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WASHINGTON — National Taxpayer Advocate Nina E. Olson today released her annual report, urging Congress to greatly simplify the tax code and recommending measures to reduce the burden on taxpayers who are struggling to pay their tax bills.

The report takes note of the serious financial difficulties facing many Americans in light of the ongoing economic downturn. "It is imperative for the IRS to consider the circumstances of taxpayers facing economic hardship before initiating enforcement actions," Olson wrote.

When the IRS contemplates taking an enforced collection action such as a levy, a lien or an asset seizure, both the tax code and IRS procedures require that IRS personnel consider whether the collection action will impose an economic hardship on the taxpayer. Despite these requirements, "current IRS guidance provides little direction to help IRS employees identify taxpayers who are experiencing economic hardship and prevent undue economic burden," Olson wrote.

Call for Tax Simplification

The report designates the complexity of the tax code as the most serious problem facing taxpayers. According to data compiled by Olson's office, U.S. taxpayers and businesses spend about 7.6 billion hours a year complying with tax-filing requirements. "If tax compliance were an industry, it would be one of the largest in the United States," the report says. "To consume 7.6 billion hours, the 'tax industry' requires the equivalent of 3.8 million full-time workers."

The report estimates that U.S. taxpayers spend \$193 billion a year complying

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Two examples of tax law complexity:

The Alternative Minimum Tax (AMT) effectively requires taxpayers to compute their taxes twice — once under the regular rules and again under the AMT regime — and then to pay the higher of the two amounts. Absent repeal or continuing AMT patches, the AMT will affect 33 million taxpayers in 2010. Although the AMT was originally conceived to prevent wealthy taxpayers from escaping tax liability through the use of tax-avoidance transactions, 77 percent of the additional income subject to tax under the AMT today is attributable to the disallowance of deductions otherwise allowed for state and local taxes and personal and dependency exemptions. “Few people think of having children or living in a high-tax state as a tax-avoidance maneuver, but under the unique logic of the AMT, that is essentially how those actions are treated,” the report notes.

The tax code provides tax breaks to encourage taxpayers to save for education and retirement. However, the number of such tax incentives has grown to at least 27 and the eligibility requirements, definitions of common terms, income-level thresholds, phase-out ranges and inflation adjustments vary among the provisions. This complexity undermines the intent of the incentives, as taxpayers can only respond to incentives if they know they exist and understand them.

Olson recommends that Congress substantially simplify the tax code. The report includes a series of recommendations, including recommendations to repeal the Alternative Minimum Tax; streamline education and retirement savings tax incentives;

simplify the family status provisions of the tax code; simplify the rules under which workers are classified as employees or independent contractors; reduce sunset and phase-out provisions and revise the overall penalty structure. More

broadly, Olson recommends six core principles on which fundamental tax reform

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1. Make greater use of collection alternatives when economic hardship is present. While enforced collection actions like levy and seizure authority are important collection tools that allow the IRS to address serious incidents of noncompliance, a review of IRS historical enforcement data show that more enforcement actions do not translate into commensurate increases in revenue collection. One example: The number of levies issued by the IRS increased by 1,608 percent from FY 2000 to FY 2007 — from 220,000 levies to about 3.76 million levies — yet the increase in the total collection yield during the period was slightly less than 45 percent. By contrast, historical enforcement data indicate that collection alternatives, such as offers in compromise and partial-payment installment agreements, may be more effective at collecting liabilities from taxpayers having difficulty paying their tax debts. (For details, see *Most Serious Problem: The IRS Needs to More Fully Consider the Impact of Collection Enforcement Actions on Taxpayers Experiencing Economic Difficulties.*)

2. Simplify the “cancellation of debt” minefield that many taxpayers who default on debts must navigate. Most financially distressed individuals who lose their homes to foreclosure or cannot pay off their car loans, credit card balances, student loans, or medical bills probably do not realize that their delinquency may increase their tax liabilities, but it often does. If a creditor writes off a debt, the tax code generally

treats the amount of the canceled debt as taxable income to the debtor.

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However, taxpayers do not receive the benefit of these exclusions automatically.

A taxpayer must file Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment), to claim an exclusion.

Form 982 is extremely complex, and very few taxpayers or preparers are familiar with it.

IRS data show that approximately two million Forms 1099-C, Cancellation of Debt, are issued to taxpayers and the IRS each year reporting canceled debts.

In an economic downturn, the number of taxpayers defaulting on credit card

bills, car loans, home mortgages and other debts can be expected to rise.

Olson estimates that tens of thousands and possibly hundreds of thousands of taxpayers who qualify to exclude canceled debts from gross income do not

file Form 982 to claim allowable exclusions. Instead, some of these taxpayers

unnecessarily include the amount of the canceled debt in gross income, and other taxpayers who fail to include it unnecessarily face IRS examinations and tax assessments.

Olson recommends that Congress change the law to remove taxpayers with modest

amounts of debt cancellation from the cancellation of debt income regime,

and she recommends that the IRS develop an insolvency worksheet that

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3. Implement a “screen” to protect low income Social Security recipients from continuous, automated tax levies. Under the Federal Payment Levy Program, the IRS is authorized to “levy” (or withhold) 15 percent of any federal payment made to a delinquent taxpayer.

Using this authority, the IRS levied against 1.8 million payments to Social Security recipients in 2008. TAS estimates that more than 25 percent of these

taxpayers had incomes below the poverty level and more than one-third would

likely be classified by the IRS as unable to pay if their cases were subject to human review. However, the automated levy system does not use built-in screens to identify and shield these taxpayers. The report contains a research

study recommending the implementation of such a screen. (For details, see Research Study: Building a Better Filter: Protecting Lower Income Social Security

Recipients from the Federal Payment Levy Program.)

Finally, taxpayers who are unable to make their tax payments and face enforced collection action will generally qualify for assistance from the Taxpayer Advocate Service (TAS), which Olson heads. (See information below about contacting TAS.)

Other Issues

Olson reiterates her longstanding recommendation that Congress regulate unenrolled

tax preparers to protect taxpayers from preparer errors and exploitation. She

notes that 62 percent of taxpayers use preparers, yet anyone can now be a “preparer”

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The penalty creates what Olson calls “unconscionable” results and may have the effect of bankrupting middle class families who had no intention of entering into a tax shelter. Under the law, the IRS must impose the penalty where a taxpayer fails to make the special disclosures – even if the taxpayer had no knowledge that the transaction was listed or even questionable, even if the taxpayer derived no tax savings from the transaction, and even if the transaction is not “listed” until years after the taxpayer entered into it and filed a return reflecting the transaction. A taxpayer who does business through a wholly owned S corporation is subject to a penalty of \$300,000 (\$200,000 at the entity level and \$100,000 at the individual level) for each year in which the transaction is reflected on a return. The IRS is currently considering this penalty in hundreds of cases.

Overall, the report discusses 21 problems facing taxpayers, makes dozens of recommendations for administrative change, proposes 17 recommendations for legislative change and analyzes the 10 tax issues most frequently litigated in the federal courts during the past fiscal year. It also contains a second volume that presents in-depth studies on three subjects — the penalty regime in the tax code, the development of a “filter” to protect low income Social Security recipients from automated levies and strategies to improve tax compliance by tax preparers and their clients.

More information about the IRS Taxpayer Advocate Service is at www.irs.gov/advocate.

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