Deduction

Another approach is to amend IRC § 67(a) to allow legal fees as an itemized deduction not subject to the two-percent-of-AGI limitation. This proposal would require creating an exception to the IRC § 68 rules regarding the limitation of itemized deductions for high income taxpayers, and allowing a deduction for AMT purposes under IRC § 56 in order to mitigate the AMT effect under current law.

[33] Gross taxable damages are required to be reported to the IRS in Box 3, Other Income, on Form 1099-MISC.

[34] IRC § 6045(f).

This alternative would not have the same net effect as the other two proposals. Although the complete amount of the legal fees would be deductible, the entire amount of any settlement or award would be included in AGI, thus decreasing all other itemized deductions that are subject to AGI limitations, such as medical expenses and miscellaneous itemized deductions, and affecting other computations that are dependent on the AGI amount, such as AMT. Further, the proposal would increase taxpayer and IRS burden, because it would increase the time needed to prepare a tax return and require additional form changes by the IRS.

The National Taxpayer Advocate recommends the second of the three approaches described above. Legal fees awarded or received in settlement of nonphysical personal injury cases should be included in gross income. Internal Revenue Code section 62 should be amended to permit an adjustment to gross income for that portion of a nonphysical personal injury award or settlement that is attributable to legal fees. This proposal would enable the IRS to track accurate reporting of these awards and fees. It would avoid triggering the Alternative Minimum Tax and would not reduce other itemized deductions dependent on Adjusted Gross Income. Most importantly, it would effect uniform treatment of all taxpayer-complainants who receive these awards and settlements, irrespective of their place of residence.

**TABLE 2.1.1**
**LEGAL FEE CASES BY FEDERAL CIRCUIT COURT**

| CIRCUIT | STATE | NAME | CITATION (YEAR) | DECISION | BASIS |
|---|---|---|---|---|---|
| 1 | Maine | | | | |
| | Massachusetts | Alexander | 72 F.3d 938 (1st Cir. 1995) | Include | "In lieu of" test |
| | New Hampshire | | | | |
| | Puerto Rico | | | | |
| | Rhode Island | | | | |
| 2 | Connecticut | | None litigated in this circuit. | | |
| | New York | | | | |
| | Vermont | | | | |
| 3 | Delaware | | | | |
| | New Jersey | | | | |
| | Pennsylvania | O'Brien | 319 F.2d 532 (3d Cir. 1963) | Include | Assignment of income |
| | Virgin Islands | | | | |
| 4 | Maryland | | | | |
| | North Carolina | Young | 240 F.3d 369 (4th Cir. 2001) | Include | Assignment of income |
| | South Carolina | | | | |
| | Virginia | | | | |
| | West Virginia | | | | |
| 5 | Louisiana | | | | |
| | Mississippi | | | | |
| | Texas | Srivastava | 220 F.3d 353 (5th Cir. 2000) | Exclude | State attorney lien statute |
| 6 | Kentucky | | | | |
| | Michigan | Estate of Clarks* | 202 F.3d 854 (6th Cir. 2000) | Exclude | State attorney lien statute |
| | Ohio | | | | |
| | Tennessee | | | | |
| 7 | Illinois | | | | |
| | Indiana | | | | |
| | Wisconsin | Kenseth | 259 F.3d 881 (7th Cir. 2001) | Include | Assignment of income |
| 8 | Arkansas | | | | |
| | Iowa | | | | |
| | Minnesota | | None litigated in this circuit. | | |
| | Missouri | | | | |
| | Nebraska | | | | |
| | North Dakota | | | | |
| | South Dakota | | | | |

**TABLE 2.1.1: LEGAL FEE CASES BY FEDERAL CIRCUIT COURT *(cont.)***

| CIRCUIT | STATE | NAME | CITATION (YEAR) | DECISION | BASIS |
|---|---|---|---|---|---|
| 9 | Alaska | Coady | 213 F.3d 1187 (9th Cir. 2000) | Include | Economic benefit |
| | Arizona | Sinyard | 268 F.3d 756 (9th Cir. 2001) | Include | Fee shifting, constructive income |
| | California | Benci-Woodward | 219 F.3d 941 (9th Cir. 2000) | Include | Refuted state attorney lien statute |
| | Guam | | | | |
| | Hawaii | | | | |
| | Idaho | | | | |
| | Montana | | | | |
| | Nevada | | | | |
| | Oregon | | | | |
| | Washington | | | | |
| 10 | Colorado | | | | |
| | Kansas | Hukkanen-Campbell | 274 F.3d 1312 (10th Cir. 2001) | Include | Assignment of income |
| | New Mexico | | | | |
| | Oklahoma | | | | |
| | Utah | | | | |
| | Wyoming | | | | |
| 11 | Alabama | Cotnam** | 263 F.2d 119 (5th Cir. 1959)[35] | Exclude | State attorney lien statute |
| | Alabama | Davis** | 210 F.3d 1346 (11th Cir. 2000) | Exclude | State attorney lien statute |
| | Alabama | Foster** | 249 F.3d 1275 (11th Cir. 2001) | Exclude | State attorney lien statute |
| | Florida | | | | |
| | Georgia | | | | |
| D.C. | D.C. | | None litigated in this circuit. | | |
| U.S. Court of Appeals for the Federal Circuit | Maryland | Baylin | 43 F.3d 1451 (Fed. Cir. 1995) | Include | Assignment of income, capital expense under origin of claim test |

* The IRS' position is that this precedent is limited to cases arising under Michigan law.
** The IRS' position is that these precedents are limited to cases arising under Alabama law.

[35] Cotnam is an Alabama case that was decided when Alabama was in the Fifth Circuit. In 1981 the Fifth Circuit was split into the Fifth and Eleventh Circuits.

## 2 MARRIED COUPLES AS BUSINESS CO-OWNERS

### PROBLEM

An unincorporated business jointly owned by a married couple is classified as a partnership for federal income tax purposes. As such, the business is subject to complex record-keeping requirements and must file a partnership income tax return (Form 1065, U.S. Return of Partnership Income). The IRS estimates that it takes the average partnership approximately 165-200 hours to complete and file this return.[36] If one member of the couple were to treat this task as a 40-hours-per-week job, it could take him or her four to five weeks of work each year.

Notwithstanding that unincorporated husband-and-wife-owned businesses are required to file partnership tax returns, there is compelling anecdotal evidence that many do not. Instead, they report the results of their business operations on Form 1040, Schedule C (Profit or Loss From Business (Sole Proprietorship)). The IRS estimates that it takes the average taxpayer about 11 hours to complete a Schedule C and about two hours to complete a Schedule C-EZ – a tiny fraction of the time required to file a partnership return.[37] By statute, these businesses and/or their owners are subject to penalties for failing to comply with the partnership tax return requirements.[38]

A couple's decision to file a Schedule C in lieu of a partnership tax return can also have nontax ramifications. By its terms, a Schedule C can only be filed by a sole proprietor. If married co-owners of a business file a single Schedule C, they must report all income from the business under the name of one spouse. Because the husband and wife are self-employed, they must also complete a Form 1040, Schedule SE (Self-Employment Tax) to report and pay Social Security and Medicare taxes. If all business income is reported on a Schedule C under the name of one spouse, only that spouse can file a Schedule SE and receive credit for paying into the Social Security and Medicare systems. Reporting all income under the name of one spouse may lead to two unanticipated problems:

- **Inability to Obtain Social Security and Medicare Benefits**. The spouse for whom no earned income is reported (the "ineligible spouse") does not receive credit for paying Social Security or Medicare tax. In the event of disability, the ineligible

[36] 2001 Instructions for Form 1065, *U.S. Return of Partnership Income*, page 32; 2002 Form 1040 Instructions, page 76. This range reflects the amount of time the IRS estimates it would take to prepare both Form 1065 and Form 1040, Schedule E (Supplemental Income and Loss). A partner must file Schedule E with his or her individual income tax return. The lower end of the 165-200 hour estimate range assumes that the partnership completes Form 1065 and the associated Schedule K-1. The upper end of the estimate range assumes that the partnership completes all schedules associated with Form 1065.

[37] 2002 Form 1040 Instructions, page 76.

[38] As discussed below, the IRS generally does not assess the penalty where the failure to file a partnership tax return was inadvertent. *See* Rev. Proc. 84-35, 1984-1 C.B. 509.

spouse would not qualify for Social Security disability benefits. In the event of death, the surviving spouse and children would not qualify for Social Security survivor benefits. The ineligible spouse also would not qualify for Medicare benefits.

- **Adverse Consequences Upon Divorce**. Depending on the applicable state law, the inaccurate classification of a jointly owned business as a sole proprietorship can have adverse consequences if the couple gets divorced. If the couple had operated the business on a 50/50 basis but reported the business for tax purposes as wholly owned by one spouse, the other spouse would have to prove that the tax return was inaccurate to substantiate his or her interest in the business. If the couple had filed joint tax returns (as do 97 percent of married couples filing Schedules C[39]), both spouses would have signed the returns and the ineligible spouse would be placed in the difficult position of having to argue that a document that he or she had signed contains false statements.



### EXAMPLE

A married couple with two young children jointly owns and operates a small dairy farm. The wife keeps the books, orders supplies, and coordinates deliveries. The husband takes care of the cows, milks them, and delivers the milk to customers. The couple has reported an average business profit of $40,000 each year for the past 15 years.

Instead of dividing the business income between them on a partnership income tax return and filing two Schedules SE, the couple has chosen to file a Form 1040, Schedule F (Profit or Loss From Farming) and one Schedule SE (Self-Employment Tax) and to report all earnings under the husband's Social Security number.[40] The couple had considered hiring a bookkeeper and using a paid tax preparer but determined it would be too costly.

The wife dies unexpectedly at age 40. Because all contributions to the Social Security system had been made in her husband's name and not her own, the husband and children cannot collect Social Security survivor benefits. Without the wife's contributions to the business, the husband must now either hire someone to perform her business duties or take over her tasks himself. Social Security benefits would have assisted the husband in meeting these additional responsibilities.

If the couple had divided the farm income between them and each had paid self-employment tax, the surviving family members would have been eligible for Social Security survivor benefits based on the wife's contributions.[41]

[39] Tax Year 1999, Compliance Research Information System (CRIS), Model IFM 2002.

[40] A farmer would report the results of his or her business operations on a Schedule F in lieu of a Schedule C.

[41] The couple's aggregate self-employment tax would not increase as long as the net income of the business remains below the Social Security wage base cap. For 2003, the cap will be $87,000.

## RECOMMENDATIONS

- Amend Internal Revenue Code section 761(a) to allow a married couple operating a business as co-owners to elect out of subchapter K of the Code and file one Schedule C (or one Schedule F in the case of a farming business) and two Schedules SE if –[42]
  1. all of the capital and profits interests in the partnership are owned by two individuals who are married to each other; and
  2. the couple makes an election; and
  3. the couple files a joint return for all taxable years that includes the items of the partnership, provided that the couple maintains adequate records to substantiate their respective interests in the partnership.
- Amend Internal Revenue Code section 6017 to require each spouse who operates an unincorporated business solely with his or her spouse as co-owners to file separate Schedules SE.

The National Taxpayer Advocate recommends that, if this proposal is enacted, the IRS create a Schedule C supplemental form for married co-owners of a business. All income and expenses of the business would be reported on this form, and the business' net profit or loss would be allocated between the spouses.

## PRESENT LAW

### Income Tax Law

An unincorporated business owned by more than one individual is classified as a partnership for federal tax purposes. Internal Revenue Code section 761(a) defines a partnership to include "a syndicate, group, pool, joint venture or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not … a corporation or a trust or estate."

Internal Revenue Code section 761 is a part of subchapter K of the Code, which sets forth the rules governing the taxation of partners and partnerships.[43] The rules of subchapter K are extraordinarily complex and require partnerships to maintain extensive records. While a detailed description of the partnership tax rules is beyond the scope of this report, the complexity of the partnership tax rules was elegantly characterized in an often-quoted passage from a 1964 U.S. Tax Court decision written by Judge Arnold Raum:

[42] Subchapter K is a portion of the Internal Revenue Code that contains rules and regulations governing the taxation of partnerships and partners. The complexity of these rules is discussed in the "Present Law" section below.

[43] Subchapter K consists of IRC §§ 701-777.

> The distressingly complex and confusing nature of the provisions of subchapter K present a formidable obstacle to the comprehension of these provisions without the expenditure of a disproportionate amount of time and effort even by one who is sophisticated in tax matters with many years of experience in the tax field … Surely, a statute has not achieved "simplicity" when its complex provisions may confidently be dealt with by at most only a comparatively small number of specialists who have been initiated into its mysteries.[44]

Over the past 38 years, the complexity of subchapter K has increased. Today, there are several multi-volume treatises devoted to the subject and a leading guide to general income tax law devotes nearly 700 pages to partnership taxation.[45]

As discussed above, if a husband and wife jointly own a business, they are considered to be operating a partnership for federal tax purposes and are subject to subchapter K. Significantly, even absent a formal partnership agreement, a husband and wife may be deemed to be carrying on a partnership if they operate a business together and jointly share in the business's profits and losses.[46]

Where a married couple is carrying on a partnership – or is deemed to be carrying on a partnership – the couple must report the results of its business operations on a Form 1065 (U.S. Return of Partnership Income).[47] As part of Form 1065, a Schedule K-1 must be prepared for, and sent to, each partner that lists, among other things, the partner's share of the partnership income or loss for the taxable year. Each partner must include this amount on his or her joint or separate Form 1040 (U.S. Individual Income Tax Return).

The Internal Revenue Code imposes both criminal and civil penalties on taxpayers that fail to file required returns. Internal Revenue Code section 7203 provides that a person who willfully fails to file a required return is guilty of a misdemeanor, is subject to a fine of up to $25,000 and imprisonment of up to one year, and is liable for prosecution costs. Therefore, a married couple that jointly owns a business and is aware of the requirement



[44] Foxman v. Commissioner, 41 T.C. 535, 551 n.9 (1964), *acq.*, 1966-2 C.B. 4, aff'd, 352 F.2d 466 (3d Cir. 1965).

[45] *See* William S. McKee et al., *Federal Taxation of Partnerships and Partners* (3d ed. 1997); Arthur B. Willis et al., *Partnership Taxation* (6th ed. 1997); *CCH Standard Federal Tax Reporter* (2002).

[46] The Supreme Court has held that a partnership exists for federal income tax purposes when "considering all the facts … the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise." Commissioner v. Culbertson, 337 U.S. 733, 742 (1949) (footnote omitted). While a number of factors are considered in determining whether a partnership exists, the joint ownership of material income-producing capital typically ensures partnership classification. *See* Evans v. Commissioner, 447 F.2d 547 (7th Cir. 1971), *aff'g* 54 T.C. 40 (1970), *acq.*, 1978-2 C.B. 2.

[47] IRC § 6031.

that it must file a partnership tax return can face serious consequences for failing to do so. Internal Revenue Code section 6698 provides that each partnership shall be liable for a penalty of up to $250 per partner for each required tax return that is not filed. In the case of a married couple that jointly owns a business, the penalty for failure to file could be $500 per year. This penalty may apply even if the couple is not aware that its business is classified as a partnership and that a partnership return is required.

As a practical matter, these penalties are rarely, if ever, imposed. Criminal penalties under IRC § 7203 generally are not imposed in the absence of willful tax evasion. And the IRS has issued guidance stating that the penalty under IRC § 6698 ordinarily will not be imposed on partnerships with 10 or fewer partners on the ground that such partnerships, based on their size, have "reasonable cause" for failing to file a partnership return.[48] Notwithstanding the IRS's exercise of administrative restraint, married co-owners of a business and/or the business itself remain subject to these penalties by statute.

### Employment Tax Law

A partner generally is considered to be self-employed for purposes of Social Security and Medicare taxes and is therefore required to report his or her net earnings from self-employment on Form 1040, Schedule SE (Self-Employment Tax).[49] Where a married couple jointly owns a business and files a Form 1065, each spouse must include his or her respective share of self-employment income on a separate Schedule SE.[50] Where a married couple jointly owns a business but files one Schedule C (or Schedule F) in lieu of a Form 1065, it is reporting that one spouse earned all of the business income. Thus, only one spouse would report self-employment earnings on a Schedule SE.[51]

[48] Rev. Proc. 84-35, 1984-1 C.B. 509. This revenue procedure is based on legislative history relating to IRC § 6698. A House-Senate conference committee report states: "The penalty [under IRC § 6698] will not be imposed if the partnership can show reasonable cause for failure to file a complete or timely return. Smaller partnerships (those with 10 or fewer partners) will not be subject to the penalty under this reasonable cause test so long as each partner fully reports his share of the income, deductions, and credits of the partnership." H.R. Conf. Rep. No. 95-1800, at 221 (1978), reprinted in 1978-3 (vol. 1) C.B. 521,555.

[49] *See* IRC § 6017; 2002 Instructions for Schedule SE, Self-Employment Tax, page SE-2.

[50] *Id.*

[51] A married couple might avoid filing a Form 1065 and get Social Security credits for both spouses by filing a Schedule C that reports one spouse as the sole owner and the owner pay a salary to the other spouse. However, there are two drawbacks to this approach under current law. First, it may not be legal. If the husband and wife operate the business jointly, the business likely is a partnership. Second, if one spouse paid the other a salary, the paying spouse would be required to file employer tax returns and to withhold tax, effectively trading one set of complex rules for another. *See* IRS Publication 15, Circular E, Employer's Tax Guide, page 7.

### REASONS FOR CHANGE

Married co-owners of a business who file joint tax returns face a difficult choice when determining whether to report the results of the business operations on a partnership tax return or a sole proprietorship return. If they file as a partnership, they must learn and apply the daunting complexities of subchapter K and either devote an average of up to nearly 200 hours of their own time to tax return preparation or pay an attorney, accountant or other tax preparer to do the job. If they file as a sole proprietorship, they may face penalties and one spouse generally must forego Social Security and Medicare coverage. As demonstrated in the example above, the ineligibility of one spouse for Social Security benefits can have a devastating impact on a family upon the spouse's death or disability. Other unfortunate consequences are the spouse's ineligibility for Medicare coverage and difficulty substantiating an ownership interest in the family business in the event of a divorce.

This dilemma is unnecessary and should be eliminated for the following reasons:

- **No Adverse Effect on Tax Collection.** Because our proposal would amend Internal Revenue Code section 761(a) only with respect to married co-owners of a business who file *joint* income tax returns, the revenue impact of the proposal would be negligible. And in the overwhelming majority of cases, married co-owners do file joint returns.[52] In the unusual case where two partners in a partnership file separate returns and face different marginal tax rates, the possibility of shifting income to the lower-taxed individual exists. But a husband and wife who file a joint return each year cannot engage in income shifting and therefore generally would not be able to reduce their tax liability under our proposal.
- **Recordkeeping/Regulatory Burden is Unreasonable.** The burden of maintaining partnership records, complying with the intricacies of subchapter K, and filing a partnership tax return is unreasonably onerous for a married couple owning a small business. Regulatory burdens are justifiable only when the compliance benefits to the system outweigh the burdens imposed on the individuals or entities that must bear them. In this case, the systemic benefits of the existing rules are few, if any.

  Moreover, the consequences to taxpayers who do not comply with these technical rules – even though they generally will owe the same amount of tax – are severe. As discussed above, Social Security and Medicare benefits are available only if

[52] The percentage of all married couples who file joint tax returns is approximately 95 percent (Tax Year 1999, Compliance Research Information System (CRIS), Model IFM 2002). The percentage of all married couples filing at least one Schedule C who file joint tax returns is approximately 97 percent (Tax Year 1999, Compliance Research Information System (CRIS), Model IFM 2002). While we cannot determine precisely the percentage of all married couples jointly operating a business who file joint tax returns, we do not believe the percentage would differ materially.

Social Security and Medicare contributions are made, and the inability to obtain credits for both spouses if one Schedule C is filed can have serious long-term consequences where the uncovered spouse becomes injured or dies.[53] The attribution of all business income to one spouse also may, depending on the applicable state law, lead to an inequitable division of property in the event of a divorce. While the amount of income reported for each spouse on a tax return is not controlling for non-tax purposes, a joint tax return is signed by both spouses under penalties of perjury, and the return therefore carries a strong presumption of correctness. A spouse later claiming that the return did not accurately reflect his or her income or ownership interest in the property could theoretically be exposing himself or herself to a charge of perjury, although it is quite unlikely that a criminal charge would be brought under this circumstance.

The partnership return filing requirement affects a significant number of businesses jointly owned by married couples. While the actual number of married couples owning businesses as co-owners cannot be determined with precision, one can infer some sense of the nature and magnitude of this problem from tax return data. A review of 1999 Forms 1040 shows that over 2,130,000 joint tax returns with Schedules C were filed on which one spouse reported no wages. Many of the reported business activities seem likely to have been undertaken jointly. Consider the following examples culled from tax returns where one spouse reported income as a sole proprietor and the other spouse reported no earned income:

- In California, over 6,800 businesses that provide accommodations, food, or drink;
- In Pennsylvania, over 2,900 dairy farms;
- In Montana, 480 cattle ranches;
- In Hawaii, 290 fruit and vegetable markets;
- In Iowa, 684 hog and pig farms; and
- In Idaho, 1,243 hotels, motels or bed and breakfast establishments.[54]

The burden of the partnership-return filing requirement falls heavily on lower and middle income taxpayers. According to the U.S. Small Business Administration,

[53] The tax reporting of a couple's income from a business is not necessarily controlling for purposes of Social Security. In some instances, individuals who discover that they will not be receiving Social Security benefits because their spouse was reported as the sole owner of a joint business on a Schedule C have challenged their tax return position and sought a reallocation of Social Security credits between the two spouses. *See* Royer v. Apfel, 2000 U.S. Dist. LEXIS 16661 (S.D. Ind. Oct. 16, 2000). Indeed, the issue has arisen with sufficient frequency that the Social Security Administration has issued a ruling that provides guidance on reallocating Social Security credits between spouses in such cases. *See* Soc. Sec. Rul. 84-11. However, no one would reasonably plan to obtain a reallocation of Social Security credits on the basis of this ruling. Compliance with the requirements of the ruling is itself burdensome, and the prospects of success are uncertain.

[54] Tax Year 1999, Compliance Research Information System (CRIS), Model IFM 2001.

86.9 percent of self-employed individuals earned less than $50,000 for their business efforts in 1997.[55] Regulatory requirements impose a considerable burden on small businesses, because small firms have fewer resources to apply to overhead costs such as accounting and tax preparation. According to a report prepared by the Chief Counsel for Advocacy of the U.S. Small Business Administration, tax compliance and payroll record keeping create the heaviest regulatory burdens today with small businesses, including "mom and pop" partnerships, bearing a greater relative load of tax compliance costs based on their revenue.[56]

In light of the fact that the income tax liability of married co-owners of a business generally will be the same regardless of whether the results of the couple's business operations are reported on a Form 1065 or a Schedule C, there is no reasonable justification for requiring these taxpayers to comply with the intricate complexities of subchapter K.

- **Unnecessary, Unenforced Requirements Undermine Respect for Tax System.** Respect for the integrity of the tax system suffers when rules are imposed that place an unnecessarily heavy compliance burden on taxpayers, that many taxpayers ignore (precisely because of the heavy compliance burden), that the IRS (for good reason) does not enforce, and that have no impact on tax liability. It is confusing and pointless for the Internal Revenue Code to require all partnerships to file a partnership tax return, while the IRS (on the basis of clear legislative history) does not enforce the requirement in the case of partnerships with 10 or fewer partners. Why not simply change the law to reflect the desired policy and then enforce it?



### EXPLANATION OF RECOMMENDATION

The National Taxpayer Advocate recommends that Internal Revenue Code section 761(a) be amended to allow husband and wife co-owned businesses to elect out of Subchapter K – Partners and Partnerships.[57] At this time, we recommend that the election be made avail-

[55] Office of Advocacy, U.S. Small Business Administration, *Annual Report on Small Business and Competition,* 1998.

[56] Office of the Chief Counsel for Advocacy, U.S. Small Business Administration, *The Changing Burden of Regulation, Paperwork, and Tax Compliance on Small Business: A Report to Congress* 1995.

[57] In Rev. Proc. 2002-69, the IRS authorized this election for married co-owners of businesses located in states with community property laws. Married co-owners in these states may now, at the couple's discretion, treat the business as either a partnership or a sole proprietorship. However, residents of states that do not have community property laws, which constitute a significant majority of the states, do not have this option. Moreover, Rev. Proc. 2002-69 does not address whether or how a couple that elects to treat the business as a sole proprietorship would be entitled to file two Schedules SE.

[58] As discussed above, if the husband and wife elect to file separate returns and face different marginal tax rates, the couple might be able to allocate disproportionate amounts of income to the lower-taxed spouse. The partnership tax rules ordinarily would not allow this, because special allocations can be made under subchapter K only if such allocations have "substantial economic effect." If the husband and wife were to file separate returns and the "substantial economic effect" rule in subchapter K were not to apply, the couple might be able to take advantage of this election to reduce its tax liability. For that reason, we believe that further study is required if the election we are proposing is to be made available to married couples filing separate returns.

able only to married couples who file joint income tax returns.[58] By making the election, the business would be exempt from the application of the complex rules of subchapter K and the husband and wife would be entitled to file a Schedule C instead of a Form 1065, (U.S. Return of Partnership Income). Internal Revenue Code section 761(a) already allows certain categories of taxpayers to opt out of subchapter K, so there is precedent for this approach.[59]

Amending IRC § 761(a) to allow a husband and wife co-owned business to elect out of subchapter K would not require an additional amendment to Internal Revenue Code section 6031 regarding filing partnership returns.[60] Treasury Regulations currently state that a taxpayer who has made an election to be exempt from subchapter K is not required to file a partnership return except in the year of the election.[61] In the election year, the taxpayers would only need to file a partnership return with the election statement. All income and deductions would then be reported on a Schedule C in the election year and for all subsequent years.

If this proposal is enacted into law, we recommend that the IRS design a form to supplement Schedule C for married co-owners who make the election to opt out of subchapter K. It could be called Schedule C-MC (for "Married Couple"). The business entity's income and expenses would be reported on Schedule C. The net profit (or loss) would then be allocated between the husband and wife on Schedule C-MC.

The supplemental form would serve three important purposes. First, the amount of income allocated to each spouse – and thus carried to separate Schedules SE – would be shown on the form.

Second, the form could be used to record each spouse's respective interest in the business. This could become important if, for example, one spouse dies and the value of his

[59] Section 761(a) provides that the Secretary may, at the election of all of the members of an unincorporated organization, exclude such organization from the application of all or part of subchapter K, if it is availed of (1) for investment purposes only and not for the active conduct of a business, (2) for the joint production, extraction, or use of property, but not for the purpose of selling services or property produced or extracted, or (3) by dealers in securities for a short period for the purpose of underwriting, selling, or distributing a particular issue of securities, if the income of the members of the organization may be adequately determined without the computation of partnership taxable income.

[60] Senator Christopher Bond (R-Mo.), and Representative Donald Manzullo (R-Il.) have introduced legislation that aims to achieve the same objective as our proposal by simply exempting businesses owned jointly by married couples from the IRC § 6031 requirement to file a partnership income tax return. *See* S. 189 and H.R. 1037 (107th Congress). Under their proposal, however, businesses owned jointly by married couples would remain subject to all other partnership tax rules of subchapter K. After studying the issue, we believe that exempting such businesses from the definition of a partnership under Internal Revenue Code section 761 would provide more comprehensive relief.

[61] Treas. Reg. § 1.6031(a)-1(c).

or her interest must be determined for purposes of computing the estate tax.

Third, the form could be designed to allow the business to make certain tax elections that are only available at the entity level. This issue arises because even if a business co-owned by a husband and wife is excluded from the definition of a partnership for purposes of subchapter K, the business generally remains a partnership for all other purposes of the Code.[62] The principal significance of partnership classification outside the context of subchapter K is that a partnership may make certain tax elections available only to an entity and not to individuals. For example, a partnership may make an election under IRC § 179 to expense depreciable business assets.[63] We see no reason to prohibit husband-and-wife-owned partnerships that elect out of subchapter K from making tax elections of this nature.

In sum, our legislative proposal would reduce the tax compliance burden on many husband-and-wife-owned businesses, would facilitate the coverage of both spouses under the Social Security and Medicare systems and, depending on state law, could facilitate more equitable divisions of property in the event of divorce. The revenue impact of the proposal should be negligible. Regardless of how the net earnings from the business are reported – either as a flow-through item from the partnership return or as net earnings from Schedule C – the income tax liability of the husband and wife generally will be the same.[64] Social Security and Medicare receipts generally will also be the same.[65]



[62] Internal Revenue Code section 761(a) defines a partnership *for purposes of subchapter K only*, and IRC § 7701(a)(2) provides a similar definition of a partnership *for all* purposes of the Code. There is some authority that suggests an entity excluded from the definition of a partnership under subchapter K is also excluded from treatment as a partnership under other provisions of the Code, but this interpretation has not been generally accepted. For discussion of this point, *see* William S. McKee et al., *Federal Taxation of Partnerships and Partners* ¶ 3.05[3] (3d ed. 1997).

[63] *See also* IRC § 614 (election to treat multiple mineral interests in a single parcel of land as separate assets for purposes of the depletion allowance for mines, wells, and other natural deposits); IRC § 1033 (election to avoid gain recognition upon certain involuntary conversions).

[64] In unusual cases, the income tax liability of married co-owners of a business might be different if they file a Schedule C instead of a partnership tax return. For example, IRC § 1031(a)(2)(D) provides that partnership interests may not be exchanged under the like-kind exchange rules, but IRC § 1031(a)(2) also provides that an interest in a partnership that has elected out of subchapter K (which a small category of partnerships are authorized to do under current law) is treated as an interest in each of the assets of the partnership. *Id.* Therefore, married co-owners could engage in certain tax-deferred like-kind exchanges as Schedule C filers that would be unavailable to them under subchapter K.

[65] Approximately 3 percent of Schedules C and Schedules F report income that exceeds the Social Security wage base limitation, which will be $87,000 in 2003. Tax Year 2000, Compliance Research Information System (CRIS), Model IMF 2002. This cap applies to each spouse separately. Therefore, a couple with significant earned income that allocates all business income to one spouse would pay less Social Security tax than a couple that divides the same income between both spouses. However, our proposal would not increase the Social Security tax liability of married co-owners of a business for two reasons. First, our proposal merely provides partnerships with an election. Second, if a business is classified as a partnership under current law, both spouses already are required to report a share of the partnership's business income. If they are reporting all income in the name of one spouse and are therefore subject to only one cap, it is only because they are not complying with current law.

## APPENDIX I: TAXPAYER BURDEN

The IRS estimates it takes almost 13 times longer to prepare a partnership return and its related forms than a Schedule C and its related forms. It takes an average of 160 hours and 58 minutes to keep basic partnership records, read and learn about the law and forms, prepare the forms, and send the information to the IRS.[66] In contrast, a Schedule C can be prepared in approximately 12 hours and 16 minutes.[67]

Table 2.2.1 shows the estimated paperwork burden placed on sole proprietors and partners. Although business and individual taxpayers incur other burdens such as audits, litigation, and payroll that are not included in the model, it provides a useful starting point for measuring taxpayer burden.

### TABLE 2.2.1
### ESTIMATED IRS PAPERWORK BURDEN[68]

| FORM NUMBER OR SCHEDULE | RECORD KEEPING | LEARNING ABOUT THE LAW OR FORM | PREPARING THE FORM OR SCHEDULE | COPYING, ASSEMBLING, AND SENDING THE FORM TO THE IRS | TOTAL TIME |
|---|---|---|---|---|---|
| Sch. C | 6 hr.4 min. | 1 hr.31 min. | 2 hr. 19 min. | 41 min. | 10 hr. 35 min. |
| Sch. SE | 26 min. | 20 min. | 35 min. | 20 min. | 1 hr. 41 min. |
| | | | | | **12 hr. 16 min.** |
| | | | | | |
| **Form 1065** | 41 hr. 54 min. | 23 hr. 35 min. | 41 hr. 17 min. | 4 hr. 1 min. | 110 hr. 47 min. |
| Sch. K-1 | 26 hr. 46 min. | 10 hr. 25 min. | 11 hr. 19 min. | N/A | 48 hr. 30 min. |
| Sch. SE | 26 min. | 20 min. | 35 min. | 20 min. | 1 hr. 41 min. |
| | | | | | **160 hr. 58 min.** |

[66] 2001 Instructions for Form 1065, *U.S. Return of Partnership Income*, page 32. This assumes that the partnership files only the basic Form 1065 and Schedules K-1. Depending on the circumstances of the partnership, there are additional schedules that it may be required to complete that accompany Form 1065. If all schedules must be completed, the estimated average time is approximately 200 hours. *Id.*

[67] 2001 1040 Instructions, Paperwork Reduction Act Notice, p. 72; 2001 Instructions for Form 1065, U.S. Return of Partnership Income, Paperwork Reduction Act Notice, p. 32.

[68] Figures in this table are based on information from Arthur D. Little, *Development of Methodology for Estimating the Taxpayer Paperwork Burden*, Report to the Department of the Treasury, Internal Revenue Service, June 1988. The figures from this report are included on IRS forms and instructions as part of the Paperwork Reduction Act Notice. Although some have criticized this report as flawed and outdated, it is the currently the only information available to estimate taxpayer paperwork burden.
Figures were taken from: 2001 1040 Instructions, Paperwork Reduction Act Notice, p. 72; 2001 Instructions for Form 1065, U.S. Return of Partnership Income, Paperwork Reduction Act Notice, p. 32.
The timeframes for preparing Form 1040 (U.S. Individual Income Tax Return) were not considered in these calculations because these would be required and remain constant under any of the filing options.

## APPENDIX II: SOCIAL SECURITY IMPACT

Filing a Schedule C in lieu of a partnership return may immediately save taxpayers time, but it may result in long-term consequences, notably lost Social Security and Medicare benefits. Unless both spouses file Schedules SE and pay self-employment tax, they may not be eligible for the full range of Social Security and Medicare benefits.

The following tables summarize different scenarios under which a spouse might receive Social Security benefits based on whether he or she paid self-employment tax.

### TABLE 2.2.2
### ELIGIBILITY OF SOCIAL SECURITY RETIREMENT BENEFITS[69]

| | RETIREMENT BENEFITS FOR BOTH IF COUPLE STAYS MARRIED | RETIREMENT BENEFITS FOR BOTH IF COUPLE DIVORCES AFTER 10 YEARS OF MARRIAGE | RETIREMENT BENEFITS FOR BOTH IF COUPLE DIVORCES BEFORE 10 YEARS OF MARRIAGE | RETIREMENT BENEFITS FOR BOTH IF COUPLE DIVORCES AFTER 10 YEARS OF MARRIAGE AND ONE REMARRIES |
|---|---|---|---|---|
| **Only Husband Pays Into Social Security System** | YES | YES | NO | NO |
| **Only Wife Pays Into Social Security System** | YES | YES | NO | NO |
| **Both Spouses Pay Into Social Security System** | YES | YES | YES | YES |



[69] *Social Security Survivors Benefits*, Publication No. 05-10084, August 2000; *Social Security: Understanding The Benefits*, Publication No. 05-10024, February 2002; *Social Security Administration: What Every Woman Should Know*, SSA Publication No. 05-10127, March 2002.

### TABLE 2.2.3
### ELIGIBILITY OF SOCIAL SECURITY SURVIVOR AND DISABILITY BENEFITS[70]

| | SURVIVOR BENEFITS RECEIVED IF WIFE DIES | SURVIVOR BENEFITS RECEIVED IF HUSBAND DIES | DISABILITY BENEFITS FOR WIFE | DISABILITY BENEFITS FOR HUSBAND |
|---|---|---|---|---|
| Only Husband Pays Into Social Security System | NO | YES | NO | YES |
| Only Wife Pays Into Social Security System | YES | NO | YES | NO |
| Both Spouses Pay Into Social Security System | YES | YES | YES | YES |

[70] *Social Security Survivors Benefits*, Publication No. 05-10084, August 2000; *Social Security: Understanding The Benefits*, Publication No. 05-10024, February 2002; *Social Security Administration: What Every Woman Should Know*, SSA Publication No. 05-10127, March 2002.

## 3 MATH ERROR AUTHORITY

### PROBLEM

Internal Revenue Code section 6213(b) authorizes the Internal Revenue Service to assess an addition to tax, without issuance of a notice of deficiency, where the adjustment is the result of a mathematical or clerical error on the tax return. Section 6213(g) defines mathematical or clerical error. This summary assessment authority allows the IRS to assess and collect the additional tax and provides no opportunity for review in the United States Tax Court.

In recent years, this "math error" summary assessment authority has been extended to errors that do not fall within the traditional definition of mathematical or clerical errors. The application of this authority to return items that are not numerical or quantitative in nature can lead to incorrect assessments, administrative re-work, and even denial of taxpayer access to the United States Tax Court.

### EXAMPLE

Taxpayer and Ex-spouse have joint custody of their three children. Taxpayer and Ex-spouse's custody decree granted Taxpayer physical custody of two children and Ex-spouse physical custody of one child. The custody decree was registered with the appropriate state agency. Under that state's procedures, all joint custody decrees are entered into the database showing the father (here, the Ex-spouse) as the custodial parent.

In 2004, Taxpayer claims dependency exemptions, child credit and Earned Income Tax Credit (EITC) for the two children who live with her. Taxpayer's return is flagged by the Federal Case Registry database as that of a non-custodial parent and the IRS, under its math error authority, summarily assesses additional tax by disallowing the dependency exemptions, child credit, child and dependent care credit, and Earned Income Tax Credit (EITC) for those children. If the father (Ex-spouse) erroneously claimed tax benefits for all three of his children on his return, the Federal Case Registry would identify him as the custodial parent.

In 2005, Taxpayer and Ex-spouse agree that it would be in the best interests of the third child if he resides with Taxpayer and the other two children for the entire year. Since they reached an agreement between themselves, Taxpayer and Ex-spouse see no reason to spend money going back to court to modify their custody decree. The IRS, through the Federal Case Registry identification of a "math error" (i.e., Taxpayer deemed "non-custodial parent"), can summarily assess additional tax against Taxpayer resulting from the disallowance of all three dependency exemptions, child credit and EITC, even though the children satisfy all eligibility requirements for these provisions.

## RECOMMENDATION

- Amend IRC § 6213(g)(2) to limit the definition of mathematical and clerical error to the following items:
    - Inconsistent items in which the inconsistency is determined from the face of the return;
    - Omitted items, including schedules, that are required to be included with the return; and
    - Items reported on the return that are numerical or quantitative and which can be verified by a government entity that issues or calculates such information.
- Repeal Internal Revenue Code section 6213(g)(2)(M), which authorizes the Internal Revenue Service to use math error summary assessment procedures for an entry on the return with respect to a qualifying child for the Earned Income Credit, where the taxpayer has been identified as the non-custodial parent of that child by the Federal Case Registry of Child Support Orders established under section 453(h) of the Social Security Act.

Where Congress authorizes the expansion of the math error summary assessment authority beyond inconsistencies in numerical or quantitative items included on the face of the return, such authorization should be preceded by a detailed analysis providing both a justification for the expansion and a thorough impact analysis relating to taxpayer rights and taxpayer burden. Specifically, this report, prepared by the Department of Treasury in consultation with the National Taxpayer Advocate, should analyze the specific need for such expansion, the alternative methods for resolving the identified need, the projected revenue and cost savings attributed to the expansion of math error notices, and the alternative methods identified. Further, the report should include an analysis, prepared by the National Taxpayer Advocate, of the impact on taxpayer rights of such expansion. This taxpayer rights impact statement should identify the substantive and procedural rights that may be affected by the expansion, and provide an analysis of the taxpayer segments most likely to be impacted by the proposed expansion. It should also include a discussion of the potential resource consequences for both the taxpayer and the IRS in trying to address and resolve post-assessment matters flowing from the expanded math error authority.

## PRESENT LAW

### Deficiency Procedures

In general, when the Internal Revenue Service (IRS) identifies an error on a taxpayer's income tax return that will result in an understatement of tax, the IRS undertakes a series of administrative steps to notify the taxpayer of the proposed deficiency.[71] The taxpayer is first provided with a report, setting forth the items to be adjusted, the tax, if any, reported on the original return, and the correct tax according to the IRS. The taxpayer has thirty days in which to accept this adjustment or request an administrative appeals conference with an Appeals Officer.

If the taxpayer does not respond to the initial report, or if the taxpayer does not prevail in the appeals conference, the IRS will issue a Statutory Notice of Deficiency (SNOD).[72] This notice sets forth the proposed deficiency in tax, and informs the taxpayer that he or she has ninety days from the date of the notice to file a petition in the United States Tax Court to challenge the proposed deficiency.[73] The SNOD, which is sent by certified mail to ensure that the taxpayer pays attention to this notice, provides important procedural rights and protections. If the taxpayer does not timely file a petition with the Tax Court, the proposed deficiency will be assessed.[74]

The Tax Court is the only judicial forum in which a taxpayer can challenge a tax liability (proposed or assessed) before paying the actual liability in full. Thus, for most taxpayers, the Tax Court is effectively the only forum for tax litigation. Congress has recognized the importance of the Tax Court for U.S. taxpayers by mandating "small case" procedures, in which discovery is limited and the court's procedures are user-friendly.[75] The Notice of Deficiency provides the taxpayer with the "ticket" to the Tax Court – that is, without the issuance of a Notice of Deficiency and the subsequent timely filing of a petition, the Tax Court has no jurisdiction over the proposed deficiency.

### Mathematical or Clerical Error Procedures

Internal Revenue Code section 6213(b) authorizes the IRS to make a summary assessment of an addition to tax due where that addition is the result of a mathematical or clerical error and without providing the taxpayer with an opportunity to petition the United States Tax Court. In order to make this summary assessment, the IRS must give the taxpayer an explanation of the error.[76] The taxpayer has 60 days from the date of the



[71] A "deficiency" is defined as the amount by which the tax exceeds "the excess of (1) the sum of (A) the amount shown as the tax by the taxpayer upon his return … plus (B) the amounts previously assessed (or collected without assessment) as a deficiency, over (2) the amount of rebates … made." IRC § 6211(a).

[72] IRC § 6212.

[73] IRC § 6213(a).

[74] IRC § 6213(a).

[75] IRC § 7463.

[76] IRC § 6213(b)(1).

notice to request that the IRS abate the tax.[77] The IRS cannot begin to collect the tax due until the taxpayer has agreed to the tax or the 60-day period has ended.[78] If the taxpayer requests the tax be abated, the IRS must use the deficiency procedures under IRC § 6212 if it believes that the additional tax is in fact due.[79] The abatement request is the only procedure for protesting the tax liability available to a taxpayer receiving a math error adjustment without first paying the tax in full.[80]

The mathematical or clerical error ("math error") summary assessments are statutorily authorized in the following circumstances:

1. An error in addition, subtraction, multiplication, or division shown on any return;[81]
2. An incorrect use of any table provided by the IRS with respect to any return if other information on the return makes the incorrect use apparent;[82]
3. An entry on a return of an item which is inconsistent with another entry of the same or a different item on that return;[83]
4. An omission of information which is required to be supplied on the return to substantiate an entry on that return;[84]
5. An entry on a return of a deduction or credit in an amount which exceeds the statutory limit for that deduction or credit, if that limit is expressed as a specific monetary amount or as a percentage, ratio, or fraction, and if the component items of that limit appear on that return;[85]
6. A correct Taxpayer Identification Number is not provided on the return as required for:

    the Earned Income Credit (IRC § 32),[86]
    the child and dependent care credit (IRC § 21),[87]
    the personal or dependent exemption (IRC § 151),[88]
    the child tax credit (IRC § 24(e)),[89] and
    the Hope and Lifetime Learning credits (IRC § 25A(g)(1));[90]

[77] IRC § 6213(b)(2)(A).
[78] IRC § 6213(b)(2)(B).
[79] IRC § 6213(b)(2)(A).
[80] IRC § 6213 (b)(1).
[81] IRC § 6213(g)(2)(A).
[82] IRC § 6213(g)(2)(B).
[83] IRC § 6213(g)(2)(C).
[84] IRC § 6213(g)(2)(D).
[85] IRC § 6213(g)(2)(E).
[86] IRC § 6213(g)(2)(F).
[87] IRC § 6213(g)(2)(H).
[88] IRC § 6213(g)(2)(H).
[89] IRC § 6213(g)(2)(I).
[90] IRC § 6213(g)(2)(J).

7. A return claiming an earned income credit for net earnings from self-employment, where the self-employment tax imposed by IRC § 1401 on those net earnings has not been paid;[91]
8. An omission of information required for recertification of eligibility for the earned income credit;[92]
9. An entry on the return of a TIN required for the EIC, the child credit, and the child and dependent care credit, when information associated with that TIN indicates the child does not meet the age eligibility requirements for those credits;[93] and
10. Effective 2004, an entry on the return of a claim for the EIC where the Federal Case Registry of Child Support Orders indicates that the taxpayer is the noncustodial parent of that child.[94]



### REASONS FOR CHANGE

The legislative history to the early authorizations of summary assessments for mathematical or clerical errors makes very clear that this deviation from the protections of deficiency procedures was intended to be limited in scope. Math error authority was to be used only in those instances where errors were apparent on the face of the return or from information that was provided on the return. It is clear from the above list of items to which math error authority today applies, that math error authority has expanded well beyond that limited scope. Where once math error assessments were the exception, today these exceptions have swallowed up the rule.[95] To understand how far we have deviated from the original conception, it is worth reviewing the legislative history of this authority.

#### Legislative History

Math error assessments were first authorized by the Revenue Act of 1926, which denied the taxpayer a right to appeal to the Board of Tax Appeals where a deficiency was based on a mathematical error. It further authorized the Commissioner to make an assessment and collect the tax due as a result of that mathematical error.[96]

In 1976, Congress expanded the summary assessment authority to include clerical errors as well as mathematical errors. The Tax Reform Act of 1976 set forth for the first time a definition of the phrase "mathematical or clerical error." The phrase encompassed the first five instances of the present law described above, namely,

[91] IRC § 6213(g)(2)(G).

[92] IRC § 6213(g)(2)(K).

[93] IRC § 6213(g)(2)(L).

[94] IRC § 6213(g)(2)(M).

[95] 7 million Individual Master File Notices and 2 million Business Master File Notices are issued annually. IRS Notice Volume Report.

[96] Revenue Act of 1926, enacting IRC § 274(f). See H.Rep. 69-1, pp. 10-11.

- an error in adding, subtracting, etc., *on the return*;
- an incorrect use of a *table related to the return*;
- inconsistent *entries on the same return*;
- omitted information that is required to substantiate an *entry on the return*; and
- an *entry* that claims a deduction or credit amount in excess of the statutory limit, where that limit is described as a *specific monetary amount or as a percentage, ratio or fraction*.[97]

In making these changes, the House Committee on Ways and Means noted that the IRS advised the committee that the deficiency notice procedure was significantly more costly than the math error procedure, both in terms of personnel and processing costs as well as in collection delay costs. In justifying its request for expanded summary assessment authority, the Service maintained that it properly used that authority in cases where most taxpayers do not dispute the Service's conclusions, thereby reducing administrative and other costs. While mindful of these issues, the committee was concerned that the Service should not be able to move forward summarily where it might have made an error in its determination.[98]

Congress attempted to strike a balance between these two concerns by providing greater protection to taxpayers who wished to contest a math error assessment. Further, Congress attempted to restrict the Service's powers in these cases by clarifying the types of cases in which this limited summary assessment procedure could be used.[99]

The committee reports make clear that the lawmakers were very concerned that the IRS might use this procedure in ways that would undermine taxpayer rights.[100] For example, the committees cautioned the IRS that where a taxpayer supplied an omitted schedule, the related summary assessment must be abated. Disputes as to the adequacy of the submitted schedule were to be dealt with under normal administrative (deficiency) procedures and not by use of the extraordinary summary assessment procedure.[101]

97 Pub. Law 94-455, Section 1206(b), enacting IRC § 6213(f)(2).

98 H. Rep. 94-658, p. 289.

99 Both the Ways and Means and Senate Finance Committees noted that, prior to 1976, the IRS interpreted the term "mathematical error" to include much more than the phrase's literal meaning of arithmetical error. The committees also noted that court opinions had generally limited the scope of the phrase "mathematical error" to arithmetic errors involving numbers which are themselves correct. Accordingly, the committees added the words "or clerical" to the statute, to permit the Service to lawfully do what it was already doing. See H. Rep. 94-658, p. 289; S. Rep. 94-938, p. 375.

100 The Senate modified the House provision by giving the taxpayer 60 days within which to request an abatement of tax. If the taxpayer filed an abatement request, the IRS was required to abate the tax and assert the tax under the deficiency procedures. See S. Rep. 94-938, p. 378.

101 H. Rep. 94-658, p. 291; S. Rep. 94-938, p. 377.

Where there are inconsistent entries on the return, the committee reports stated that "[t]his category is intended to encompass those cases where it is apparent which of the inconsistent entries is correct and which is incorrect."[102] The reports discussed two examples, one in which the use of math error is permitted, and the other where it is not.

- In the first instance, a taxpayer listed six taxpayers or dependents on the face of the return, and entered the number '6' as the total number of exemptions. However, on the second page of the return, the taxpayer entered a dollar amount for the personal and dependent exemptions that was equal to a multiple of '7'. The committees stated that the IRS may treat this as a math error and correct the exemption amount to the multiple of '6'. However, the committees further stated that "your committee expects that the Service will so phrase its notification to the taxpayer as to include questions designed to show whether the taxpayer is indeed entitled to the greater number of exemptions."[103]
- The second example involved a taxpayer who listed three names as dependents but entered '4' in the box for the total number of dependents. The committee stated that it is not clear from the face of the return whether the taxpayer inadvertently omitted a dependent's name from the face of the return or simply added incorrectly. Here, the committee believed that *"the summary assessment procedure is not to be used where it is not clear which of the inconsistent entries is the correct one."*[104] (Italics added.)

The next series of changes to IRC § 6213(g)(2) involved the use of math error procedures where a taxpayer's identification number (TIN) was not supplied as required for eligibility under various code provisions and for tax benefits. In 1996, Congress authorized the use of summary assessment procedures where the taxpayer failed to supply a TIN for a dependent (leading to the denial of the dependency exemption and indirectly impacting a claim for head of household status or the dependent care credit).[105] Also in 1996,



[102] H. Rep. 94-658, p. 291; S. Rep. 94-938, p. 376.

[103] H. Rep. 94-658, p. 291; S. Rep. 94-938, p. 377.

[104] The Committee stated on several occasions that it expected the Service to send to the taxpayer detailed, itemized, line-by-line explanations of the math or clerical errors. In one example, the committee stated,

> [I]t is expected that the notification to the taxpayer will indicate that the taxpayer used the single person's rate schedule, that the taxpayer checked line 3 on the Form 1040, that such a taxpayer should have used the married persons filing separately schedule, and the notification should show the amount of the difference in tax (indicating the amount from the married persons filing separately schedule minus the amount from the single persons schedule). The notice to the taxpayer is also to inquire whether the taxpayer is in fact married and is to inquire as to such other information which might enable the taxpayer to determine whether he or she might be eligible for a more favorable tax status even though married.

The National Taxpayer Advocate has already noted the inadequate and confusing nature of math error notices in the "Most Serious Problems" section of this report. *See infra* Problem Topic #3, Math Error Authority.

[105] Pub. Law 104-188, The Small Business Job Protection Act of 1996, section 1615(c) (H.R. 3448) 8/20/96, amending IRC 6213(g)(2).

Congress authorized the use of math error procedures where a required TIN was not supplied with respect to the earned income tax credit, and where a taxpayer, receiving the EITC on the basis of self-employment income, did not pay self-employment tax on that income. Under this math error authority, the IRS could summarily assess the disallowed EITC and the omitted self-employment tax.[106]

In 1997, the 105th Congress extended math error summary assessment authority to omitted TINs for purposes of the Hope and Lifetime Learning Credits[107] and the Child Tax Credit.[108] Math error procedures were also authorized where the taxpayer had been denied the earned income credit in prior years and did not provide "recertification" information with the return.[109]

The attention focusing specifically on Taxpayer Identification Numbers arose from Congress' concern that taxpayers were claiming tax benefits involving children – dependency exemptions, earned income and child credits, education credits, among others – for which they were not eligible. Checking the child's social security number as listed on the return or the child's age against the information held by the Social Security Administration (the name, age, date of birth, and Social Security Number) was viewed as an effective means to limit such erroneous claims.[110]

The amendments to math error authority in the mid-1990s expanded this summary assessment procedure to take into account inconsistencies beyond the "four corners" of the income tax return itself. Whereas early math error authority was designed to be limited to those inconsistencies apparent on the return itself, Congress in the nineties was concerned about the revenue loss associated with erroneous claims for various newly enacted or expanded credits. Although math error authority was perceived as a useful tool for stopping erroneous claims before payments left the Treasury, Congress still limited the expansion of math error authority to numerical or quantitative items (the social security number, or the child's birth date or age) that could be verified against an inherently accurate source (the provider of the number, i.e., the Social Security Administration). Although not explicitly stated, Congress in the nineties attempted to balance the need for efficient tax administration against possible overreaching by the Service and protection of taxpayer rights.

[106] Pub. Law 104-193, The Personal Responsibility and Work Opportunity Reconciliation Act of 1996, section 451(c), H.R. 3734, amending IRC 6213(g)(2).

[107] Pub. Law 105-34, section 1201(b), adding IRC § 6213(g)(2)(J).

[108] Pub. Law 105-34, Section 101(d)(2), adding IRC § 6213(g)(2)(I).

[109] Pub. Law 105-34, Section 1085(a)(3), as amended by Pub. Law 105-206, Section 6010(p)(3), adding IRC § 6213(g)(2)(K).

[110] Pub. Law 105-277, section 3003, adding IRC § 6213(g)(2)(L) to authorize the IRS obtain such information from the issuer of the Taxpayer Identification Number. See Conf. Rep. 105-825, 1588-89.

In 2001, Congress took a different approach to math error authority. In response to reports of a high percentage of erroneously paid EIC claims,[111] Congress authorized the use of summary assessment procedures, beginning in 2004, where data from the Federal Case Registry (FCR) of Child Support Orders indicates that the taxpayer is the noncustodial parent of the qualifying child.[112] The Federal Case Registry (FCR) is a national database maintained by the Department of Health and Human Services. States are required to electronically submit specified data regarding all child support cases handled by State Title IV-D child support agencies and all non-Title IV-D support orders established or modified on or after October 1, 1998.[113]

While the changes in the 1990s targeted a numerical item on the face of the return and checked for inconsistencies against a numerical or quantitative database maintained by a single, reliable source, the expansion of math error authority in 2001 involves a highly qualitative, subjective, and inherently fluid item (the residence of a child over a period of time) and checks for inconsistencies against a source that is composed of data maintained by 52 different jurisdictions[114] in a non-uniform fashion, reporting a single condition that is subject to different interpretations in each of those jurisdictions, and that does not necessarily reflect the actual living arrangements of the child at the time in question. Unlike the child's date of birth, age, or social security number, a child's physical residence can change over time, despite the terms of a custody order that might have been entered into over 5 years ago.

It is this expansion of math error authority that concerns the National Taxpayer Advocate. Under the limited approach taken by Congress in 1976, math error assessments are appropriate where *"not only is the error apparent from the face of the return, but the correct amount is determinable with a high degree of probability from the information that appears on the return."*[115] The 1990 legislation went beyond the face of the return to determine the correct item, but retained the high degree of probability that the summary correction was accurate. The same cannot be said about the 2001 expansion into the fluid arrangements parents make between themselves, over time, regarding the residence of their children. This type of item more accurately fits into the category of adjustments Congress specifically required the IRS to address through deficiency procedures.

[111] *See* Internal Revenue Service, Compliance Estimates for Earned Income Tax Credit Claimed on 1997 Returns (Sept. 2002).

[112] Pub. Law 107-16, The Economic Growth and Tax Relief Reconciliation Act of 2001, Section 303(g). The National Taxpayer Advocate expressed concerns regarding the accuracy of the FCR and the appropriateness of the expansion of math error authority to inconsistencies between the return and the FCR. The Senate Report requested a study of the FCR database by the Department of Treasury, in consultation with the National Taxpayer Advocate, which would cover the accuracy and timeliness of the data in the FCR; the efficacy of using math error authority in this instance in reducing costs due to erroneous or fraudulent claims; and the implications of using math error authority in this instance, given the findings on the accuracy and timeliness of the data. S. Rep. 107-30, p 16-22.

[113] 42 USC § 653.

[114] 50 states plus Guam and the District of Columbia. IRM 21.8.1.2.4.8 (Rev. 12/2000).

[115] H. Rep. 94-658, p. 292; S. Rep. 94-938, p. 378. (Italics added.)

### Taxpayer Rights Concerns

Basic principles of tax administration require that administrative efficiency be balanced against taxpayer rights. Striking the right balance is often a difficult task, but we believe that the breadth of the IRS's current math error assessment authority under IRC § 6213 imposes too heavy a burden on taxpayer rights. The summary assessment procedure should be used very cautiously, and only in those instances where items on the return are numerical, quantifiable, and verified against reliable, quantifiable sources.

Here is what is being compromised with the expansion of math error authority: under normal examination procedures, if the taxpayer makes no response at all to the IRS correspondence *proposing* an adjustment, the taxpayer will receive a Notice of Deficiency by certified mail, providing the taxpayer an opportunity to petition the Tax Court. Under the math error summary assessment procedure, if the taxpayer makes no response to the IRS correspondence *summarily assessing* the adjustment, the taxpayer will *not* have an opportunity to petition the Tax Court.

Consider the population targeted by the 2001 changes – those taxpayers who are eligible for the Earned Income Tax Credit. By definition, these taxpayers are the working poor. Congress acknowledged in the IRS Restructuring and Reform Act of 1998 (RRA98) that these taxpayers do not have access to representation, are often afraid to communicate with the IRS, or are unable to take time off from work to call, or do not understand the IRS notices they receive.[116] The Service's own studies show a high no-response rate for this population.[117] We may be able to justify the summary denial of this important taxpayer right (the access to Tax Court) where we are dealing with true math or clerical errors. But support for this justification diminishes "where the Service is merely resolving an uncertainty against the taxpayer."[118]

The National Taxpayer Advocate believes that it is inappropriate to use the summary math error assessment where there is merely uncertainty on the return. Thus, where a taxpayer lists 4 dependents who lived with her, including their social security numbers, on the Form 1040, but lists two children as eligible for the earned income tax credit (the

[116] In response to these concerns, Congress enacted IRC § 7526, which provides for matching funding of Low Income Taxpayer Clinics that represent low income taxpayers in IRS disputes for free or a nominal charge, and that conduct education and outreach to taxpayers who speak English as a second language.

[117] Internal Revenue Service, Compliance Estimates for Earned Income Tax Credit Claimed on 1999 Returns, 8 (Feb. 28, 2002). A recent attempt by the Small Business/Self-Employed Division to determine the reasons for the high level of no-response to service center correspondence ended up with only 8 individuals participating in focus groups out of 1,767 people contacted. Study of Service Center Correspondence Examination No Reply Assessments, Project 2.08, SB/SE Research, April 2001.

[118] H. Rep. 94-658, p. 291; S. Rep. 94-938, p. 377. This is not to say that the IRS should pay out credit amounts that are in error. The IRS is currently exploring many different means of identifying erroneous claims of various credits. The IRS can freeze refunds pending the resolution of these inconsistencies. It can, and is, developing taxpayer-friendly approaches to this problem resolution.

maximum number of children for eligibility), and one of those two children's social security number is incorrect, the use of math error authority is inappropriate. It is not clear from the face of the return which is the correct entry – that is, another of the remaining two children might make the taxpayer eligible for the same amount of credit. To utilize summary assessment procedures in such a case, without the inquiries and contacts that attend to other administrative return examinations, erodes taxpayer confidence, results in repeat-work for other functions (including the Taxpayer Advocate Service and the audit reconsideration function), and impairs taxpayer rights by limiting their access to the United States Tax Court.

Today, the IRS has 500 math error codes that it enters into IDRS to indicate the type of math error identified on the return. There are approximately 35 million errors identified in the Error Resolution Section (ERS) each year, resulting in the generation of 7 million Individual Master File (IMF) and 2 million Business Master File (BMF) math error notices.[119] The Taxpayer Advocate Service received 27,480 cases during FY 2002 in which math errors were the major issues, accounting for 12 percent of all TAS case receipts (227,373) for that period.[120] Math error cases involving EITC constituted 1.2 percent of Taxpayer Advocate Service cases closed in FY 2002. In 61 percent of those 2,813 cases, intervention by TAS resulted in a positive change for the taxpayer.[121]



### Explanation of Recommendation

The National Taxpayer Advocate recommends that Internal Revenue Code sections 6213(b) and 6213(g)(2), as appropriate, be amended to specifically limit the scope of the summary assessment authority for mathematical or clerical errors and provide standards by which to judge any proposed expansion of this authority. Specifically, she proposes that "math error" assessments be limited to the following situations:

- Inconsistent items in which the inconsistency is determined from the face of the return;
- Omitted items, including schedules, that are required to be included with the return; and
- Items reported on the return that are numerical or quantitative and which can be verified by a government entity that issues or calculates such information.

By limiting the scope of math error assessment authority to items that are either self-contained on the return, or that are numerical or quantitative, Congress can ensure that the delicate balance between efficient tax administration and taxpayer rights is maintained.

[119] MIS24 Report (12/10/02), 2-Year Trend Report and Notice Volume Reports.

[120] TAMIS Data Base.

[121] *See* the discussion of Math Error under Most Serious Problems, Problem Topic #3.

Under this approach, math error summary assessment authority would not be permitted where the inconsistent items are of a qualitative nature, dependent on facts and circumstances, and inherently subject to change or interpretation. By their very nature, such items should be subject to the IRS' normal examination and deficiency procedures from the very outset of the dispute.

Thus, the National Taxpayer Advocate recommends that Congress repeal Internal Revenue Code section 6213(g)(2)(M), which defines as math or clerical error and authorizes the Internal Revenue Service to use summary assessment procedures for an entry on the return with respect to a qualifying child for the Earned Income Tax Credit, where the taxpayer has been identified as the non-custodial parent of that child by the Federal Case Registry of Child Support Orders established under section 453(h) of the Social Security Act. This provision fails the limited scope test for math error authority, since the underlying factual situation is inherently qualitative in nature and subject to change from year to year. A facts and circumstances analysis, using deficiency procedures, is the appropriate approach to the earned income tax credit's statutory requirement of where a child resided for more than half the year.[122]

The National Taxpayer Advocate understands the need for efficient, cost-effective methods to deal with noncompliance and tax administration programs. However, she believes that administrative efficiency is only one component of a fair and just tax system. Administrative efficiency must be balanced by protections for taxpayers where there is a likelihood of IRS error or where the category of taxpayers impacted by the procedure is likely to experience obstacles in exercising their rights under the Internal Revenue Code.

Where Congress authorizes the expansion of the math error summary assessment authority beyond inconsistencies in numerical or quantitative items included on the face of the return, the National Taxpayer Advocate recommends that IRC § 6213(g) be amended to require the Department of Treasury to submit to Congress a study of the proposed expanded authority prior to granting such expansion. This report, prepared in consultation with the National Taxpayer Advocate, should set forth and analyze the specific need for such expansion, the alternative methods for resolving the identified need, and the projected revenue and cost savings attributed to the expansion of math error notices and the alternative methods identified. Further, the report should include an analysis, prepared by the National Taxpayer Advocate, of the impact on taxpayer rights of such expansion. This taxpayer rights impact statement should identify the substantive and procedural rights that may be affected by the expansion and include an analysis of the

[122] The National Taxpayer Advocate is not impressed by arguments that the FCR is the most effective means to screen out erroneous claims of EITC qualifying children. During 2002 the NTA served on a joint Treasury-IRS EITC Steering Committee, which identified several approaches to better administration of the EITC. None involved the use of math error authority, and all had a significant likelihood of reducing erroneous EITC claims.

taxpayer segments most likely to be impacted by the proposed expansion of math error authority. The report should also include a discussion of the consequences for both the taxpayer and IRS in attempting to address and resolve post-assessment matters arising from the expanded math error authority.

The approach outlined above will enable Congress to maintain the delicate balance between efficient administrative processes and taxpayer rights. Given the importance of the Tax Court as the prepayment judicial forum for resolving tax disputes and the deficiency procedure's gatekeeping to that forum, summary assessment authority should be the exception rather than the rule.

## 4 THE OFFICE OF THE TAXPAYER ADVOCATE

### PROBLEM

It is now almost five years since the enactment of the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98) and three years since the Taxpayer Advocate Service "stood up." During this period, all of RRA 98's provisions relating to the National Taxpayer Advocate and the Office of the Taxpayer Advocate (OTA) have been implemented in some fashion. Further, the National Taxpayer Advocate and the OTA have had almost three years of experience with operating independently within the IRS. Based on the experience of the last three years, the National Taxpayer Advocate believes that additional statutory measures are required to protect the independence of the Office of the Taxpayer Advocate and taxpayer rights through that office.

The following recommendations are designed to enhance the independence of the Office of the Taxpayer Advocate and the ability of the National Taxpayer Advocate to protect taxpayer rights and taxpayer confidences both within the Internal Revenue Service and in federal courts.

### RECOMMENDATION

The National Taxpayer Advocate (NTA) recommends that the independence of the National Taxpayer Advocate and the Office of the Taxpayer Advocate be strengthened by amending Internal Revenue Code sections 7803(c)(3) and 7811 as follows:

- 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.
- Amend IRC § 7803(c)(3) to authorize the National Taxpayer Advocate to intervene as amicus curiae in any federal litigation, excluding litigation before the United States Supreme Court, that raises issues relating to taxpayer rights under the Internal Revenue Code.
- Amend IRC § 7811 to provide the National Taxpayer Advocate with the non-delegable authority to issue a Taxpayer Advocate Directive to the Internal Revenue Service with respect to any program, proposed program, action, or failure to act that may create a significant hardship for a taxpayer segment or taxpayers at large.

- Amend IRC § 7811 to include "impairment of taxpayer rights" as a definition of "significant hardship" for purposes of issuing a Taxpayer Assistance Order or Taxpayer Advocate Directive.
- Amend IRC § 7803(c)(4)(A)(iv) to clarify that, notwithstanding any other provision of the Internal Revenue Code, Local Taxpayer Advocates have the discretion to withhold from the Internal Revenue Service the fact that a taxpayer contacted the Taxpayer Advocate Service (TAS) or any information provided by a taxpayer to TAS.
- Amend IRC § 7803(c)(4)(A) to provide that in litigation before a federal court, Local Taxpayer Advocates shall not through discovery or compulsory process be required to disclose the fact that the taxpayer contacted the Taxpayer Advocate Service or any information provided by the taxpayer to TAS, unless the court determines that such testimony or disclosure is necessary to:

  (a) prevent a manifest injustice;

  (b) help establish a violation of law; or

  (c) prevent harm to the public health or safety,

  of sufficient magnitude in the particular case to outweigh the integrity of the Taxpayer Advocate Service in general by reducing the confidence of taxpayers in future cases that their communications will remain confidential.

RECOMMENDATIONS

LEGISLATIVE RECOMMENDATIONS

### PRESENT LAW

The Office of the Taxpayer Advocate was created in 1996 by the Taxpayer Bill of Rights 2 (TBOR 2).[123] This Act also established the position of the Taxpayer Advocate. The Taxpayer Advocate replaced the position of the Taxpayer Ombudsman, which was created in 1979 by the Internal Revenue Service to serve as the primary advocate for taxpayers within the IRS and which was later codified in the Taxpayer Bill of Rights 1 (TBOR 1).[124]

The Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98)[125] significantly strengthened the Office of the Taxpayer Advocate (OTA) and renamed the Taxpayer Advocate as the National Taxpayer Advocate (NTA). The Act established the OTA as a separate, independent entity within the IRS. The National Taxpayer Advocate reports directly to the Commissioner of Internal Revenue[126] and the employees of the Office of the Taxpayer Advocate, including Local Taxpayer Advocates, report directly to the National Taxpayer Advocate or a delegate thereof.[127]

The Office of the Taxpayer Advocate has four statutory general functions:

1. Assist taxpayers in resolving problems with the Internal Revenue Service;
2. Identify areas in which taxpayers have problems in dealings with the Internal Revenue Service;
3. To the extent possible, propose changes in the administrative practices of the IRS to mitigate the identified systemic problems; and
4. Identify potential legislative changes which may be appropriate to mitigate such systemic problems.[128]

In addition to these general functions, the National Taxpayer Advocate is required to submit two reports a year directly to Congress, without any prior review or comment from the Commissioner, the Secretary of the Treasury, the IRS Oversight Board, or any other officer or employee of the Department of the Treasury or the Office of Management and Budget. These two reports, one of which is due on June 30th and the other on December 31st of each year, respectively address the objectives of the OTA for the upcoming fiscal year and the activities of the OTA for the past fiscal year.[129]

[123] Pub. L. No. 104-168, § 101 (1996).

[124] Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 6230(a) (1988).

[125] Pub. L. No. 105-206 (1998).

[126] IRC § 7803(c)(1)(B).

[127] IRC § 7803(c)(4)(A)(i).

[128] IRC § 7803(c)(2)(A)(i) – (iv).

[129] IRC § 7803(c)(2)(B). The December 31st report includes, among other statutorily required items, a listing and discussion of the top 20 problems experienced by taxpayers; a listing of the 10 most litigated issues for each category of taxpayers, including recommendations for mitigating such disputes; and recommendations for administrative and legislative action that may be appropriate to resolve taxpayer problems. *See* IRC § 7803(c)(2)(B)(ii).

In 1998, Congress expanded the circumstances in which the National Taxpayer Advocate could issue a Taxpayer Assistance Order, a directive that orders the IRS either to take a specific action or to review or reconsider specific information or evidence relating to a particular taxpayer's case.[130] RRA 98 provided for four specific instances of "significant hardship": (1) an immediate threat of adverse action; (2) a delay of more than 30 days in resolving taxpayer account problems; (3) the taxpayer's incurring of significant costs (including professional services fees) if relief is not granted; and (4) the taxpayer's suffering of irreparable injury or long-term adverse impact if relief is not granted.[131] The committee reports make clear that this list is a non-exclusive list of what constitutes "significant hardship" for purposes of IRC § 7811.[132]

The 1998 legislation also provided Local Taxpayer Advocates with the discretion to withhold from the IRS the fact that a taxpayer contacted TAS and any information provided by a taxpayer to TAS.[133] In order to protect the confidential communications between taxpayers and the Office of the Taxpayer Advocate, each Local Taxpayer Advocate must have phone, facsimile, electronic communication and mailing addresses separate from those of the IRS.[134] Further, the Local Taxpayer Advocate must advise taxpayers at their first meeting of the fact that "the taxpayer advocate offices operate independently of any other Internal Revenue Service office and report directly to Congress through the National Taxpayer Advocate."[135]



### REASONS FOR CHANGE

As noted above, the Office of the Taxpayer Advocate has four statutory functions, which include identifying both specific and systemic problems that taxpayers encounter in their dealings with the Internal Revenue Service and making administrative and legislative recommendations for mitigating those problems. This mission is achieved through advocacy in specific taxpayer cases (case advocacy) and through advocacy in matters impacting taxpayer rights and tax administration (systemic advocacy).

[130] IRC § 7811. See H.R. Conf. Rep. No. 105-599, at 26, 28 (1998). In 1988, Congress granted the Taxpayer Ombudsman the statutory authority to issue a Taxpayer Assistance Order (TAO) if, "in the determination of the Ombudsman, the taxpayer is suffering or about to suffer a significant hardship as a result of the manner in which the IRS is administering the internal revenue laws." S. Rep. No. 100-445 (1988). TBOR 2 extended the scope of the TAO by providing the Taxpayer Advocate with broader authority "to affirmatively take any action as permitted by law with respect to taxpayers who would otherwise suffer a significant hardship as a result of the manner in which the IRS is administering the tax laws." JCT General Explanation of the Tax Legislation Enacted in the 104th Congress (JCS-12-6) December 18, 1996, at 22.

[131] IRC § 7811(a)(2)(A) – (D).

[132] See H.R. Conf. Rep. No. 105-599, at 26, 28 (1998).

[133] IRC § 7803(c)(4)(A)(iv).

[134] IRC § 7803(c)(4)(B).

[135] IRC § 7803(c)(4)(A)(iii).

Throughout the hearings of the National Commission on Restructuring the Internal Revenue Service and the 1998 legislative process, the Commission and the Congress expressed their concern about the lack of independence of the Office of the Taxpayer Advocate. The reforms enacted in RRA 98 were designed both to strengthen the office and to make it as independent of the Internal Revenue Service as possible while it remained a part of the IRS. The office's effectiveness and success in achieving its mission is dependent on its ability to maintain the delicate balance between being "independent" and being "inside." The proposals discussed below are designed to strengthen and enhance the independence of the Office of the Taxpayer Advocate while preserving the Advocate's role within the IRS organization.

### Counsel to the National Taxpayer Advocate

Currently, the National Taxpayer Advocate receives legal advice from the Special Counsel to the National Taxpayer Advocate. The Special Counsel to the NTA advises the National Taxpayer Advocate on matters pertaining to the Office of the Taxpayer Advocate as well as matters pertaining to tax administration, including taxpayer rights. The Special Counsel to the NTA reports directly to the Chief Counsel of the Internal Revenue Service. This reporting structure impairs the National Taxpayer Advocate's ability to receive independent legal counsel since her counsel may be placed in a position of rendering advice that is directly contrary to the advice of the Office of Chief Counsel, to whom the Special Counsel to the NTA reports and by whom she is evaluated.

The National Taxpayer Advocate and the Office of the Taxpayer Advocate play a particularly important role in tax administration with respect to the protection of taxpayer rights. It is possible, and it has in fact occurred, that the IRS's corporate decision to proceed in a particular fashion for administrative and cost efficiencies directly and negatively impacts on taxpayer rights or causes significant hardship to an unwarranted extent. While the IRS's corporate decision may be well within the bounds of the law, the National Taxpayer Advocate may also have a legally supportable position. For the National Taxpayer Advocate to develop the most persuasive case to present to the Commissioner for consideration, the National Taxpayer Advocate's legal advisor must be free to render such advice without concern that her advice would create an untenable conflict between her duties to her client and her duties to her supervisors.

In RRA 98, the Senate passed legislation providing for counsel to the National Taxpayer Advocate, to be appointed by and report directly to the National Taxpayer Advocate and to operate within the Office of the Taxpayer Advocate.[136] Senator Grassley, the sponsor of this provision, provided the following rationale:

[136] H.R. Conf. Rep. No. 105-599, at 26 (1998).

> The purpose of doing this is to give the Taxpayer Advocate ready access to legal opinions and legal judgments. Currently, the Taxpayer Advocate must put requests into the Office of Chief Counsel.
>
> In order to make the Taxpayer Advocate more independent, which is what this bill does, it logically follows that the Taxpayer Advocate should have its own legal counsel. This will guarantee it fast, confidential legal advice to help those taxpayers in greatest need. Because it is the taxpayers in greatest need who go to the Taxpayer Advocate.[137]

This provision was eliminated in the conference agreement. However, the conference report noted that "[t]he conferees intend that the National Taxpayer Advocate be able to hire and consult counsel as appropriate."[138]

The ability of the National Taxpayer Advocate to hire and consult outside counsel is dependent upon the Office of the Taxpayer Advocate's having sufficient resources for this purpose. Since the initial pass and ongoing adjustments of the OTA's budget is determined by the Commissioner, who must balance the overall needs of tax administration against the specific needs of the OTA, it is highly likely that the NTA's retention of outside counsel (i.e., a contractor), on a continuing basis, would not be funded. Further, it is unlikely that an outside counsel would have the ability to participate in preliminary and pre-decisional discussions with attorneys in the Office of Chief Counsel and other employees of the IRS.

Unlike any other employee of the Internal Revenue Service, the National Taxpayer Advocate is alone authorized by statute to not only advocate within the IRS but also *publicly* advocate for positions, even where those positions differ from those of the commissioner. In order to effectively fulfill this role, the National Taxpayer Advocate must have access to equal counsel that is both independent and free of possible conflicts of interest.

### Amicus Curiae Authority

As noted above, the National Taxpayer Advocate and the Office of the Taxpayer Advocate have a mission-related interest in the subject of taxpayer rights, particularly where an infringement, restriction, or redefinition of such rights will cause significant hardship to taxpayers or might undermine taxpayer confidence in the U.S. tax system. It is possible that the Commissioner or the United States will advance a position in litigation that would be justifiable with regard to efficient tax administration and yet would impact the legal rights of taxpayers. It is also possible that the Commissioner's or the United States' position would be supported and enhanced by the particular perspective and arguments made by the National Taxpayer Advocate with respect to taxpayer rights and tax administration.

[137] 144 Cong. Rec. SS40 (daily ed. May 7, 1998) (Statement of Sen Grassley)

[138] H.R. Conf. Rep. No. 105-599, at 28 (1998).

We believe that the National Taxpayer Advocate should have the opportunity to present such arguments, and the federal courts should have the opportunity to consider them.

Within the IRS, the National Taxpayer Advocate reports directly to the Commissioner and has access to discuss with him matters relating to tax administration and taxpayer rights. On occasion her views will not prevail, nor will they be accepted by the Office of Chief Counsel, which represents the United States before the United States Tax Court. Where the National Taxpayer Advocate is unsuccessful (or even partially successful) in advancing her position internally, she should be permitted to ask the court for permission to intervene in litigation, not as a party but as a friend of the court.

The only other "advocate" in the federal government – the Chief Counsel for Advocacy for the Small Business Administration – has amicus brief authority. The Office of Advocacy of the Small Business Administration was created in 1976.[139] The office has numerous statutory "primary functions," which include examining the role of small business in the American economy and the contributions that small business can make, assessing the effectiveness of existing Federal subsidies and assistance programs for small business, measuring the direct costs and other effects of government regulation on small businesses, and determining the impact of the tax structure on small businesses.[140] The most visible responsibility of the Office of Chief Counsel for Advocacy is to oversee agency compliance with the Regulatory Flexibility Act.

In 1980, Congress authorized the Chief Counsel for Advocacy to file amicus briefs to present his views with respect to the effect of the rule at issue on small entities.[141] In 1996, Congress amended the Regulatory Flexibility Act to allow the Chief Counsel for Advocacy also to file amicus briefs to present his views with respect to compliance with the Act and the adequacy of the rulemaking record.[142] Thus, the Regulatory Flexibility Act grants the Chief Counsel for Advocacy the authority to appear as amicus curiae in any action brought in a court of the United States to review a rule. In any such action, the Chief Counsel for Advocacy of the Small Business Administration is authorized to present his views regarding compliance with the Act, the adequacy of the rulemaking record with respect to small entities, and the effect of the rule on small entities.

On the one occasion when the Chief Counsel for Advocacy of the Small Business Administration sought and received permission from the court to file an amicus brief, the Department of Justice opposed the brief on the ground that the provision granting the Chief Counsel for Advocacy the authority to file an amicus brief violated the

[139] Small Business Investment Act, Pub. L. No. 94-305, § 201 (1976).

[140] 15 U.S.C. § 634(b).

[141] 5 U.S.C. § 612(b); Regulatory Flexibility Act, Pub. L. No. 96-354, § 3(a) (1980).

[142] Contract with America Advancement Act of 1996, Pub. L. No. 104-121, § 243(b) (1996).

Constitution because it impairs the ability of the executive branch to fulfill its constitutional functions.[143] The Chief Counsel for Advocacy ultimately withdrew his amicus brief.

As in the case of the Chief Counsel for Advocacy of the Small Business Administration, there is a compelling argument for providing the federal judiciary with the perspective of an independent advocate for taxpayers who functions within the IRS. This perspective will not necessarily be adopted by the Commissioner or the United States, nor would it be advanced by the specific taxpayers involved in the litigation. It is, however, a point of view that Congress has continually advanced through legislation and through the creation of the Office of the Taxpayer Advocate. Congress should consider allowing this viewpoint to be presented in judicial proceedings as well.



### Taxpayer Advocate Directive

The Commissioner has delegated to the National Taxpayer Advocate the authority to issue Taxpayer Advocate Directives.[144] A Taxpayer Advocate Directive (TAD) may mandate administrative or procedural changes "to improve the operation of a functional process or to grant relief to groups of taxpayers (or all taxpayers) when implementation will protect the rights of taxpayers, prevent undue burden, ensure equitable treatment or provide an essential service to taxpayers."[145] The TAD provides the National Taxpayer Advocate with the authority to prevent IRS programs from being implemented before their impact on taxpayers has been fully considered.

The current National Taxpayer Advocate has advised the Commissioner or Operating Division Commissioners of her intent to issue a TAD on two occasions since March 2001. In the first instance, the Commissioner placed a moratorium on the implementation of the Federal Payment Levy Program against Social Security benefits until the National Taxpayer Advocate's concerns were addressed. In the second case, the Small Business/Self-Employed Operating Division clarified and modified its position regarding an offer-in-compromise procedure to address the NTA's concerns. In neither instance was it necessary for the National Taxpayer Advocate to issue a formal TAD.

[143] The United States Constitution requires the President to "take care that the laws be faithfully executed." U.S. Const. Art. II, §3. The Constitution also imposes a requirement that a case or controversy exist before a matter is presented before a United States court. U.S. Const. Art. III. With respect to the latter concern, the National Taxpayer Advocate is proposing only to intervene as a friend of the court in suits that are already justiciable. Such litigation will be between a taxpayer and the United States (or the Commissioner), not between the National Taxpayer Advocate and the United States (or the Commissioner). For a discussion of the "take care" clause of Article II and other objections to congressional grants of amicus brief authority to executive branch officials, see Memorandum of the American Law Division (Congressional Research Service), Constitutional Analysis of Section 612(b) of the Regulatory Flexibility Act Authorizing the Chief Counsel for Advocacy of the Small Business Administration to Appear as Amicus Curiae in Any Court Action to Review an Agency Rule (October 22, 1993).

[144] *See* Del. Order 250 (01/17/01) at IRM 1.2.2.151.

[145] *Id.*

Since the Taxpayer Advocate Directive derives from a delegation of the Commissioner's own authority, the National Taxpayer Advocate holds this authority at the pleasure of the Commissioner, and the Commissioner may revoke or modify it at any time. Although used infrequently, the TAD is a means for ensuring that systemic issues – those involving taxpayer rights, burden, equitable treatment, or service to taxpayers – are elevated to senior IRS leadership and given appropriate consideration. Thus, the TAD and the TAD process are powerful tools for effecting systemic change and help the National Taxpayer Advocate to advocate effectively for taxpayer rights.

### Definition of Significant Hardship

The issuance of a Taxpayer Assistance Order is conditioned upon the National Taxpayer Advocate's finding that a taxpayer is suffering or about to suffer a significant hardship as a result of the manner in which the Secretary is administering the internal revenue laws.[146] The Taxpayer Advocate Service uses the same standard in determining whether to accept a case. Therefore, the definition of "significant hardship" is critical to taxpayers gaining access to and assistance from the office of the Taxpayer Advocate.

As noted above, Congress has on two occasions expanded the definition of "significant hardship" under IRC § 7811(a). The definition of "significant hardship" now includes –

- An immediate threat of adverse action;
- A delay of more than 30 days in resolving taxpayer account problems;
- The incurring by the taxpayer of significant costs (including fees for professional representation) if relief is not granted; or
- Irreparable injury to, or a long-term adverse impact on, the taxpayer if relief is not granted.[147]

Each of these instances addresses some kind of economic or systemic hardship, yet none explicitly describes a situation where the violation of a taxpayer's rights under either a statute or an IRS regulation or procedure would constitute a significant hardship.

For example, a taxpayer timely requested a Collection Due Process hearing under IRC § 6320. The taxpayer was notified that a telephonic hearing was scheduled for January 10, 2001. On January 4th, the Appeals Officer returned a message from the taxpayer (who had requested a face-to-face hearing). The Appeals Officer informed the taxpayer that the January 4th call would constitute his CDP hearing. The court ruled that an unscheduled telephone call does not constitute a hearing.[148] Had the taxpayer contacted the Taxpayer Advocate Service for assistance prior to filing his complaint in court, it is doubtful that the taxpayer would meet the criteria under the current definition of significant hardship.

[146] IRC § 7811(a)(1)(A).

[147] IRC § 7811(a)(2).

[148] Montijo v. United States, 2002 U.S. Dist. LEXIS 9602.

An explicit definition of significant hardship as the immediate threat of an impairment of a taxpayer's rights under the Code or regulations would eliminate any remaining questions about the National Taxpayer Advocate's ability to intercede on behalf of a taxpayer and to issue a Taxpayer Assistance Order in such a case.

### Confidentiality of Taxpayer Communications with the Taxpayer Advocate Service

Internal Revenue Code section 7803(c)(4)(A)(iv) provides that a Local Taxpayer Advocate may, at his or her discretion, not disclose to the rest of the Internal Revenue Service the fact that the taxpayer has contacted the Taxpayer Advocate Service or any information provided to TAS by the taxpayer. This provision, enacted in 1998, was designed to give taxpayers assurances that they could contact the Taxpayer Advocate Service for assistance in difficult cases, including discussing the actions or proposed actions of an IRS employee, without those conversations being reported to the IRS. These protections were viewed as particularly important where the taxpayer feared repercussions or reprisals from the IRS employee working the taxpayer's case.[149]



Confidentiality has long been viewed as essential to relationships in which one party is charged with representing, advocating on behalf of, or negotiating for another party. Confidentiality is also a key element of alternative dispute resolution. Further, confidentiality is considered an essential characteristic of ombudsmen offices.

Both the Administrative Dispute Resolution Act of 1996[150] (ADR Act) and the American Bar Association Standards for the Establishment and Operation of Ombuds Offices explicitly acknowledge the role confidentiality plays in bringing parties in a dispute to resolution. The ABA Standards provide that

> [a]n ombuds does not disclose and is not required to disclose any information provided in confidence, except to address an imminent risk of serious harm. … An ombuds may, however, at the ombuds's discretion disclose non-confidential information and may disclose confidential information so long as doing so does not reveal its source.[151]

[149] Senator Breaux, a sponsor of RRA 98 in the Senate, made the following statement regarding the confidentiality of taxpayer communications with TAS:

> We are really trying to build some walls between the IRS and the Taxpayer Advocate and their work with the taxpayers, the American citizens of this country, to make sure that they, the taxpayers, know the person they are dealing with is independent, has their interests at heart, and doesn't have to go report to the Internal Revenue Service district director about what he or she has discussed or talked about with the taxpayer who is seeking assistance.

144 Cong. Rec. 54 (daily ed. May 5, 1998) (statement of Sen. Breaux).

[150] 5 U.S.C. §§ 571-584.

[151] American Bar Association, Standards for the Establishment and Operation of Ombuds Offices 3 (August 2001).

The ADR Act sets forth the rules governing alternative dispute resolution in federal agencies that elect to be covered by the Act. Under the ADR Act, dispute resolution communications between the parties and a neutral are held in confidence by the neutral unless –

1. All parties to the dispute resolution proceeding and the neutral agree in writing (and if the communication was provided by a nonparty, the nonparty agrees in writing);
2. The communication has already been made public;
3. The communication is required to be disclosed by statute (but should be disclosed by the neutral only if no other person is reasonably available to disclose the communication); or
4. A court determines that the testimony or disclosure is necessary to prevent a manifest injustice, help establish a violation of law, or prevent harm to the public health or safety. In making its determination, the court must find that the harm brought about by nondisclosure is "of sufficient magnitude in the particular case to outweigh the integrity of dispute resolution proceedings in general by reducing the confidence of parties in future cases that their communications will remain confidential."[152]

The Federal ADR Steering Committee developed and published guidance for the exercise of confidentiality under the ADR Act, which was approved by the Federal ADR Council, a group of high-level government officials chaired by the Attorney General. The Taxpayer Advocate Service has modeled its confidentiality policies and procedures after this guidance and the ABA Standards.

The Taxpayer Advocate Service is in a unique position to help taxpayers resolve their problems with the IRS. By design, taxpayers who contact TAS are concerned about the handling of their case and often fear that their coming to TAS will result in retaliation or bad acts by the IRS. However groundless these fears may be, taxpayers who have made a mistake on past returns and want to make amends are hesitant to admit their errors unless they have some assurances that these discussions will be held in confidence while the taxpayer and TAS attempt to solve the taxpayer's problem.

On the other hand, TAS is a part of the IRS. The Taxpayer Advocate Service must balance the need to protect the taxpayer's confidences with the tax system's need for compliance. Confidentiality is not an excuse or a means for getting around either TAS or the IRS. TAS cannot allow itself to be compromised in this way.

[152] 5 U.S.C. § 574(a). The Federal ADR Council guidance states that the "need for the information must be so great that it outweighs a loss of confidence among other potential parties that their dispute resolution communications will remain confidential in future proceedings." The Council noted the importance of confidentiality, identifying it as "a critical component of a successful ADR process." Federal Alternative Dispute Resolution Council, Department of Justice, Confidentiality in Federal Alternative Dispute Resolution Programs, 65 Fed. Reg. 83,085 (Dec. 29, 2000).

The National Taxpayer Advocate and the Taxpayer Advocate Service have developed guidance for TAS employees about confidentiality, particularly with regard to a taxpayer's statement about criminal acts or civil fraud. We believe that 99.9 percent of the taxpayers who come to TAS for help will want and need TAS to share information they provide with the IRS. In order to resolve a problem, TAS must tell the IRS it is working on the taxpayer's case and give the IRS the requisite information to resolve the taxpayer's problem.

The guidance recognizes that there will be a small number of cases where the taxpayer is reluctant or unwilling to "come clean" with the IRS. Here, confidentiality is an important tool for persuading the taxpayer to become compliant with the tax laws. As long as the taxpayer is working with TAS to become compliant and correct errors, TAS may keep the taxpayer-provided information confidential.

Where the taxpayer walks out the door and refuses to become compliant with his or her responsibilities under the tax laws, the Local Taxpayer Advocate (LTA) must exercise his or her discretion in determining whether to disclose taxpayer-provided information to the IRS. In exercising this discretion, the LTA should weigh the harm to the tax system against the harm to the confidence that future taxpayers would have in TAS if they knew TAS had disclosed this information.[153] In cases involving criminal violations of law, civil fraud, or threats of significant personal injury or harm, there is no discretion – TAS will disclose taxpayer-provided information relevant to these matters.

In the course of developing this guidance, a disagreement arose among the National Taxpayer Advocate, the Internal Revenue Service, and the Office of Chief Counsel regarding the scope of the statute and its interaction with pre-existing law. Although this dispute has been resolved, we believe that IRC § 7803(c)(4)(A)(iv) should be amended to clarify that the Local Taxpayer Advocate's discretion to not disclose taxpayer-provided information to the IRS is applicable notwithstanding any other provision of the Internal Revenue Code. This change will place all Internal Revenue Code provisions relating to confidentiality of taxpayer communications with TAS within the statute governing the operation of the Office of the Taxpayer Advocate, thereby reinforcing the essential importance of maintaining and protecting taxpayer communications in the work performed by that Office.[154]

[153] The ABA Standards note that "[a]n ombuds will rarely, if ever, be privy to something that no one else knows. Therefore, providing confidentiality protection to the ombuds allows the ombuds to perform assigned duties while at the same time, society continues to have access to the underlying facts." ABA Standards at 8. Thus, if the IRS already has access to taxpayer-provided information in one form or another, TAS would generally not disclose the information again.

[154] The statutory amendment will also reassure employees of the Office of the Taxpayer Advocate that so long as they comply with the confidentiality policies and procedures of the Office of the Taxpayer Advocate, they will not be subject to discipline under another Code section that requires disclosure. *See, e.g.,* IRC § 7214(a)(8).

The independence of the Taxpayer Advocate Service will be further enhanced if the language of the ADR Act relating to discovery or compulsory process is incorporated into IRC § 7803(c)(4)(A). Thus, where the Local Taxpayer Advocate has exercised his or her discretion not to disclose taxpayer-provided information to the IRS, he or she cannot be *compelled* to disclose the information unless a court finds that the need for the testimony or disclosure is so great that it outweighs a loss of confidence among other taxpayers that their communications with TAS will remain confidential in future cases.

### EXPLANATION OF RECOMMENDATIONS

The Office of the Taxpayer Advocate serves an important role within the IRS by protecting taxpayer rights and solving taxpayer problems with the IRS.[155] The recommendations discussed in this section are intended to strengthen and support this important mission.

### Counsel to the National Taxpayer Advocate

The National Taxpayer Advocate recommends that IRC § 7803(c)(3) be amended 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.

The position of Counsel to the National Taxpayer Advocate should be authorized within the statutory provision describing the position of the National Taxpayer Advocate and the Office of the Taxpayer Advocate. This placement reinforces the concept that the Counsel to the National Taxpayer Advocate is essential to the functioning of the Office of the Taxpayer Advocate but is not an encroachment on the authority of the office of the Chief Counsel.

The statute should clearly state that the Counsel to the National Taxpayer Advocate shall have the ability to participate in preliminary and pre-decisional discussions with the Office of Chief Counsel about rules, regulations, and other significant Chief Counsel work product to the same extent as the Special Counsel to the NTA does today. Thus, the Counsel to the National Taxpayer Advocate shall be consulted on and review such legal opinions and other guidance as may be required in the preparation and review of rulings and memoranda of technical advice, proposed legislation, regulations and Executive Orders relating to laws affecting the Internal Revenue Service.

Under current procedures, the employees of the Taxpayer Advocate Service receive their initial legal advice in specific taxpayer cases from the local Small Business/Self-Employed Area Counsel attorneys. Where TAS disagrees with this advice, the issue is elevated through TAS and Counsel management. The Special Counsel to the National Taxpayer Advocate reviews the issue and attempts to resolve any conflict.

[155] *See* S. Rep. No. 105-174.

The recommendation does not envision any change to this procedure. However, under the recommendation, if the Counsel to the NTA advises the National Taxpayer Advocate that TAS's position is legally justified but that Chief Counsel takes an opposing position, the NTA may bring the matter to the attention of the Commissioner. In doing so, she has the benefit of independent legal advice with respect to TAS's position. Under current procedures, the NTA may not necessarily have the benefit of such legal advice.

The National Taxpayer Advocate should be authorized to recruit the Counsel to the National Taxpayer Advocate from either within or outside the Office of Chief Counsel. The position should be of sufficient stature and rank that it will attract candidates of the highest caliber and experience.

### Amicus Brief Authority

The National Taxpayer Advocate recommends that IRC § 7803(c)(3) be amended to authorize the National Taxpayer Advocate to intervene as amicus curiae in any federal litigation, excluding litigation before the United States Supreme Court, that raises issues relating to taxpayer rights under the Internal Revenue Code.

The National Taxpayer Advocate's authority to appear as amicus curiae would be invoked only in those rare instances in which all informal attempts to persuade the United States to consider the merits of the Advocate's position had failed. The National Taxpayer Advocate's authority to intervene as amicus curiae would extend only to cases involving issues of tax administration and taxpayer rights. Further, the intervention as amicus curiae would be reserved to those instances in which the particular issue at hand was of such significance that the use of this extraordinary step is justified. Finally, it would only be considered after administrative intervention or legislative proposals were rejected as not viable alternatives.

It is not necessary that the National Taxpayer Advocate intervene as a friend of the court in litigation before the United States Supreme Court. Intervention through amicus briefs in lower courts is sufficient to place the National Taxpayer Advocate's concerns regarding taxpayer rights and taxpayer administration on the record for consideration by the original and intermediate tribunals. This limitation may address possible concerns that the Executive branch should speak with one voice before the Supreme Court.

### Taxpayer Advocate Directive

The National Taxpayer Advocate recommends that IRC § 7811 be amended to provide the National Taxpayer Advocate with the non-delegable authority to issue a Taxpayer Advocate Directive to the Internal Revenue Service with respect to any program, proposed program, action, or failure to act that may create a significant hardship for a taxpayer segment or taxpayers at large.

In the Taxpayer Bill of Rights 1 enacted in 1988, Congress provided authority for the Taxpayer Ombudsman to issue Taxpayer Assistance Orders.[156] Congress later expanded and modified the provisions regarding Taxpayer Assistance Orders in 1996 and 1998.[157] The Taxpayer Advocate Directive incorporates and applies the approach inherent in the expanded Taxpayer Assistance Order to groups of taxpayers or programs. It enables the National Taxpayer Advocate to provide relief on a systemic scale.

As discussed above, the National Taxpayer Advocate currently has the non-delegable authority to issue a Taxpayer Advocate Directive under Delegation Order 250, but this authority can be revoked or modified at any time by the Commissioner. The National Taxpayer Advocate may issue a TAD only where its implementation will improve the operation of a functional process or will grant relief to a group of taxpayers (or all taxpayers).

A TAD is authorized where its implementation will protect the rights of taxpayers, prevent undue burden, ensure equitable treatment, or provide an essential service to taxpayers.[158] Under the proposal, a TAD would be authorized where a program creates a significant hardship for a group of taxpayers or all taxpayers. As discussed in the following recommendation, the National Taxpayer Advocate recommends that the definition of significant hardship be expanded to include impairment of taxpayer rights.

In codifying the Taxpayer Advocate Directive, Congress should consider the terms of a TAD and by whom a TAD can be rescinded or modified. As with the Taxpayer Assistance Order, only the National Taxpayer Advocate or the Commissioner or Deputy Commissioner should be able to rescind or modify a Taxpayer Advocate Directive, and he or she should be required to provide a written explanation of the reasons for modification or rescission. Further, the National Taxpayer Advocate should be required to report on any TADs issued, and the response thereto, in the Annual Report to Congress due on December 31st of each year.

### Definition of Significant Hardship

The National Taxpayer Advocate recommends that IRC § 7811 be amended to include "impairment of taxpayer rights" as a definition of "significant hardship" for purposes of issuing a Taxpayer Assistance Order or Taxpayer Advocate Directive.

The existence of a "significant hardship" provides both access to the Taxpayer Advocate Service and a basis upon which relief, including a Taxpayer Assistance Order, can be granted. The current definition of significant hardship does not explicitly state that such access or relief can be granted where a taxpayer's rights have been violated. Historically, the criteria under the existing statute have been narrowly interpreted.

156 Pub. L. No. 100-647, § 6230(a) (1988).

157 Pub. L. No. 104-168, § 101 (1996); Pub. L. No. 105-206 § 1102 (1988).

158 Del. Order Number 250 (Rev. 1) IRM 1.2.2.151 (Jan. 17, 2001).

The term "taxpayer rights" is broad and amorphous. This proposal contemplates that the term will be defined, in the context of a Taxpayer Assistance Order or Taxpayer Advocate Directive, to include those rights enunciated in Delegation Order 250. Specifically, taxpayer rights would include due process, prevention of undue burden, equitable treatment, and the provision of essential service to taxpayers.

**Confidentiality of Taxpayer Communications with the Taxpayer Advocate Service**

The National Taxpayer Advocate recommends that IRC § 7803(c)(4)(A)(iv) be amended to clarify that, notwithstanding any other provision of the Internal Revenue Code, Local Taxpayer Advocates may have the discretion to withhold from the Internal Revenue Service the fact that a taxpayer contacted the Taxpayer Advocate Service (TAS) or any information provided by a taxpayer to TAS.

Further, the National Taxpayer Advocate recommends that IRC § 7803(c)(4)(A) be amended to provide that in litigation before a federal court, Local Taxpayer Advocates shall not through discovery or compulsory process be required to disclose the fact that the taxpayer contacted the Taxpayer Advocate Service or any information provided by the taxpayer to TAS, unless the court determines that such testimony or disclosure is necessary to:

(a) prevent a manifest injustice;

(b) help establish a violation of law; or

(c) prevent harm to the public health or safety,

of sufficient magnitude in the particular case to outweigh the integrity of the Taxpayer Advocate Service in general by reducing the confidence of taxpayers in future cases that their communications will remain confidential.

Confidentiality of taxpayer communications is essential to the Taxpayer Advocate Service's effective advocacy on behalf of taxpayers. Publicized instances of TAS sharing taxpayer-provided information with the IRS or in the courts may result in a loss of taxpayer trust in the integrity of the Taxpayer Advocate Service. These proposals will strengthen the ability of the Taxpayer Advocate Service to fulfill its mission of assisting taxpayers in resolving their problems with the IRS.

The proposals acknowledge that TAS is a part of the IRS organization. Thus, the decision by the Local Taxpayer Advocate to withhold taxpayer-provided information from other parts of the IRS is discretionary. The Taxpayer Advocate Service has as much interest as the rest of the IRS in ensuring that its programs are not abused to perpetrate a fraud or otherwise cheat the tax system. To this end, with the advice of the Office of Chief Counsel, and outside counsel the National Taxpayer Advocate has provided policies and procedures that set forth clear disclosure requirements in appropriate cases.

The scope of the current provision has been the subject of debate within the Internal Revenue Service and the Office of Chief Counsel. While this particular debate has been resolved, to prevent future disagreements about the scope of IRC § 7803(c)(4)(A)(iv) and its relationship to other provisions in the Code, the National Taxpayer Advocate recommends that the section be amended to provide clearly that its provisions operate notwithstanding any other Code requirement.

While IRC § 7803(c)(4)(A)(iv) provides for the confidentiality of taxpayer-provided information from the IRS, there is no provision addressing the confidentiality of information provided by a taxpayer to the Taxpayer Advocate Service where a case ends up in court. The independence and integrity of the Taxpayer Advocate Service would be significantly eroded if a TAS employee were required to disclose taxpayer confidences through discovery or compulsory process without the court weighing the impact of such disclosure.

Internal Revenue Code section 6103 generally provides for the confidentiality of returns and return information. The restrictions imposed by IRC § 6103 are applicable to the Taxpayer Advocate Service. Thus, taxpayer returns and return information are generally protected from disclosure by TAS to third parties.

There are many exceptions under IRC § 6103.[159] This proposal does not impact the exceptions under IRC § 6103, except in the context of litigation in federal courts. To the extent that IRC § 6103 would allow the disclosure of information in litigation or preparation for litigation, those provisions of IRC § 6103 would no longer apply. All other sections of the statute continue to be applicable.

In sum, the effect of the two proposals is as follows: Where a taxpayer has provided TAS with information that the Local Taxpayer Advocate, in his or her discretion, has appropriately determined should not be disclosed to the IRS, that decision will stand. If an exception to the disclosure rules of IRC § 6103 applies to that information, the information will be disclosed in accordance with the provisions of the exception. In a judicial proceeding, an employee of the Taxpayer Advocate Service cannot be required to disclose such information through discovery or compulsory process unless the court has made a determination that the need for that information outweighs the chilling effect that disclosure in a court proceeding will have on the likelihood that taxpayers will seek help from TAS in the future.

[159] *See, e.g.,* IRC § 6103(i) (Disclosure to Federal Officers or Employees for Administration of Federal Laws Not Relating to Tax Administration).

This procedure is not designed to prevent the sharing of information with federal agencies, including the Department of Justice, as provided by IRC § 6103. The concern here is with the chilling effect on taxpayers' willingness to use TAS in the future if they see an employee of the Taxpayer Advocate Service take the witness stand against a taxpayer in a judicial proceeding. In these instances, we believe that the court should weigh the impact of the testimony on TAS's ability to perform its mission in the future against the need for that testimony.

Taken together, all of the foregoing recommendations will strengthen the independence of the Office of the Taxpayer Advocate and the ability of the National Taxpayer Advocate to protect taxpayer rights and taxpayer confidences both within the Internal Revenue Service and in the federal courts.

## 5 REGULATION OF FEDERAL TAX RETURN PREPARERS

### PROBLEM

For many taxpayers, the tax filing season generates anxiety and frustration as they set out to fulfill their tax obligations. They are faced with a complex set of tax laws and a multitude of requirements for deductions, exemptions, and credits. Frequent tax law changes compound their confusion and concern.

Taxpayers who understand the tax laws may feel secure enough in this knowledge to complete their own income tax returns. The rest of the taxpaying public – over fifty percent – pay a tax return preparer to complete their income tax returns. Many tax preparers are not required to meet minimum standards of competency. Taxpayers are ill-equipped to assess the competency of someone's expertise in an area in which they have limited knowledge themselves.

Taxpayers must be confident that federal tax preparers meet basic standards of expertise and competence, and that these standards are maintained over time. Taxpayers would be better served, and compliance would likely be improved, if tax preparers were required to meet minimum standards of competency.

Currently there are no national standards that a person is required to satisfy before presenting him- or herself as a federal tax preparer and selling tax preparation services to the public. Anyone, regardless of his or her training, experience, skill or knowledge, is able to prepare federal tax returns for others for a fee.

### EXAMPLES

Taxpayers can be harmed in a number of ways by tax preparers who lack basic standards of expertise and competence or don't maintain these standards over time.

- A married couple with two children paid a tax preparer to prepare their income tax return. The tax preparer informed the couple that since each spouse worked and contributed toward household expenses, it was appropriate to file two tax returns with each claiming head of household status, each claiming one child, and each receiving the earned income tax credit. The adjustments made to the taxpayers' accounts in subsequent examinations resulted in a bill in excess of $4,000, which the taxpayers have no means to pay.
- An immigrant laborer with a wife and child is uncertain about how to comply with the tax obligations of a new country and a new state. He relies on a tax preparer

referred to him by other immigrants in their growing community. They are elated when their tax preparer informs them of a refund in excess of $1,000. Two years later, over 700 laborers in this community, including this taxpayer, received multiple year tax bills because the same tax preparer routinely made errors in filing status, exemptions, and earned income tax credits.

- A single taxpayer relied on the advice of a tax preparer to determine his tax home for employee business expenses. The tax preparer relied on an outdated provision of the tax home rules in effect over 15 years ago when preparing four consecutive years of income tax returns. The taxpayer arranged for an installment agreement to pay the tax bill that exceeded $40,000.

### RECOMMENDATION

The National Taxpayer Advocate recommends that Congress enact a registration, examination, certification, and enforcement program for Federal Tax Return Preparers. This program should consist of the following components:

- A Federal Tax Return Preparer ("FTRP") is someone, other than an attorney, certified public accountant, or enrolled agent, who prepares more than five (5) federal tax returns in a calendar year and satisfies the registration, examination, and certification requirements described below.
- A requirement that all persons who prepare more than five (5) federal tax returns for a fee must register with the Internal Revenue Service. The IRS would be authorized to impose a per return penalty for failure to register, absent reasonable cause for the failure.
- A requirement that the IRS develop a series of examinations designed to test the technical knowledge and competency of unenrolled return preparers to prepare federal tax returns. The IRS should develop at least four examinations: an examination testing knowledge of individual income tax return preparation, including the Earned Income Tax Credit and simple Sole Proprietorship schedule preparation; an examination testing knowledge of business income tax return preparation, including more complex Sole Proprietorship schedule preparation and employment taxes; and an annual refresher and update examination in individual and one in business tax preparation.
- A requirement that all persons who prepare more than five (5) federal tax returns for a fee must pass, in their first year of preparing such returns, an initial examination testing their technical knowledge and competency to prepare individual and/or business tax returns. Each such preparer must also pass an annual refresher

examination (including tax law updates) in each succeeding year in which the preparer prepares returns. The IRS would be authorized to impose a per return penalty on unenrolled preparers who fail to take or pass the examination, absent reasonable cause.

- A requirement that the IRS annually certify as Federal Tax Return Preparers those unenrolled paid preparers who have successfully passed the required examinations and are authorized to prepare federal tax returns for a fee.
- Authorization for 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 (1) sign the return prepared for a fee; and (2) display their Federal Tax Return Preparer registration card, which demonstrates current skill and competency in federal tax return preparation (either individual or business).
- Authorization for the IRS to maintain a public list (in print and electronic media, including internet-based) of Federal Tax Return Preparers who are registered and certified, of Federal Return Preparers who are registered but not certified, and of Federal Tax Return Preparers whose registration has been revoked.
- Authorization for the IRS to notify any taxpayer about the fact that his or her return was prepared by an unenrolled return preparer who is not registered or by a Federal Tax Return Preparer who is registered but not certified.

## PRESENT LAW

Today, taxpayers pay a third party to prepare their individual income tax returns more often than they prepare their own returns. Of these paid preparers, only attorneys, certified public accountants, and enrolled agents are subject to some form of regulation or oversight by the Internal Revenue Service or state licensing agencies. Unlike attorneys, certified public accountants, and enrolled agents (collectively known as "practitioners" because they are able to "practice" before the IRS), unenrolled return preparers are not required to demonstrate a minimum competency in the field of tax law, nor must they satisfy any continuing education requirements in order to prepare federal tax returns.

### Practice before the Internal Revenue Service

Treasury Department Circular 230[160] describes who may practice before the IRS, establishes minimum standards for that practice, and sets forth a hierarchy of discipline for those who violate those standards.[161] The IRS Office of Professional Responsibility conducts disciplinary proceedings of practitioners authorized to practice before the IRS and makes recommendations for discipline, where warranted. Attorneys, certified public accountants, and enrolled agents who have violated one of the practice rules may be subject to censure, suspension, or disbarment.[162]



As noted above, three types of practitioners are authorized to practice before the IRS. Each of these categories of preparers is subject to stringent requirements, including examinations, continuing professional education, and ethics.

- **Attorneys** are subject to state licensing requirements and discipline. Prior to admission to a state bar to practice law, attorneys generally must complete a 3-year, post-graduate degree program in law and pass an initial examination (in most jurisdictions, this examination takes place over 2 days, and consists of a multi-state part and a part focusing on the local law of the testing jurisdiction). In 42 out of 51 jurisdictions (including the District of Columbia), attorneys must satisfy a minimum annual continuing education requirement, which often includes training in legal ethics.

[160] 31 CFR part 10.

[161] Circular 230 defines "practice" before the IRS as comprehending

> all matters connected with a presentation to the Internal Revenue Service or any of its officers or employees relating to a client's rights, privileges, or liabilities under laws or regulations administered by the Internal Revenue Service. Such presentations include preparing and filing necessary documents, corresponding and communicating with the Internal Revenue Service, and representing a client at conferences, hearings, and meetings.

Circular 230, § 10.2.

[162] Circular 230, § 10.50(a), Sanctions. "Censure" is a public reprimand. This sanction was introduced in the recently issued final regulations. 67 F.R. 48760, amending CFR part 10.

- **Certified Public Accountants (CPAs)** are also subject to state licensing and regulation. CPAs must generally complete a defined course of study as well as work under the supervision of another CPA for a specified period of time. The CPA must successfully complete a multi-part examination testing his or her knowledge of a wide array of accounting topics, including tax law. CPAs in 50 out of 51 jurisdictions (including the District of Columbia) must satisfy a minimum annual continuing education requirement, which often includes training in tax law and procedure.
- **Enrolled Agents (EAs)** are persons who have successfully passed an IRS examination testing the applicant's knowledge of tax law and procedure and practice before the IRS.[163] Enrolled Agents generally must complete 72 hours of continuing professional education during each 3 year enrollment cycle.[164]

### Tax Return Preparers

Internal Revenue Code section 7701(a)(36) defines an income tax return preparer as any person who prepares for compensation, or who employs one or more persons to prepare for compensation, a tax return. This definition also includes any person who furnishes the taxpayer with sufficient information and advice so that the completion of a return is largely a mechanical or clerical matter.

Present law does not address skill, knowledge of tax rules, regulation, training or other basics that would define a minimum standard of competence for tax preparers. In fact, Treasury regulation 31 CFR section 301.7701-15(a)(3) states that "a person may be an income tax return preparer without regard to educational qualifications and professional status requirements."

### Preparer Due Diligence Requirements and Penalties

Internal Revenue Code section 6694 imposes several penalties on income tax return preparers who understate a taxpayer's tax liability. Where a preparer has taken a position on a return or refund claim for which he or she knew or should have known that there was "not a realistic possibility of being sustained on its merits," that preparer shall be subject to a $250 penalty, absent a showing of reasonable cause for the understatement.[165] A preparer will be subject to a $1,000 penalty if the understatement is attributable to the preparer's willful attempt to understate the tax liability or is due to the preparer's reckless or intentional disregard of rules or regulations.[166]

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[163] If the Director of Practice approves, a former IRS employee may become an enrolled agent, possibly subject to limitations on the type of representation he or she can undertake on behalf of taxpayers. Treas. Reg. 31 CFR 10 § 10.4(b) (2002).

[164] IRS Publication, *Practice before the IRS and Power of Attorney*, (Rev. April 2002), p. 5.

[165] IRC § 6694(a).

[166] IRC § 6694(b). The IRS rarely assesses this penalty. Office of Professional Responsibility (August 2002).

Tax return preparers must meet certain statutory requirements for each income tax return, including:

- Providing the taxpayer with a copy of the tax return;[167]
- Signing the tax return which he or she prepares;[168]
- Providing an identifying number on the tax return which he or she prepares;[169] and
- Maintaining and preserving a copy or list of all such returns for 3 years after the close of the return period.[170]

In addition to the above requirements and associated penalties, a preparer who "endorses or otherwise negotiates" a federal tax refund check payable to another taxpayer shall pay a $500 penalty for each check, unless the preparer is depositing the check into the taxpayer's account for the taxpayer's benefit.[171]

Preparers are also subject to criminal sanctions, including:

- The willful attempt to evade or defeat tax;[172]
- The willful making of false statements under penalties of perjury;[173] and
- The willful aiding, assisting, counseling, or advising in the preparation of any document in connection with the Internal Revenue laws that is false or fraudulent with respect to a material matter.[174]



[167] IRC § 6695(a); the preparer is subject to a $50 penalty for each failure, subject to a reasonable cause exception, and an annual maximum penalty of $25,000. *See also* IRC § 6107(a).

[168] IRC § 6695(b); the preparer is subject to a $50 penalty for each failure, subject to a reasonable cause exception, and an annual maximum penalty of $25,000.

[169] IRC § 6695(c); the preparer is subject to a $50 penalty for each failure, subject to a reasonable cause exception, and an annual maximum penalty of $25,000. *See also* IRC § 6109(a)(4).

[170] IRC § 6695(d); the preparer is subject to a $50 penalty for each failure, subject to a reasonable cause exception, and an annual maximum penalty of $25,000. *See also* IRC § 6107(b).

[171] IRC § 6695(f). The penalties under IRC §§ 6694 and 6695 are applicable in addition to any other penalties applicable to the situation. These penalties are assessed without regard to the deficiency procedures under IRC § 6212.

[172] IRC § 7201.

[173] IRC § 7206(1).

[174] IRC § 7206(2). In 1996, the IRS Criminal Investigation Division launched the Return Preparer Program (RPP). "The program was developed to enhance compliance in the return-preparer community by engaging in enforcement actions and/or asserting appropriate civil remedies against unscrupulous or incompetent return preparers." http://treas.gov/irs/ci/tax_fraud/docreturnpreparer.htm. Criminal Investigation reports that for the four fiscal years from October 1, 1998 through September 30, 2001, the Return Preparer Program resulted in 468 investigations, 303 prosecution recommendations, 291 indictments or informations, 283 convictions, and an incarceration rate of 92.9 percent.

A preparer who knowingly or recklessly discloses any information provided to him in connection with the preparation of a return, or who uses that information for any non-preparation related purpose, shall be guilty of a misdemeanor.[175]

Under Internal Revenue Code section 7407(a), the IRS has the authority to bring a civil action in the appropriate federal district court to seek an injunction to prohibit certain specified actions of income tax return preparers. Preparers who engage in practices that would subject the preparer to penalties under IRC §§ 6694 and 6695, who misrepresent their education or experience as an income tax preparer or their eligibility to practice before the IRS, who engage in fraud or deceptive conduct, or who guarantee the payment of a tax refund or the allowance of a tax credit may be enjoined from engaging in such practices under IRC § 7407(b). Where the court determines that a preparer has continuously or repeatedly engaged in one of the above specified practices, the court may also enjoin the preparer from acting as an income tax return preparer. IRC § 7407(b).

### State Law Regulation of Tax Return Preparers

Both California and Oregon regulate persons who prepare federal and state tax returns. In California, the regulatory program is administered by the California Tax Education Council (CTEC).[176] A tax preparer is required to post a $5,000 bond, complete an initial requirement of 60 hours of basic individual tax law education within the previous 18 months, and a continuing education requirement of 20 hours per year, including 12 hours of federal taxation.[177] The Council's website permits taxpayers to enter a preparer's name to determine the preparer's registration status – i.e., registered, delinquent, or expired registration.

The California Tax Preparers Act[178] imposes certain duties upon tax preparers, including the obligation to *not* ask the taxpayer to sign a tax return which contains blank spaces that will be completed after it is signed.[179] County superior courts may enjoin tax preparers who are in violation of the Act from various conduct, including preparing taxes.[180] A violation of the Act is punishable by a civil penalty of $1,000 and/or up to one year imprisonment.[181] Further, any person can bring a civil action against a return preparer

[175] IRC § 7216(a). The preparer may be subject to a fine of up to $1,000 and/or up to 1 year imprisonment. The preparer who discloses such information in response to a court order or as required by some other Code provision is not subject to criminal sanctions. IRC § 7216(b)(1).

[176] The California Tax Education Council (CTEC), a public and private entity, began its official duties on July 1, 1997. It assumed the responsibility for the Tax Preparer Program, formerly administered by the California Department of Consumer Affairs.

[177] Tax Preparers Act, Chapter 14, California Business and Professions Code, § 22255.

[178] The Tax Preparers Act, originally passed in 1997, was reauthorized, effective January 1, 2002, and will be reviewed before its expiration on July 1, 2008.

[179] Col. Bus. & Prof. Code § 22253(b).

[180] Col. Bus. & Prof. Code § 22256(a).

[181] Col. Bus. & Prof. Code § 22256(b).

who has violated the Act. A successful plaintiff can recover specific enforcement and/or a penalty of $1,000, in addition to reasonable attorneys' fees and costs.[182]

The Act defines a tax return preparer as a person who assists or prepares tax returns (both federal and state) for another for a fee, or who assumes final responsibility for such work, or who holds himself or herself out as offering those services.[183] Tax return preparers can be a business entity, including a corporation.[184] Various persons are exempt from the Act's requirements, including accountants licensed by the California State Board of Accountancy, members of the State Bar of California, and enrolled agents.[185]

Upon satisfactory completion of the education and registration requirements, the preparer receives a certificate of completion, an identification card, and a window sticker identifying the preparer as a tax return preparer certified by CTEC. Each CTEC Registered Tax Preparer is assigned a unique registration number.



The Oregon State Board of Tax Practitioners regulates any person who prepares personal income tax returns for a fee or who holds himself or herself out as doing so.[186] Only CPAs, public accountants licensed by the Oregon Board of Accountancy, and members of the Oregon State Bar are exempt from the licensing requirement. Enrolled agents must be licensed if they are preparing, assisting, or advising in the preparation of individual income tax returns.

Oregon provides two types of licenses – the Tax Preparer and the Tax Consultant. A Tax Preparer must work under the supervision of a licensed Tax Consultant, a CPA, a public accountant, or an attorney. The Tax Preparer must be 18 years of age, be a high school graduate or have completed the GED, complete 80 hours of basic income tax law education, and pass the Board administered Tax Preparer Examination.

Upon completing 780 hours of tax preparation work in two of the last five years, a Tax Preparer can take the Tax Consultant exam. The Tax Consultant can prepare personal income tax returns in Oregon for a fee as a self-employed or independent practitioner.[187] Both Tax Preparers and Tax Consultants must annually provide the Board with evidence of 30 hours of continuing education in tax law.[188]

The Oregon Tax Preparer's examination tracks the federal Form 1040 line-by-line, with Oregon adjustments. The Tax Consultant exam covers additional issues, including net

182 Col. Bus. & Prof. Code § 22257(a) and (b).

183 Col. Bus. & Prof. Code § 22251(a)(1)(A).

184 Col. Bus. & Prof. Code § 22251(a)(1)(B).

185 Col. Bus. & Prof. Code § 22258(a),(b),(e).

186 See OR. Admin. R. 800-25-0020.

187 An enrolled agent can become a Tax Consultant by passing the portion of the Tax Consultant exam applicable to Oregon tax law. OR. Admin. R. 800-020-0015, (5) (2002).

188 OR. Admin. R. 800-015-010 (1) (2002).

operating losses, Investment Tax Credit recapture, passive activities and rentals, and business income and deductions.

Violations of the Board's requirements are punishable by fines up to $5,000 for each violation. The Board may consider each business day a person continues in violation following notification by the Board to be a separate violation.[189] Failure to respond to a Board's request for information is subject to a $1,000 penalty.

The State of North Carolina recently increased the penalties for paid tax preparers who file a fraudulent return. The new law provides that a preparer who files returns that avoid $100,000 or more in taxes will be subject to a maximum sentence of 210 months, an increase from the prior law's maximum term of 24 months.[190]

### REASONS FOR CHANGE

The tax return represents a taxpayer's entry point into the federal tax system. Errors on returns, however inadvertent and unintentional, can have serious consequences for taxpayers, in terms of money owed, time spent resolving the problem, and related adjustments in future years.

The tax return preparer plays a pivotal role in the tax administration system. Currently, about 54 percent of all individual taxpayers who file tax returns are paying a tax preparer to determine their tax obligation.[191]

The Federal Return Preparer is an important gatekeeper for the federal tax system. The preparer explains the taxpayer's responsibilities (filing, recordkeeping) as well as the taxpayer's rights. The preparer also advises his or her client, by identifying issues where guidance is unclear, and assessing the risks associated with a possible reporting position.

The tax system is increasingly viewed as an efficient vehicle to deliver social benefits to targeted populations – including those who are unlikely to be well-versed in the complexities of the tax law.[192] Each year, Congress enacts laws and the IRS develops procedures that hinge on specific documentation requirements. A well-educated and professional return preparer can prevent inadvertent errors that undermine the vitality of these programs and consume IRS compliance resources to a disproportionate degree.

Despite the due diligence requirements and penalty regime described above, stories abound in the press and in the tax practitioner and professional community about

[189] OR. Admin. R. 800-030-0025 (1) (2002).

[190] 2002 NC Sess. Laws 106 (Sept. 2002). See Daily Tax Report, No. 168, August 29, 2002, p. H-1.

[191] There were 130.1 million individual income tax returns filed in tax year 2000. Of those, 70,726,315 million or 54.3% were submitted by a tax preparer. Statistics of Income, Spring Bulletin, 2002. This number reflects preparers who sign the returns; anecdotal evidence suggests the number is much larger, since some paid preparers do not sign the returns.

[192] The Earned Income Tax Credit is only one example of such social policy delivered through the Internal Revenue Code. See, for example, the HOPE and Lifetime Learning Credits, Dependent Care Credit, Low Income Housing Credit.

unqualified or unscrupulous preparers. From used car dealers filing taxes so taxpayers can use their refunds as down payments toward automobiles, to preparers in check-cashing storefronts charging pay-day loan rates for refund loans and disappearing without a trace after April 15th, to preparers in migrant or immigrant communities getting a percentage fee of any (incorrect) refund – each of these preparation outlets provide a product, at a high cost to taxpayers who do not always have strong bargaining positions or additional preparation options. The high profit margin on tax return-related products, including refund anticipation loans, attracts legitimate and illegitimate preparers alike. To date, the IRS has not launched an effective enforcement initiative against the illegitimate preparers.

In recent years, most efforts at regulating return preparers have focused on and around the Service's need to achieve a satisfactory level of electronic return filing. Although the Taxpayer Advocate Service are fully cognizant of the critical importance electronic filing plays in the future of the U.S. tax system, the qualifications of return preparers should be addressed as a discrete issue, independent of the need to achieve near-universal electronic filing.

Taxpayers choose a tax preparer because they don't understand the requirements of the tax law well enough to prepare the tax return themselves. Focus group respondents indicate that taxpayers are motivated to use tax preparers for several reasons, including: fear, tax law complexity, changing life situations (birth, marriage, retirement, etc.), overall time and effort requirements, and to obtain rapid refunds.[193]

A 2001 IRS study identified approximately 85,000 commercial firms listed on the Dun & Bradstreet database under three categories – tax preparation firms, accounting firms, and certified public accountants. IRS 1999 filing season data through July 3, 1999, showed 1.2 million paid tax return preparers.[194] Approximately 779,000 of these preparers filed between zero and 9 returns. These preparers far outnumber any other category of preparer. Because it is very unlikely that this category of preparer is employed full-time in tax preparation, it is also unlikely that these preparers are rigorously schooled in tax law.

There is no consistent data regarding the number and types of errors on returns, tracked by type of return preparer. We do know from a 1999 tax year Earned Income Tax Credit (EITC) sample that the more education and training in tax law, and the more oversight, a preparer has, the lower the overclaim rate on the returns these preparers file on behalf of clients. Thus, based on a sample of EITC returns, CPAs and attorneys had a 20.4 percent overclaim rate; enrolled agents and preparers who worked at H&R Block or Jackson Hewett had a 26.0 percent overclaim rate; and unenrolled preparers (other paid return

[193] May – June 2001 Focus Groups held in Tampa, FL and Indianapolis, IN by a research team comprised of representatives from Taxpayer Advocate Service, Tax Forms & Publications, Multimedia Publishing, and Research Group 3.

[194] This number does not include preparers who were paid but did not sign the tax return they prepared. Internal Revenue Service, Task 124: Market Research for e-file Options: Tax Preparer Research & Analysis of Available Data (March 2001).

preparers) had a 34.3 percent overclaim rate. Table 2.5.1 set out the 1999 EITC overclaim rates based on this sample by type of third party preparer.[195]

**TABLE 2.5.1**

| TYPE OF PREPARATION | PERCENT OF RETURNS | AVERAGE EITC CLAIM | AVERAGE EITC OVERCLAIM | OVERCLAIM RATE | MARGIN OF ERROR |
|---|---|---|---|---|---|
| CPA/Attorney | 5.0% | $1,279.22 | $260.45 | 20.4% | 8.43% |
| EA/HR/JH | 26.4% | $1,917.67 | $499.08 | 26.0% | 5.47% |
| Other Professional | 32.4% | $1,755.53 | $603.00 | 34.3% | 3.80% |

Analysis of data detailing complexity and accuracy factors reveals there are errors on returns signed by tax preparers as well as self prepared returns. Nearly 26 percent of the returns filed with math errors in 2000 (1999 tax year) were computed and signed by tax preparers.[196] Furthermore, for every type of Form 1040 filed in 2000 (TY99), a larger portion of taxpayers claiming EITC used paid preparers than those who did not claim EITC.[197] Since the EITC is targeted to low income taxpayers who frequently have limited literacy skills (both in terms of computers or language), this suggests that those who are least likely to possess the skills needed to determine the qualifications of a tax preparer, rely on preparers more than the general population.

The largest number of EITC over-claims is associated with taxpayers claiming a child who was not the taxpayer's qualifying child.[198] Recent reports of $8.5 to $9.9 billion of erroneous Earned Income Tax Credits paid in 1999[199] indicate that tax preparer errors contribute to this revenue loss.

Regulating tax preparers could significantly improve the accuracy of tax returns. As noted above, Oregon established a state-licensing program for tax preparers in the early 1970's. When comparing the numbers of returns that contain errors as a proportion of the total returns filed for the state of Oregon, there is compelling support for registering tax preparers. The error rate of returns filed from tax preparers in Oregon is from 30 to 60 percent lower than those states of similar size which do not require tax preparer licensing.[200]

Proposals to regulate federal return preparers have surfaced in different venues over the years.

[195] Internal Revenue Service, Compliance Estimates for Earned Income Tax Credit Claimed on 1999 Returns. (2/28/02). This data was derived from taxpayer answers to the examiners' question about how the return was prepared.

[196] More than 65% of taxpayers who claimed EITC used a paid preparer as compared with about 53% of those who did not claim EITC (but used a preparer). CRIS Model 2001 IMF TY99 data. (4/3/02).

[197] CRIS Model 2001 IMF TY99 data. (4/9/02).

[198] Internal Revenue Service, Compliance Estimates for Earned Income Tax Credit Claimed on 1999 Returns. (2/28/02).

[199] *Id.*

[200] CRIS Model 2001 IMF TY99 data. (3/22/02).

- In 1995, the Ethics in Business subgroup of the Commissioner's Advisory Group proposed a program to identify, regulate and improve the expertise and professionalism of all individuals engaged in the preparation of Federal tax returns for a fee. A final decision was not rendered.[201]
- In 1997 the National Commission on Restructuring the IRS recommended that "all paid preparers be subject to regulation under Circular 230." The Commission concluded, "Uniform requirements will increase professionalism, encourage continuing education, improve ethics and better enable the IRS to prevent unscrupulous tax preparers from operating."[202] Their recommendation was not adopted by Congress in the subsequently enacted IRS Restructuring and Reform Act of 1998.
- On April 30, 2001, Senator Bingaman introduced the Low Income Taxpayer Protection Act of 2001, which was referred to the Committee on Finance. The Bill provides for the regulation of income tax return preparers and refund anticipation loan providers. Regulations include registration, rules of conduct, and reasonable fees and interest rates charged to taxpayers made by refund anticipation loan providers. A penalty is provided for each incident of non-compliance.[203]



## EXPLANATION OF RECOMMENDATION

The National Taxpayer Advocate seeks to strengthen the professionalism of those who prepare tax returns for compensation through a registration framework that provides for testing, certification, continuing education, and consumer education. Tax preparers who become certified would be required to prominently display their proof of certification. Publicizing of this requirement would put taxpayers on notice of the simple fact that you should only pay someone to prepare your return if they are registered with and certified by the IRS. Taxpayers would be able to choose a tax preparer with confidence because they could easily determine which preparers are certified.

Individuals covered by this proposal provide a vital service to the public. This program is not intended to limit or reduce the number of available tax return preparers.[204] This program is intended to improve the expertise and professionalism of all individuals engaged in the preparation of federal tax returns for compensation. Improvements that increase the professionalism of the tax preparer community will also increase the confidence of the public they serve.

201 Minutes of the Commissioner's Advisory Group, January 18, 1995.

202 A Vision for the New IRS, National Commission on Restructuring the Internal Revenue Service, G.5 (June 25, 1997).

203 S. 182, Low Income Taxpayer Protection Act of 2001, 107th Cong. (2001).

204 Many unenrolled return preparers already satisfy the proposed continuing education requirements, through attendance at the annual Tax Forums and other tax courses offered by professional organizations.

*Registration and Certification*

The registration process would begin with an application and fee that would cover certain administrative costs of the program. Each applicant would be required to obtain certification based on the complexity of the returns the applicant wishes to prepare. The suggested tiers would be categorized by the complexity of returns:

- Tier 1 Individual returns including Forms 1040, 1040A, 1040EZ with schedules and deductions, EITC and other family-status credits, Schedule F (farm income), Schedule E (rental income), Schedule D (capital gains) and simple Schedule Cs (sole proprietorship income).
- Tier 2 everything in Tier 1 plus small business and S-Corp returns; Employment tax returns including 941, 940, 1099 and W-2.

Applicants would be required to pass a test with minimum standards for tax preparation before receiving certification. IRS would set the standards for the competencies that need to be tested in each tier and make the certification determination. The test administration could be contracted out and those contract fees covered by a test fee paid by the applicant. The successful applicant would be issued a certificate that contains a certification number, and expiration date. The certificate would be prominently displayed for public viewing. The tax preparer's certification number would be a required entry on each tax return. Taxpayers would see the certificate and know that the preparer they chose is certified to prepare their tax return.

*Education*

There are extensive educational opportunities for individuals who prepare tax returns. Attorneys, certified public accountants and enrolled agents must meet continuing professional education requirements to retain professional licensure. A similar continuing education requirement expectation is essential for each tax preparer registered in each tier. In addition, each time there is a significant tax law change, an annual update certification requirement would ensure the preparer's competence in that area of the tax laws. Refresher courses and test preparation courses readily available to tax professionals could be expanded to meet these needs. Tax Forums and CPE courses sponsored by trade associations, business and accounting schools, and other membership groups can be alternative sources of continuing education.

*Oversight and Fines*

Individuals who prepare and submit a tax return and fail to disclose their certification would be subject to a scale of progressive deterrents ranging from educational notices and warnings to fines. The taxpayer would also be notified if the preparer of his return did not fulfill the minimum requirements for certification within a specified probationary time-frame. These taxpayer communications would complement the deterrent actions by putting both parties on notice, and enable taxpayers to enforce the law by taking their business elsewhere.

A tax preparer who fails to provide his or her certification number would indicate:

- he may have the certification number and neglected to include it either by oversight or choice, or
- he may have let his certification expire or it was revoked, or
- he may never have had certification because he did not take or pass the test or were not aware of the requirement.

Further safeguards could be provided on the tax form so that taxpayers can indicate that they paid someone to prepare the tax returns that they are signing. The proposed fine for not complying should be significant for each incident of noncompliance and compounded when repeated.



*Consumer Education and Publicity*

Public knowledge and support of this program is key to its success. Because of this, IRS needs specific authority and funding to launch an extensive public awareness campaign. A marketing campaign that provides information about the registration process for tax preparers would provide taxpayers with the consumer information they need to make an informed decision. It would be a simple message, and would not require an assessment of the competence of a tax preparer by a taxpayer poorly equipped to do so. Taxpayers could go to the IRS website to check on the certification status of their intended return preparer.

The campaign message would be clear: look for the certificate before you consider paying anyone to prepare your tax return. Providing consumers with clear standards about what to look for (the certification) so that they could easily determine who is qualified to prepare tax returns would enable taxpayers to "vote with their feet."

### Impact Statement

It is difficult to estimate the total number of tax preparation professionals practicing in the United States that would be impacted by this recommendation because there are no national licensing or registration requirements. Using data gathered from public and commercial sources we estimate that there are between 700,000 and 1.2 million individuals[205] who prepare income tax returns. Based on the number of participants in the IRS Tax Professional Program for TY2001 (a program established to send tax materials to tax

[205] CRIS Model 2001 IMF TY 99 data. Internal Revenue Service Research Task 124.

preparers), individuals who did not designate themselves as an attorney, certified public accountant, or enrolled agent constitute nearly 50 percent of the participants.[206] Using 50 percent as a reasonable assumption, we estimate that between 300,000 and 600,000 tax preparers would be affected by this proposal.

Primary cost would be born by those who profit from the profession: the tax preparers. Like their more regulated counterparts, they would pay for their own continuing professional education, testing and certificate of competency fees. Taxpayers would know to look for certificates posted in the office reception areas, so that market pressures would encourage participation and compliance. However, IRS could not implement this program without additional resources, especially in the start-up phase.

Initial funding to establish the program is key to its success. This would include funding for developing certification standards, testing instruments, and licensing test administration organizations. Funding to bring tax preparers into compliance, especially through the transition period, is critical. IRS would need to advertise (through paid placements) the importance of looking for the certificate to the general public. Finally, a continued enforcement presence would be needed to ensure that there are consequences for those who set out to evade certification requirements and continue to prepare returns without meeting basic competency standards.

We acknowledge that this registration, education, and certification proposal may result in some tax return preparers dropping out of the system. It is also likely that some preparers will go “underground,” that is, they will no longer sign their name to the returns they prepare. The consumer education and public information campaign plays an important role in this regard. First, taxpayers will be alert and on notice that they should not pay for return preparation unless the preparer is certified. Second, with the advent of a certification program, an underground preparer cannot claim ignorance of the requirements. (We acknowledge that any certification system should build in a reasonable cause exception.) We believe that the benefits to the public of a registration system far outweigh the loss of these return preparers.

A licensing program – one with enough resources to provide real consequences for tax preparers who contribute to non-compliance, whether through ignorance or deliberate act – has the potential to achieve significant improvements in taxpayer compliance at a much lower cost than extending audit coverage to the affected population. While we believe that a stronger audit presence is also needed, the additional measure of licensing tax preparers would be a significant step forward in tax compliance.

[206] Tax Professional Program Database, Multimedia Publishing Division, Computer Assisted Publishing System. (4/2/02).

# 6 CHILDREN'S INCOME

## DID YOU KNOW?

- The special rules pertaining to tax on investment income of a child under age 14 (the "Kiddie Tax") do not apply if neither of the parents is alive at the end of the tax year.
- A child under 14 who is subject to the Kiddie Tax often must use the information on the return of the parent with the greater taxable income to compute the child's tax. If a child cannot obtain that information directly from the parent, the child (or the child's legal representative) must request the necessary information from the Internal Revenue Service (IRS).
- The Kiddie Tax rules even apply to a child who lives with someone other than a parent.
- If a parent makes an election to include a child's income on his or her tax return, the parent's investment income will be higher, which may allow the parent to claim a larger investment interest deduction under Internal Revenue Code section 163.
- A parent's election to include the income of a child on the parent's tax return can accelerate the phase-out of itemized deductions due to adjusted gross income (AGI) limitations. It can also decrease the parent's deduction for medical expenses, casualty and theft losses, and miscellaneous deductions due to phase-out limitations. However, a child's itemized deductions are not allowable on the parent's return.
- If a parent elects to include a child's income on his or her return, the parent's Earned Income Tax Credit, Child and Dependent Care Credit, and Child Tax Credit may be reduced.
- The election to report a child's income on the parent's income tax return can only be made if no estimated or withholding tax has been paid in the child's name.
- A child whose tax is computed on Form 8615 (Tax for Children Under Age 14 With Investment Income of More Than $1,500) may also owe Alternative Minimum Tax (AMT).
- If an adjustment is made to the tax return of either a child's parent or sibling after the returns have been filed, the child's return may also require adjustment.

### PROBLEM

Dependent children often receive gifts from relatives and friends that generate investment income. For example, a child may receive U.S. savings bonds, cash, or shares of stock at birth, upon religious milestones such as a Baptism, confirmation, or Bar Mitzvah, or through periodic gifts from a parent. Dependent children, even relatively young children, also may earn income for the performance of services such as babysitting.

The rules governing the taxation of the income of dependent children impose significant compliance burdens in two respects. First, any investment income of a child under the age of 14 that exceeds $1500 must be reported in accordance with the so-called "Kiddie Tax" rules set out in Internal Revenue Code section 1(g). The Kiddie Tax rules are complex. In part, these rules (1) require parents to decide whether to file a separate return in the child's name or to include the child's income on the parent's own return (the tax consequences often differ); (2) require the child of separated parents who are still considered married to obtain tax information from the parent who has the greater taxable income; (3) require the parent of multiple children under age 14 who each have investment income in excess of $1500 and who each file a separate return to perform a series of interrelated computations involving the tax return of the parent and each of the children to compute the tax liability of each child; and (4) subject a child and/or the parent in certain circumstances to the Alternative Minimum Tax (AMT). Each of these complexities arises because the child's tax liability is not independently determined but rather must be computed in conjunction with the applicable parent's tax return.

Second, a dependent child will be subject to tax if his or her income exceeds the applicable standard deduction.[207] The standard deduction for dependents is set at a low level (as low as $750 in 2002), which often requires children with nominal amounts of income to file tax returns. Further, the standard deduction for dependents with modest amounts of both earned income and investment income must be determined through a computation – it is not a specified amount.

Based on recent data, these complex rules affect approximately one million taxpayers annually.[208] There are two ways that the tax on a child's income can be reported and paid. In all cases, the child may file his or her own tax return and calculate the tax on Form 8615 (Tax for Children Under Age 14 With Investment Income of More Than $1,500). In

[207] For purposes of this discussion, we assume that a dependent child will claim a standard deduction. In the unusual case in which a child itemizes his or her deductions, the standard deduction rules discussed in this section do not apply. Moreover, because individuals who may be claimed as dependents on the return of another taxpayer (typically a parent) may not themselves claim a personal exemption, the standard deduction for a dependent child is the same as the amount of income that is exempt from tax (except where deductions are itemized).

[208] Statistics of Income Report No. 44591, *Statistics of Returns Posted in 2001* (based on data from the Individual Master File).

some cases, a parent may elect to include the child's income on the parent's return by filing Form 8814 (Parent's Election To Report Child's Interest and Dividends). For tax year 2000, 621,960 Forms 8615 were filed and 503,444 Forms 8814 were attached to a parent's tax return.[209]

### EXAMPLE

Mother and Father are separated, but they are considered married at the end of the tax year. They will file separate tax returns. They have three children, each with investment income in excess of $1,500 and no earned income. The children are currently living with Mother, but Father has the greater income.

To file their tax returns, the children must obtain Father's tax information because they must use his return to compute their tax liability on the portion of their income that exceeds $1,500. Father is reluctant to provide his financial information because he is concerned that his wife will use it against him in a divorce proceeding. If he refuses to provide the information, the children probably will be unable to file timely returns. Instead, they will have to file requests with the IRS to obtain the information, file their tax returns based on a reasonable estimate of their tax liability, and then file amended tax returns after they receive Father's tax information from the IRS.

If Father provides the information and wishes to minimize the family's combined tax liability, he must decide whether to allow his children to file their own returns or, alternatively, to make an election to include their income on his return. This can be a time-consuming decision because making the election to include their income on his return may increase or decrease the family's combined tax liability, and it is often necessary for a taxpayer to complete all forms under all alternatives to determine the most tax-efficient option.

Finally, the tax liabilities of Father and each child are interrelated. The income of each child must be computed. Then the "net unearned income" of each child must be added on the father's tax return to compute an "allocable parental tax." Finally, the "allocable parental tax" must be allocated to each child in proportion to the child's share of the aggregate net unearned income of all of the children. If the tax liability of Father or any child is later adjusted on an audit, the tax liability of the other children will also be adjusted and underpayment interest will be charged on any additional amounts due.



[209] *Id.*

### RECOMMENDATIONS

- Repeal the rules under Internal Revenue Code section 1(g) that govern the taxation of investment income of children under age 14 and thereby sever the link between the computation of the child's tax liability and the parent's tax return. Instead, tax such children on their investment income at either (a) the tax rates applicable to estates and trusts[210] or (b) the child's own income tax rate up to a specified threshold, with investment income above that threshold taxed at a higher tax rate.
- Amend Internal Revenue Code section 63(c) to make the standard deduction for dependent children equal to the standard deduction for a single taxpayer.[211] A dependent child with total income (earned or unearned) of more than this amount would be required to file a tax return.

[210] IRC § 1(e).

[211] In the event that Congress determines the revenue loss resulting from this proposal is excessive, we offer two alternative simplification proposals in the Explanation of Recommendations section below.

## PRESENT LAW

### Kiddie Tax

Internal Revenue Code section 1(g) and Temp. Treas. Reg. § 1.1(i)[212] provide special rules for the taxation of investment income of children under the age of 14 (the Kiddie Tax rules).[213] In general, the investment income of a child is subject to tax under a three-tiered system:[214]

- The first tier is the amount of the child's investment income that equals or falls below the child's minimum standard deduction as set forth in IRC § 63(c)(5)(A).[215] This amount is not subject to tax. The minimum standard deduction in 2002 is $750.
- The second tier is the greater of (1) the minimum standard deduction as set forth in IRC § 63(c)(5)(A) or (2) if the child itemizes deductions, the amount of deductions directly connected with the production of investment income.[216] This amount is subject to tax at the child's tax rate. For a child who does not itemize deductions, this amount in 2002 is $750. Thus, investment income between $751 and $1500 would be taxed at the child's tax rate.
- The third tier consists of all income that exceeds the second-tier amount and is referred to as "net unearned income."[217] Net unearned income is taxed at the top marginal tax rate of the applicable parent (or parents, in the case of a joint income tax return),[218] and the amount of tax computed under this third tier at the parent's rate is referred to as the "allocable parental tax".[219]

> *Example:* A child under the age of 14 has investment income of $3,000 in 2002. She has no earned income and does not itemize deductions. Her parents file a joint return and face a top marginal tax rate of 35 percent. The child's first $750 of income is not subject to tax. The child's next $750 of income is taxed at her marginal rate of 10 percent. The child's remaining $1,500 of income is "net unearned income" and is taxed at her parents' top marginal rate of 35 percent. Therefore, the child's tax liability will be $600 (*i.e.*, ($750 x 10%) + ($1,500 x 35%)).

The allocable parental tax is equal to the excess of (1) the amount of the parent's tax liability computed as if the parent's income included the net unearned income of all children of the parent to whom the Kiddie Tax rules apply over (2) the amount of the

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[212] The temporary regulations were issued prior to 1990, when the statutory rules appeared at IRC § 1(i). The temporary regulations have not been redesignated.

[213] The Kiddie Tax rules do not apply if both of the child's parents are deceased. IRC § 1(g)(2)(B). The Kiddie Tax rules apply to Social Security and pension benefits received by a child. Temp. Treas. Reg. § 1.1(i)-1T, Q&A 9.

[214] IRC § 1(g)(1) provides that the tax liability will be equal to the greater of the amount computed under the Kiddie Tax rules or the amount computed without regard to the Kiddie Tax rules. In the vast majority of cases, the amount computed under the Kiddie Tax rules will be greater.

[215] IRC § 1(g)(4)(A)(ii)(I).

[216] IRC § 1(g)(4)(A)(ii)(II).

[217] IRC § 1(g)(4).

[218] IRC § 1(g)(3)(A).

[219] IRC § 1(g)(3).

parent's tax liability computed without regard to the net unearned income of the children.[220] If a parent has multiple children to whom the Kiddie Tax rules apply, the allocable parental tax is computed by combining the net unearned income of all of the parent's children and then is allocated to each child in proportion to that child's share of the aggregate net unearned income of all such children of the parent.[221]

If the parents of a child are married and file joint income tax returns, the allocable parental tax is computed using the joint return. If the parents are considered married (even if separated) but file separate returns, the allocable parental tax is computed using the return of the parent with the greater taxable income.[222] If the parents are considered unmarried (including parents who were never married and parents who are divorced), the allocable parental tax is computed using the return of the custodial parent.[223] When a child cannot obtain the required information about his or her parent's tax return, the child (or the child's legal representative) can request the information from the IRS.[224] The request must contain the following: (1) a statement that the child is attempting to comply with the Kiddie Tax rules and has attempted unsuccessfully to obtain the information from the parent; (2) proof that the child is under 14 years of age; (3) evidence that the child has more than $1,500 of unearned income; and (4) the name, address, social security number (if known), and filing status (if known) of the parent. If the child's legal representative makes the request, a power of attorney must be included.[225] If the child cannot obtain the required parental information before the filing deadline, the child may file a timely return using reasonable estimates and then file an amended return after the parent's tax information is obtained.[226]

In general, a tax return must be filed in the name of a child who has a tax liability.[227] The return must include a Form 1040, Form 1040A, or Form 1040NR along with a Form 8615 (Tax for Children Under Age 14 With Investment Income of More Than $1,500). Form 8615 is an 18-line form that must be completed in conjunction with the return of the applicable parent so that tax on the portion of the child's income that constitutes net unearned income may be computed on the basis of the applicable parent's tax rate.

Under certain circumstances, a parent may make an election to include the child's income on the parent's return.[228] If this election is made, the parent must attach to his or her return a Form 8814 (Parents' Election To Report Child's Interest and Dividends), and the child is not required to file a separate return. The parental election may be made only

[220] IRC § 1(g)(3)(A).

[221] IRC § 1(g)(3)(B).

[222] IRC § 1(g)(5)(B).

[223] IRC § 1(g)(5(A).

[224] Temp. Treas. Reg. § 1.1(i)-1T, Q&A 22 (citing IRC § 6103(e)(1)(A)).

[225] *Id.; see* IRS Publication 929, *Tax Rules for Children and Dependents*, at 11 (2002).

[226] *Id.*

[227] IRC § 6012.

[228] IRC § 1(g)(7).

if (1) the child's gross income consists solely of interest and dividends, (2) the child's gross income is more than the amount of the minimum standard deduction but less than ten times the amount of the minimum standard deduction (*i.e.*, more than $750 and less than $7,500 in 2002), and (3) no amount has been withheld and no estimated tax payments have been made in the child's name.

A family's aggregate tax liability may differ depending on whether the parental election is made. If the child files a separate return, the child's net unearned income is added to the parent's income for purposes of computing the child's tax, but the parent files his or her return without including the child's income. By contrast, a parent who makes the election must report the child's income on his or her return, resulting in greater taxable income to the parent. The parental election can alter the family's combined tax liability. On the one hand, a parent making the election must treat the child's investment income as the parent's own investment income, which may allow the parent to claim a larger investment interest deduction pursuant to IRC § 163. On the other hand, the higher adjusted gross income reported by the parent increases the dollar threshold that must be exceeded to deduct miscellaneous itemized deductions under IRC § 67 and medical expenses under IRC § 213 and may cause the parent to lose additional tax benefits because of the phase-out of personal exemptions under IRC § 151(d) and the limitation on itemized deductions under IRC § 68.[229] In addition, any itemized deductions to which the child is otherwise entitled are forfeited if the parental election is made.[230]

The Kiddie Tax rules also affect the possible application of the alternative minimum tax (AMT). If a child under the age of 14 files his or her own return, the child's AMT exemption amount is limited to the child's earned income plus $5,350 in 2002.[231] By contrast, single filers are entitled to an exemption of $35,750 in 2002.[232] If the parental election is made, any interest which is an item of tax preference of the child under IRC § 57(a)(5) shall be treated as an item of tax preference of the parent instead, potentially exposing the parent to AMT liability or increasing the parent's AMT liability.[233] An AMT tax liability of a child is most likely to arise if the child receives tax-exempt interest from a private activity bond.

### Standard Deduction

The standard deduction of a dependent child varies depending on whether the child's income consists exclusively of earned income, exclusively of unearned income, or a combination of earned and unearned income. If the child's income consists exclusively of earned income, the standard deduction will eliminate any income tax liability of the child

[229] For a description of the effects of the parental election, see IRS Publication 929, *Tax Rules for Children and Dependents*, at 7-8 (2002).

[230] *See* IRC § 1(g)(7)(B).

[231] IRC § 59(j)(1).

[232] IRC § 55(d)(1)(B).

[233] IRC § 1(g)(7)(B)(iii).

to the extent that his or her adjusted gross income does not exceed $4,700 in 2002 (i.e., the amount of the standard deduction for single filers). If the child's income consists exclusively of unearned income, the standard deduction will eliminate any income tax liability of the child only to the extent that his or her adjusted gross income does not exceed $750 in 2002. If the child's income consists of a combination of earned and unearned income, the standard deduction in 2002 is the lesser of (1) $4,700 or (2) the greater of (a) $750 or (b) the child's earned income plus $250.[234]

## REASONS FOR CHANGE

### Kiddie Tax

The Kiddie Tax rules were enacted as part of the Tax Reform Act of 1986 to discourage parents from shifting income-producing assets to their children in order to take advantage of a child's tax rate.[235] Prior to the 1986 Act, there was no provision in the Code requiring that a portion of a child's income be taxed at the parent's tax rate if higher than the child's rate.

The Kiddie Tax rules are unnecessarily complex because of the interrelationship between the child's tax return and the parent's tax return. The National Taxpayer Advocate believes that the relationship between the returns of the child and parent should be severed. Consider the following:

- *Determination of Applicable Paren*t. If a child's parents are considered married but file separate tax returns, the tax liability of the child must be computed by using information from the return of the parent with the greater taxable income. If both parents have roughly equivalent sources of income, the applicable parent can be difficult to determine. This is especially true if the parents, although still considered married, are separated and going through a divorce proceeding. It is likely that each parent would try to avoid disclosing financial information to the other. If the parents are considered unmarried, the tax liability of the child must be computed by using information from the return of the custodial parent. In some cases, it may be difficult to determine which is the custodial parent.
- *Need to Obtain Applicable Parent's Tax Return Information*. Apart from determining which parent is the applicable parent for purposes of computing the child's tax liability, the tax return information of that parent must be obtained. In cases where a child's parents are divorced or separated, the child may have difficulty obtaining tax information from the applicable parent, particularly where the applicable parent is living apart from the child and where the applicable parent cannot practically provide tax information to the child without also providing the information to an estranged or former spouse. Although the law provides procedures for the

[234] The basic standard deduction is set forth in IRC § 63(c)(2). The limitation on the standard deduction for certain dependents is set forth in IRC § 63(c)(5). All amounts cited in this paragraph are indexed annually to account for the effects of inflation. IRC § 63(c)(4).

[235] *See* S. Rep. No. 99-313, at 862 (1986).

child to request the information directly from the IRS, the request takes time to prepare and the child very likely will be required to file a return on the basis of estimates and then to file an amended return after the tax information of the applicable parent is obtained. Tax considerations aside, it is also worth considering the desirability of requiring a parent to share tax information with an estranged or former spouse even where the parent is not required under any other provision of law to do so.

- *Determination Whether to Make Election to Include Child's Income on Parent's Return.* An election to include the child's income on the parent's return may result in the same combined tax liability, a lower combined tax liability, or a greater combined tax liability. To determine the best option, it is often necessary for a taxpayer to complete all forms under all options. The forms are complicated, and the task of completing all forms and comparing the results is time-consuming. To complicate matters further, a parent with multiple children may elect to include on his or her return the income of some children and not others.[236]
- *Additional Complexity in the Case of Multiple Children.* The allocable parental tax is computed by combining the net unearned income of all of the parent's children and then is allocated to each child in proportion to that child's share of the aggregate net unearned income of all of the children. Therefore, a family with multiple children must (1) compute the income of each child, (2) add the net unearned income amounts to the applicable parent's return to compute the allocable parental tax, and (3) allocate the allocable parental tax to each child in proportion to the child's share of the aggregate net unearned income of all of the children. Not only are these computations intricate, but if one member of the family is delayed in computing his or her taxable income, all other members of the family are precluded from filing an accurate tax return.
- *Ripple Effect of Subsequent Adjustments.* If a parent's taxable income is used to compute the taxable income of a child and the taxable income of the parent is later adjusted, the child's tax liability must be recomputed using the parent's taxable income as adjusted.[237] Moreover, if multiple children use the same parent's taxable income to compute their respective shares of the allocable parental tax and a subsequent adjustment is made to the net unearned income of any of the children, the allocable parental tax of all of the children must be recomputed to reflect the adjustment.[238] If the tax liability of a child is increased in either of these situations, his or her additional tax liability is treated as an underpayment of tax, and as such, interest is imposed at the underpayment rate as provided in IRC § 6601.[239]



236 *See* IRS Publication 929, *Tax Rules for Children and Dependents*, at 7 (2002).

237 Temp. Treas. Reg. § 1.1(i)-1T, Q&A 17.

238 Temp. Treas. Reg. § 1.1(i)-1T, Q&A 18.

239 Temp. Treas. Reg. § 1.1(i)-1T, Q&A 19.

All of the foregoing problems could be avoided if the child's tax liability were determined independently of the parent's tax liability.

### Standard Deduction

The standard deduction applicable to dependent children causes taxpayer compliance burdens for two reasons.[240] First, it subjects individuals with relatively small amounts of income to tax liability. A dependent child with as little investment income as $751 – or with earned income of $500 and investment income above $250 – is subject to tax.[241] Compared with other taxpayers, this is a very low threshold. For example, a non-dependent single filer will not owe tax in 2002 unless his or her income exceeds $7,700 (*i.e.*, the standard deduction of $4,700 plus a personal exemption of $3,000). A married couple without dependents will not owe tax in 2002 unless the couple's income exceeds $13,850 (*i.e.*, a standard deduction of $7,850 plus two personal exemptions of $3,000 each). A married couple with three children would not owe tax in 2002 unless its income exceeded $22,850 (*i.e.*, $13,850 plus three dependency exemptions of $3,000 each). By setting the bar for dependent children as low as $751, current law subjects hundreds of thousands of children with relatively small amounts of income to tax liability and to tax reporting obligations.[242] And because of the complex Kiddie tax rules, the parents of these children face onerous compliance burdens.

Second, the amount of the standard deduction for dependent children in many cases must be computed – it is not a specified amount. For the 2002 tax year, the standard deduction is set at $7,850 for married couples filing a joint return, at $3,925 for married couples filing separate returns, at $6,900 for head-of-household filers, and at $4,700 for single filers. By contrast, the standard deduction for a dependent child is the lesser of (1) $4,700 or (2) the greater of (a) $750 or (b) the child's earned income plus $250. Thus, the standard deduction for a child could be as low as $750, as high as $4,700, or any number in between. Requiring the parent or legal guardian of a child with both earned income and unearned income to compute the standard deduction each year adds an additional layer of complexity that is not imposed on any other category of taxpayers.

240 For simplicity, this discussion refers to the limited standard deduction described in IRC § 63(c)(5) as applying to dependent children. However, it should be noted that the provision applies to all individuals who may be claimed as dependents on the tax return of another taxpayer – not only to dependent children.

241 An individual who may be claimed as a dependent on the return of another taxpayer is not entitled to claim a personal exemption for himself or herself. Therefore, a dependent child has a tax liability if income exceeds the standard deduction without regard to exemptions (except if the child itemizes deductions).

242 One commentator observed that the combined effect of the provisions in the Tax Reform Act of 1986 limiting the standard deduction and eliminating the personal exemption with respect to dependents created "a significant increase in complexity." He added: "The amended rules meant that hundreds of thousands of children with only modest amounts of assets were now required to file tax forms. (To add to the complexity, some income was to be taxed at the child's rate and some at the parent's rate, while those with only moderate amounts of nontaxable wage income needed to file to report a few dollars of interest from a small checking or saving account.) There is little doubt that after 1986 a significant portion of children and their parents violated this section of the tax code, often without knowing it. Here then was a classic case of the political system simply giving too little weight to the issue of administration and simplification." C. Eugene Steuerle, *The Tax Decade: How Taxes Came to Dominate the Public Agenda* 158-159 (1992).

### EXPLANATION OF RECOMMENDATIONS

The National Taxpayer Advocate recommends that Congress repeal the Kiddie Tax rules under Internal Revenue Code section 1(g) in light of the complexity that results from the mandated interaction between the tax return of a parent and the tax returns of his or her children. If Congress remains concerned about the shifting of income-producing assets from parents to children, it should instead consider taxing children on their investment income at either (a) the tax rates applicable to estates and trusts[243] or (b) the child's own income tax rate up to a specified threshold, with investment income above that threshold taxed at a higher tax rate, perhaps the maximum rate applicable to individuals. This proposal would sever the link between a child's income and the top marginal tax rate of the child's parent, yet could be tailored to be revenue neutral.

The National Taxpayer Advocate further recommends that Internal Revenue Code section 63(c) be amended to make the standard deduction for dependent children equal to the standard deduction for single filers. Under current law, the standard deduction for dependent children is effectively equal to the standard deduction for single filers with respect to *earned* income but is as low as $750 with respect to *unearned* income. For 2002, the standard deduction for a single filer is $4,700. As discussed above, the current standard deduction creates compliance burdens for two reasons. First, the low minimum standard deduction amount of $750 imposes a filing requirement on many taxpayers with relatively small amounts of income. Second, the fact that the standard deduction amount may differ depending on whether the child has earned income or unearned income – and often must be computed when a child has both earned and unearned income – adds additional complexity. Setting the standard deduction for dependents at the same level as the standard deduction for single filers – and making no distinction between earned and unearned income – would eliminate both of these compliance burdens.



Although (1) exempting individuals with small amounts of income from the return-filing requirement and (2) eliminating the disparate treatment of earned and unearned income would further the goal of simplicity, Congress may determine that the revenue effects of this proposal are too high or that the incentive to shift income-producing assets to children would be too great. If so, two alternative approaches could be considered.

One alternative would be to increase the minimum standard deduction somewhat above $750. How much higher would reflect a policy judgment that balances the revenue effects of the increase in the minimum standard deduction against the number of children with low incomes who would be relieved of income tax obligations. The advantage of this approach is that it would remove individuals with low incomes from the tax rolls. The disadvantage is that the distinction between earned and unearned income would remain.

[243] IRC § 1(e).

A second alternative would be to eliminate the disparate treatment between earned and unearned income and to set the minimum standard deduction for dependents somewhere between its current minimum of $750 and the single filer amount of $4,700. The advantage of treating earned and unearned income equally is simplicity. The disadvantage of setting the standard deduction for earned income below $4,700 is that dependents whose income consists entirely of wages would face a tax increase and would be taxed more than other taxpayers with wage income. We have reservations about this alternative on equity grounds.

In sum, we strongly recommend that the Kiddie Tax rules be repealed to eliminate the myriad problems that arise from the link between the tax returns of child and parent. Any revenue loss could be made up by taxing children on their investment income at the trusts-and-estates tax rate or at a higher individual tax rate, perhaps the maximum individual rate. We further recommend that Congress consider making revisions to the standard deduction rules applicable to dependents to reduce the number of dependents with small amounts of income who must file tax returns and, if feasible, to eliminate the disparate treatment of earned and unearned income and the complex calculations and decisions arising from this distinction.

## CHANGE OF WITHHOLDING PROCEDURE UNDER INTERNAL REVENUE CODE SECTION 3402(I).

### PROBLEM

Under present law, taxpayers can increase (but not decrease) withholding by a specified dollar amount. The only mechanism to decrease withholding is to claim additional withholding allowances. Worksheets are needed to convert deductions and credits into withholding allowances. Most taxpayers who want less withholding can figure the amount without having to compute withholding allowances.

### EXAMPLE

A single taxpayer with no dependents expects to earn $35,000 in wages during 2002. By September of 2002 she has incurred and paid unexpected medical expenses of $5,000. She estimates that she will have itemized deductions of approximately $7,475, based on the portion of her medical expenses that exceeds 7.5 percent of her adjusted gross income (AGI), along with her mortgage interest, real estate taxes, and charitable contributions. Since the amount of itemized deductions is greater than the standard deduction for a single taxpayer ($4,700) she is entitled to itemize her deductions on Schedule A when she files her 2002 federal income tax return. As a result of itemizing her deductions, the taxpayer expects her tax liability to decrease by approximately $420.

The medical expenses have caused the taxpayer a financial hardship. She is paid twice a month, and will receive eight more paychecks before the end of the year. She would like to be able to decrease her federal income tax withholding (FITW) by $50 per pay period for the remainder of the year, and receive the financial benefit immediately. She spends almost two hours reviewing the relevant instructions and completing Form W-4. However, she finds that she is not entitled to claim an additional withholding allowance because her estimated itemized deductions do not exceed the standard deduction by at least $3,000.

### RECOMMENDATAION

Amend Internal Revenue Code section 3402(i)(1) to permit taxpayers to decrease the amount of withholding where the employee requests such changes.

Internal Revenue Code section 3402(i)(1) would read:

> "The Secretary may by regulations provide for increases or decreases in the amount of withholding otherwise required under this section in cases where the employee requests such changes."

RECOMMENDATIONS

LEGISLATIVE RECOMMENDATIONS

## COLLECTION DUE PROCESS

### PROBLEM

Taxpayers submitting a Collection Due Process (CDP) request from outside the United States do not have additional time to respond. The Internal Revenue Service often grants extra time for those outside the country to file other documents or respond to inquiries where important procedural rights are involved.[244] Taxpayers outside the U.S. experience an additional burden to gather pertinent documents and allow for the processing and delivery of foreign mail. This exhausts a significant portion of their 30-day CDP filing window, which can result in late filing and the loss of their ability to pursue judicial remedy.

### EXAMPLE

A taxpayer was mailed a CDP Notice of Determination on March 30, 2001. The notice was sent to an address in Israel. He did not receive the notice until April 24, 2001 because of intervening Jewish holidays (Passover and Holocaust Memorial Day) and slow rural mail delivery. He was also delayed in mailing his petition to the court due to Israeli Memorial Day and Israeli Independence Day. He mailed his petition on April 30, 2001, and the Court received it seven days late on May 7, 2001.[245]

### RECOMMENDATION

Amend Internal Revenue Code 6330(a)(3)(b) as necessary subsection (a)(2) to provide the taxpayer outside the United States an additional 30-day period to request a hearing in response to a COP notice.

Amend Internal Revenue Code section 6330(d) to allow an additional 30-day response period to taxpayers appealing a CDP determination from outside the United States.

[244] IRC § 6213(a) grants taxpayers an additional 60 days to respond to a Notice of Deficiency. IRM 5.7.6.3(2) grants taxpayers an additional 30 days to respond to a Proposed Trust Fund Recovery Penalty Assessment Letter. Treas. Reg. 1.6081-5 grants U.S. citizens or residents either living or in military service outside the U.S. or Puerto Rico an additional two months to file a US Individual Income Tax Return.

[245] This example is derived from Sarrell v. Commissioner, 117 T.C. No. 11 (2001); which involved a tax court petition.

## DE MINIMIS EXCEPTION TO PASSIVE LOSS AND CREDIT LIMITATIONS

### PROBLEM

Losses from passive trade or business activities can only offset income from passive activities – i.e., passive losses cannot offset non-passive income such as wages, portfolio income, or income from an active trade or business. Credits from passive activities generally can only offset the tax attributable to income from passive activities. Disallowed passive losses and credits are carried forward and to the extent not used in subsequent years are allowed in full when the taxpayer disposes of his/her interest in the passive activity.

Taxpayers with relatively small amounts of passive losses and credits must complete a complex calculation and form preparation to determine and claim their allowable losses and credits from passive activities.

### EXAMPLE

Taxpayer has invested in a limited partnership that involves passive trade or business activity. For tax year 2001, the taxpayer's share of this limited partnership's net ordinary loss was $585.00. To determine whether the taxpayer can claim that loss in full on his 2001 individual income tax return, the taxpayer must first read through and complete two pages of worksheets for Form 8582, read a 12 page publication, Instructions for Form 8582 Passive Activity Loss Limitations, and complete the Form 8582. It is estimated that record-keeping, learning, preparing and filing this form will require five hours and 14 minutes.

### RECOMMENDATION

Amend Internal Revenue Code section 469(a) to provide a *de minimis* exception to the rules limiting the allowance of losses and credits from passive activities. Specifically, provide that the passive loss limitations shall not apply if the sum of the taxpayer's passive activity losses and three times his/her passive activity credits is less than $1,000, indexed for inflation.

## ELECTION TO BE TREATED AS AN S CORPORATION

### PROBLEM

Internal Revenue Code section 1362(b)(1)(B) requires that the election to be treated as an S-corporation be made on or before the 15th day of the 3rd month of the tax year. If this election is not made by the statutory date, it is deemed made for the succeeding year unless the Secretary determines that there was reasonable cause for the failure to make a timely election.

### EXAMPLE

The problem arises when a small business corporation files a Form 1120S (U.S. Income Tax Return for an S-Corporation), and the IRS has no record of an approved 2553 election. The result is as follows:

- The filed Form 1120S is unpostable, and is converted to, and posted as, a Form 1120; then the tax is assessed.
- The flow-through returns related to the Form 1120S may or may not be corrected to reflect the 1120 assessment.
- IRS notifies the small business corporation of its changed status and grants the corporation two options:
  1. if the election was in fact approved by the Service – provide proof of filing and approval notification; or
  2. if there is reasonable cause for late filing – prepare a request for Private Letter Ruling (PLR) from IRS Chief Counsel.

In most cases reasonable cause exists, and the taxpayer eventually is approved for treatment as an S-corporation in the current year. As a result, the entire 1120 set up is then reversed, including any flow through adjustments, and the original 1120S set up is transcribed.

### RECOMMENDATION

Amend Internal Revenue Code section 1362(b)(1)(B) to allow a small business corporation to elect to be treated as an S corporation at the time it files its first Form 1120S return.

## LEVY ON MUTUAL FUNDS, INCLUDING MONEY MARKET FUNDS

### PROBLEM

Existing law permits the seizure and sale of mutual fund or money market shares. The authority of the service to obtain cash from a levy on liquid mutual funds has been challenged. Some brokers argue that their only responsibility is to turn over the shares in response to the levy rather than liquidating the shares and providing funds to the IRS. Provisions in IRC § 6335 (e)(1)(A) allow for reduction in value of the asset due to expenses of sale, resulting in an amount less than the market value of shares seized being applied to the liability. The successful bid will generally be less than market value of the shares, so that the taxpayer does not benefit from the full value of the sale.

### EXAMPLE

Taxpayer has a liquid mutual fund in an account with a brokerage firm. The IRS levies this fund, up to the amount of an unpaid tax liability. The brokerage firm maintains that it is only required to turn over the shares to the IRS. The IRS then conducts a sale of the funds, and reduces the sale proceeds by the expenses of sale. Thus, only the net sale proceeds are applied toward the taxpayer's outstanding tax liability.

### RECOMMENDATION

Amend Internal Revenue Code section 6332 to include a new paragraph (d) to read:

> Special Rule for agent of mutual funds, including money market funds.
>
> Any agent for a mutual fund including money market funds shall dispose of sufficient shares at market value to satisfy the amount due on such levy up to the market value of share owned by the person against whom the tax is assessed.