

Chapter 9: IRS Update

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Corrections were made to this workbook through January of 2005. No subsequent modifications were made.

TAXPAYER ADVOCATE REPORTS ON MOST SERIOUS PROBLEMS

Annually, the National Taxpayer Advocate provides a report to Congress as required by statute. This document identifies the 20 most serious problems encountered by taxpayers, as dealt with through the Taxpayer Advocate's office. The report also describes legislative recommendations, the most litigated tax issues, and a breakdown of the most common types of cases brought to the Advocate's office.

In the 2003 report, the 20 most serious problems, in order of priority, were identified as:

1. Alternative minimum tax for individuals,
2. Nonfiling and underreporting by self-employed taxpayers,
3. Earned income tax credit compliance strategy,
4. Appeals implementation of the collection due process program,
5. Individual taxpayer identification number program and application process,
6. Combination letter,
7. Offers in compromise,
8. Math error authority,
9. Navigating the IRS,
10. No response audit cases,
11. Taxpayer assistance centers,
12. Earned income tax credit outreach and education,
13. Earned income tax credit nonfilers,
14. Separating joint tax accounts of spouses,
15. Criminal investigation freezes,
16. Appeals inventory delays,

17. Federal tax deposit penalties,
18. Federal payment levy program,
19. Manual refund inconsistencies, and
20. Combined annual wage reporting reconciliation.

These common problems have been dealt with by almost all tax professionals. The report is written from a taxpayer's point of view and includes background for each problem, as well as some recommended solutions. The IRS responds to many of the recommendations with reasons for and/or against the proposed solutions. This section provides a summary of the report for some of the top 20 problems identified in the Taxpayer Advocate report.

Note. See Chapter 8, AMT for thorough coverage of the AMT issue.

NONFILING AND UNDERREPORTING BY SELF-EMPLOYED TAXPAYERS

The report states, "income earned by self-employed persons is not reported to the IRS on any information reporting document and often is not reported at all. Thus, it is hardly surprising that self-employed persons account for the largest share of the known tax gap...which now is estimated at a whopping \$310 billion annually."

Of the \$310 billion tax gap estimated for 2001, \$30.1 billion is due to nonfiling, \$31.8 billion is due to underpaying, and \$248.8 billion is due to underreporting. This results in an overall noncompliance rate of 15%. Individual taxpayers account for \$196.3 billion of the total tax gap. Of the \$248.8 billion tax gap attributed to underreporting, \$148.8 billion is associated with individual taxpayers (approximately 60%). Schedule C taxpayers account for 58.6% of individual nonfilers.¹

The report recommends that Congress implement a withholding mechanism on certain payments to self-employed individuals. This recommendation also addresses concerns about different standards that apply in distinguishing between employees and independent contractors.

Two programs are included in the IRS's strategic plan to combat the large tax gap due to self-employed noncompliance. They are the Unreported Income Discriminant Index Function (UI DIF) and the Nonfiler Strategy.

The **UI DIF program** was started by the IRS in 2003. The returns selected for this program were chosen using a formula which was initially developed from Taxpayer Compliance Measurement Program (TCMP) data from tax year 1988 returns, the last year of that program. These formulas were enhanced and now use data from multiple years that include patterns of taxpayer's filing and reporting over several years. The returns in the program should be those returns having a high probability of unreported income. The formulas are also updated with the National Research Program (NRP) data from the 2001 tax returns once the data is available in fiscal year 2005.

The **Nonfiler Strategy** of the IRS for the current fiscal year has three elements:

- Improve case selection, to select more of the highest risk cases.
- Identify high-income nonfilers (income of \$100,000 or more). Most of these examinations will be field audits with face-to-face contact, but some will also be handled by correspondence units.
- Initiate studies of high-income nonfilers, repeat nonfilers, and UI DIF taxpayers to improve outreach and education efforts. Some of this education and outreach is sent directly to taxpayers.

¹ *National Taxpayer Advocate 2003 Annual Report to Congress*, p. 21

EARNED INCOME TAX CREDIT COMPLIANCE

The earned income tax credit (EITC) is the largest antipoverty program in the federal government today. When the EITC began in 1975, the maximum credit was \$400, and the credit was phased out at a modified adjusted gross income (MAGI) amount of \$8,000. For 2004, the maximum credit and phase-out is as follows:

No. of Children	Maximum Credit	Phaseout Begins at
1	\$2,604	\$14,040
2	4,300	14,040
0	390	6,390

In 1975, 6.2 million taxpayers claimed \$1.25 billion in EITC for an average of \$202 per taxpayer. In 2003, nearly 21 million taxpayers claimed over \$36 billion in credits, for an average of nearly \$1,800 per taxpayer.

Many taxpayers who are eligible to claim the EITC fail to do so. However, the IRS estimates that nearly \$10 billion of claimed EITC is improper. In fiscal year 2004, the IRS planned to conduct 25,000 EITC certification audits, 36,000 EITC filing status audits, 400,000 EITC correspondence examinations, and 300,000 Automated Underreporter EITC examinations.

Recommendations for IRS action as outlined by the Taxpayer Advocate in its 2003 report include the following:

1. Continue to seek more systematic ways of determining EITC eligibility.
2. Continue to pilot the precertification program in order to:
 - Test forms and notices for clarity,
 - Identify the population most likely to be ineligible and use precertification as a means to educate people about eligibility and claiming the credit, and
 - Test different methods of communicating with taxpayers who are selected, especially those who do not speak English as their primary language.
3. Develop a multiyear research strategy that provides information about the EITC population.
4. Target outreach and education to local populations to monitor demographic and geographic trends and shifts.
5. Address issues related to paid preparers by promoting the use of Low-Income Taxpayer Clinics, requiring paid unlicensed preparers to register and pass an annual examination, instituting broader due diligence requirements, applying penalties against noncompliant preparers (including a possible 100% penalty for preparers who act in reckless disregard), and continuing partnerships with low-income taxpayer representatives and community-based organizations.

Outreach and Education

In a U.S. Census Bureau survey, the EITC lifted 4.7 million people (including 2.6 million children of low-income workers) out of poverty in 1999. Many taxpayers who are eligible for EITC do not claim it. The IRS estimated in 2002 that 3.4 million taxpayers fell into this category. A recent analysis by the Wage and Investment Division and an IRS task force on EITC reforms found that approximately 30% of tax year 2000 EITC claimants did not claim the EITC in the previous year.

The IRS received \$875 million in special congressional appropriations for EITC compliance initiatives between 1998 and 2003. Congress stated that the funds were to be used to expand customer service and public outreach programs as well as to strengthen enforcement and compliance activities. In fiscal year 2002, the IRS received \$146 million to administer the EITC and reported that through examinations and mathematical account adjustments it protected approximately \$1.1 billion in revenue, a return of over 7 to 1. In 2003, the IRS planned to direct only 12% of its total EITC funding to outreach and education, using the remainder to examine potential overclaims.

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The IRS has increased its efforts to market the benefits of advanced EITC payments. However, advanced EITC claimants declined from 156,000 (.08% of all EITC claimants) in 2001 to 128,000 in the first half of 2003 (.06%). The Taxpayer Advocate suggests that additional research might help the IRS target outreach and education to those taxpayers who could benefit the most.

The Taxpayer Advocate also suggests an outreach strategy that includes tax preparers. Preparers file nearly 70% of the tax returns that claim EITC and are responsible for 68% of the errors or over claims on EITC returns. A legislative recommendation to Congress in the report suggests stronger use of penalties where abuses exist.

In June 2003, the IRS announced a five-point initiative for improving the administration of the EITC:

1. An outreach campaign through national and community-based partner coalitions that integrates tax education, volunteer tax preparation, and financial literacy
2. A national media campaign of bilingual public service advertising
3. Outreach and education to preparers, including an EITC toolkit, mailings to preparers who filed over 75 EITC returns in prior years, and a presentation on the web-based "Tax Talk Today"
4. Improvement strategies for EITC returns filed by paid preparers with special training, assistance, and oversight for those preparers with a high error percentage
5. Research on the diverse EITC taxpayer population, studying data that identify issues down to the zip code level

Nonfilers

A greater percentage of eligible taxpayers participate in the EITC than in traditional programs such as Temporary Assistance for Needy Families (TANF), food stamps, and Medicaid. However, the Taxpayer Advocate states that billions of dollars of income are lost to needy families who do not file tax returns. Five studies have been conducted over the past decade, with varying participation rate results. Particular groups of eligible taxpayers are more likely to lose potential EITC benefits:

1. Taxpayers with very low income
2. Taxpayers with a history of receiving public assistance
3. Large families
4. Workers without children
5. Parents and families whose first language is not English

In a 2002 IRS study, between \$2.1 and \$3.5 billion in EITC was not claimed. In addition, 40% of the EITC nonfilers were taxpayers without children. The states of California, Florida, New York and Texas accounted for 40% of the nonfilers and 44% of the dollars not claimed. Of the EITC nonfiler population, 24% were immigrants from Hispanic countries. Only 7.5% of the nonfiler EITC population lived in public housing.

The IRS goal is that 80% of eligible taxpayers claim the credit in 2004.

Advance EITC

The Advance EITC (AEITC) allows certain taxpayers to receive the credit in installments throughout the year, instead of a lump sum at the time of filing. Taxpayers who choose EITC must complete Form W-5 and submit the bottom portion to their employer. They should keep the top portion for their own records. Employers will then include the additional money in each paycheck. The AEITC payments are capped at \$1,563 for wages paid in 2004. Eligible taxpayers should claim any additional EITC when they file their income tax returns.

Taxpayers qualify for Advance EITC in 2004 if they are working and expected to:

- Have 2004 income below \$30,000,
- Have at least one qualifying child, and
- Qualify for the regular EITC in 2004.

If a taxpayer's income rises above the dollar limit, or the taxpayer no longer qualifies for the EITC, he will have to repay all EITC money when the tax return is filed.

INDIVIDUAL TAXPAYER IDENTIFICATION NUMBER (ITIN) PROGRAM

Many taxpayers are not eligible to receive a social security number (SSN). Non-U.S. citizens are taxpayers who cannot receive an SSN, but may need an identification number for tax purposes. Many nonresident aliens have taxable investment income, and without an identification number, a significant tax compliance problem exists.

In 1997, the IRS created individual taxpayer identification numbers (ITINs) for non-U.S. citizens to use when reporting income and filing a tax return. These numbers resemble the SSN, except they begin with 9. For example, if a taxpayer submits the number 987-65-4321, the practitioner would know the number is an ITIN.

In 2000, as in 1930, 10.4% of the United States population was foreign born. Over the past decade, immigrants (either with or without authorization) accounted for half of the new wage earners. In 2002, the IRS issued 1.5 million ITINs. Over 70% of the ITIN applications come from 11 states: Arizona, California, Colorado, Florida, Georgia, Illinois, New Jersey, New York, North Carolina, Texas, and Utah. Over 50% of the applicants were Mexican citizens.

An ITIN is needed by the following individuals:

- Foreign nationals and others who have federal tax reporting or filing requirements and do not qualify for SSNs.
- Nonresident alien filing a U.S. tax return and not eligible for an SSN, even if filing only to claim a refund of tax under the provisions of a U.S. tax treaty.
- U.S. resident alien (based on days present in the United States) filing a U.S. tax return and not eligible for an SSN
- Dependent or spouse of a U.S. citizen or resident alien
- Dependent or spouse of a nonresident alien visa holder

Application Procedures. The December 2003 revision of Form W-7, *Application for IRS Individual Taxpayer Identification Number* is used to apply for an ITIN. A valid federal income tax return is attached, unless an exception applies. The original or certified proof of identity documents are also included. Because the tax return is filed as an attachment to an ITIN application, it should not be mailed to the address listed in the Form 1040, 1040A, or 1040EZ instructions. Instead, it should be sent to the address listed in the Form W-7 instructions:

Internal Revenue Service
Philadelphia Service Center
ITIN Unit, P.O. Box 447
Bensalem, PA 19020

A taxpayer may also apply using the services of an IRS-authorized **Acceptance Agent** or visit an **IRS Taxpayer Assistance Center** in lieu of mailing the information to the above address. Taxpayer Assistance Centers (TACs) in the United States provide in-person help with ITIN applications on a walk-in or appointment basis. Applicants outside the United States will contact an overseas IRS office to find out if that office accepts Form W-7 applications. The IRS's ITIN Unit in Philadelphia issues all numbers by mail.

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Delays in ITIN Application Processing. The Advocate report noted that taxpayers experienced hardship when delays occur in obtaining ITINs. When application processing is delayed up to 10 weeks or longer, it leads to delays in tax return processing and possibly leads to the disallowance of credits or exemptions for dependents or spouses.

When a six-week delay occurs in ITIN processing, the taxpayer is directed to call a toll-free number. However, if a taxpayer calls that number, the assistor can only tell if the application has been input. If the application was not input, the caller receives no help. As of September 2003, approximately 25% of ITIN applications were rejected and never input.

The IRS implemented several program changes, effective December 13, 2003:

- All new ITIN applicants must show a tax purpose for seeking the ITIN. In most cases, the taxpayer needs to attach a tax return to the Form W-7 at the time of application and attach proof of identity documents.
- The number of documents the IRS accepts as proof of identity to obtain an ITIN was reduced from 40 to 13. These documents are:
 1. An original passport is the only document that is accepted for both identity and foreign status. If the taxpayer does not have a passport, he must provide a combination of current documents containing expiration dates, showing name and photograph, and supporting his claim of foreign status. The IRS will accept a combination (two or more) of the following documents, in lieu of a passport.
 2. National identification card (must show photo, name, current address, date of birth, and expiration date)
 3. U.S. driver's license
 4. Civil birth certificate
 5. Foreign driver's license
 6. U.S. state identification card
 7. Foreign voter's registration card
 8. U.S. military identification card
 9. Foreign military identification card
 10. Visa
 11. U.S. Citizenship and Immigration Services (USCIS) photo identification
 12. Medical records (dependents only)
 13. School records (dependents and/or students only)
- The appearance of the ITIN changed from a card to an authorization letter to avoid any similarities to a social security card.

Other Information about ITINs.

- The IRS issues ITINs for federal tax purposes, and ITINs should be used for tax reporting only.
- ITINs do not authorize a person to work in the United States or provide eligibility for social security benefits.
- If a client presents an ITIN and a Form W-2 showing an SSN, the tax return must be filed on paper. E-file rules do not permit an Electronic Return Originator (ERO) to alter information on a wage document, and mismatched taxpayer identification numbers will cause an e-filed return to reject.

- If a primary taxpayer, spouse, or both have ITINs, they are ineligible to receive the EITC, even if their dependents have valid SSNs. If the taxpayer and spouse (if filing jointly) have valid SSNs, only dependents with valid SSNs, not ITINs, qualify to receive EITC.
- In cases where a current-year tax return was already filed and it excluded a spouse or dependent who needs an ITIN, the taxpayer should complete Form 1040X, *Amended U.S. Individual Income Tax Return*, showing the ITIN applicant's information, and attach it to Form W-7.

COMBINATION LETTER

The Advocate report summarizes its dissatisfaction with the combination letter (started in 1999) to reduce the time spent to complete a correspondence examination.

The Old Process. Previously, the process involved:

1. The IRS sent an initial contact letter (Letter 556) to the taxpayer which:
 - Announced the correspondence examination,
 - Stated the specific items under examination, and
 - Requested documentation to verify the amounts reported on the tax return.
2. The taxpayer had 30 days to provide the requested information.
3. If at the end of the 30-day period, the taxpayer did not respond, or supplied insufficient information, the taxpayer was sent a 30-Day Letter (Letter 525). This letter contained the preliminary audit report, showing the tax due if items were disallowed, and included information on the taxpayer's appeal rights.
4. The taxpayer responded with additional documentation or requested an Appeals conference.
5. If documentation was insufficient, another letter requesting additional information and an audit report was sent (Letter 692) giving the taxpayer an additional 15 days to respond.
6. If the taxpayer did not request an Appeals conference by the end of this 15-day period, a Statutory Notice of Deficiency (the 90-Day Letter) was issued. This required the taxpayer to file a petition with the Tax Court if they wished to litigate the issues before assessment.

Therefore, the taxpayer had at least 60 days or more from the initial contact letter (Letter 556) to the issuance of the 90-Day Letter to work with the correspondence unit to resolve the issue.

New Process. Starting in 1999, the IRS combined the initial contact letter with the 30-Day Letter (Letter 566B). As the taxpayer's initial contact with the IRS, he receives a preliminary report of the tax that is due if the issue or issues on the return are not substantiated. This combination letter informs the taxpayer that he needs to request an administrative Appeals hearing at the same time he submits information to substantiate his claims. The taxpayer has only 30 days before a 90-Day letter can be issued.

In fiscal year 2001, the Correspondence Examination units conducted 401,448 EITC examinations, 9,624 nonfiler examinations, and 129,830 other examinations. All of the letters and reports were issued through the Report Generation Software (RGS) system. Taxpayers receive the applicable letter, and Publication 3498, *The Examination Process*, and Form 886, *Explanation of Items*.

The Advocate notes:

- 30 days may not be sufficient to gather birth certificates, social security cards, school records, and so on.
- Even though the IRS will not issue the Statutory Notice of Deficiency until at least 60 days after the initial contact, the taxpayer may only think that they have 30 days, and may feel it is too late to respond after the 30 days have passed.

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In response to concerns in the Advocate's report, the IRS is testing the concept of sending an additional 30-day letter to the 25,000 EITC certification cases. The IRS response states:

- The IRS does not think taxpayers will understand the Appeals process any better if it is mentioned twice in a letter instead of once, and
- Many taxpayers who do not have records, or who are not entitled to the items in question will not respond, no matter how many letters they receive.
- The taxpayer has an opportunity to have his case resolved more quickly if he accepts the Examination report.
- Publication 3498 will be revised to more clearly communicate with taxpayers. It will mention that a taxpayer can orally request an Appeals conference.

The Taxpayer Advocate's recommendations are as follows:

1. Discontinue the use of the combination letter and return to the previous procedure. This gives the taxpayer a realistic amount of time to submit documentation and work with the correspondence exam unit to resolve issues before a statutory notice is issued.
2. Include in all correspondence the name and telephone number of the tax examiner handling the case.
3. Requests for substantiation should be as specific as possible to the case in order to prevent misunderstandings, as opposed to using the generic letters sent using the Report Generating System (RGS).
4. Include a clear statement in the 30-day letter indicating when the 30-day period for requesting an appeals conference begins and ends.
5. Include clear instructions regarding appeal rights in both the 30-day letter to the taxpayer and in IRS Pub. 3498. This includes the specific steps for requesting an appeals conference. The instructions should describe the taxpayer's right to orally request an appeals hearing, both before and after the issuance of the statutory notice of deficiency. It needs to be clear that, if requesting an appeals conference after issuance of the statutory notice of deficiency, the 90-day period continues to run for the taxpayer to petition the Tax Court.
6. Conduct a pilot in which the publication listing Low Income Tax Clinics is included with the initial contact letter to assist eligible taxpayers in receiving professional help in the audit process.

MATH ERROR AUTHORITY

Math error authority is described in IRC §6213(b). This section states that the IRS may assess tax, interest, and penalties when mathematical or clerical errors have been identified. The Taxpayer Advocate Report identifies a concern that the IRS has expanded this math error authority to other adjustments that are not based on math or transcription errors.

There are currently 14 different error categories, including the determination of who is a custodial parent for certain tax benefits under IRC §6213(g)(2). The Advocate is concerned that the abatements of these math error assessments are strictly limited and poorly communicated to taxpayers, leading to many incorrect assessments. The 2002 National Taxpayer Advocate's Annual Report listed three major problems with math error authority applications:

1. Math error notices are confusing and offer inadequate explanations about the items that the IRS modified or denied on a taxpayer's return.
2. Taxpayers have difficulty reconciling the adjustments with their originally filed tax returns.
3. Taxpayers are not sure how to correct or challenge the notices, nor do they understand their right to challenge them.

The IRS began several **short-term initiatives** to improve taxpayer correspondence, including:

- **Redesigning notices** to improve clarity,
- **Revising math error codes** to simplify the procedure for IRS employees to choose the code that correctly corresponds to the taxpayer's situation, and
- **Resequencing math error codes** to correspond to specific sections of the tax return.

Math error notices during the 2004 filing season will include specific tax return line references for adjustments. The IRS is also expanding and improving employee training.

Long-term initiatives include the following:

- Eliminating notices that are obsolete or redundant
- Revising abatement and appeal rights language
- Making all math error codes line item specific if applicable
- Creating templates for notices to improve consistency
- Improving notice language based on recommendations from external stakeholders
- Studying methods to track abatements

In recommendations made in the 2002 Annual Taxpayer Advocate to Congress, math error assessments were to be limited to the following:

- **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
- **Numerical or quantitative items** reported on the return, which can be verified by a government entity that issues or calculates such information

In response to the 2003 report, the IRS made the following improvements:

1. Math error notice clarity will be made.
2. All business and some individual Taxpayer Notice Codes were revised to include line-specific references for 2003 returns. The remaining notice codes are scheduled to be revised in July 2004.
3. Recommendations to improve language were accepted.
4. By January 2005, the IRS plans to implement changes in notice language on Appeals and the elimination of obsolete or redundant notices.
5. An analyst from the Taxpayer Advocate's office is serving on the Notice Process Improvement Initiative Team.

NAVIGATING THE IRS

The Advocate's office recognized and stated in its report that taxpayers and practitioners (and even IRS employees) cannot locate the function or employee at the IRS who has the responsibility and authority for resolving a particular tax problem.

Note. Initiatives from 2003 that relate to navigating the IRS are discussed in the IRS Update Chapter in the *2003 University of Illinois Federal Tax Workbook*.

The Advocate's report states that the IRS has done little to educate taxpayers about using its website. According to the IRS Customer Satisfaction Survey, 64% of wage and investment taxpayers have Internet access at home, and 74% of customers are aware of the IRS website, but only 17% have used the site. Low-income, minority, and elderly taxpayers may lack Internet access or experience and may continue to require the more conventional assistance methods of telephone, mail, and walk-in assistance.

International taxpayers have a difficult time contacting the IRS. Overseas taxpayers do not have access to toll-free lines, but are referred in the instructions to toll-free numbers. Several toll-free numbers were recently added, and a toll-free number is included on collection notices sent to overseas taxpayers. Many noncompliance notices sent to international addresses also include these international toll-free numbers.

The Advocate Report also addressed the lack of one-stop service by the IRS. When the Restructuring and Reform Act of 1998 was passed, it required IRS employees to provide their name and badge number when a telephone or personal contact was made with a taxpayer. Also, if it was advantageous to the taxpayer, only one IRS employee was assigned to handle a taxpayer's needs until all issues were resolved.

The IRS response indicated self-help is often more efficient and user-specific than talking to a live assistant, given the current technology available. The IRS has modified service hours.

NO-RESPONSE AUDIT CASES

Taxpayers continue to disregard IRS letters and reports sent to them by the correspondence examination units. In a 1999 GAO study, it was determined that over 50% of taxpayers who were audited by correspondence did not respond to the IRS letters.

The IRS decided to study the issue to determine reasons for this no-response rate. The IRS decided to conduct focus groups in Chicago, Los Angeles, and Memphis, where approximately 27,000 taxpayers met the criteria for the groups. To locate these taxpayers and screen them for participation, the names and addresses were provided to an independent research group. Despite this group's effort, the group was unable to find telephone numbers for 79% of the individuals on the list. Disconnected telephones and language problems also limited the number of participants in the focus group sessions. Ultimately, only 22 taxpayers out of this initial group of 27,000 agreed to participate in these sessions. When the sessions were held, only eight taxpayers took part in the interviews. The following information was identified by the eight taxpayers:

1. Correspondence examination letters are complex and confusing. The letters were too general, and did not seem to apply to the taxpayer's specific tax situation.
2. There were differing levels of satisfaction with the toll-free customer assistance, including the quality and quantity of help received, and the length of time that the taxpayer had to wait.
3. Seven of these eight taxpayers used paid preparers to assist them in filing returns and responding to the IRS correspondence, because they did not understand the intent of the letters and reports. Some of the preparers said that they would handle the matter, but did not follow through to resolve the problem.
4. The participants had a sincere fear of the IRS. They believed that making a mistake on their tax return would result in consequences up to and including jail time.
5. The most common response was that the taxpayers lacked the money to pay the tax, so there was no point in responding. They felt that the IRS would correct the errors automatically.

In 2002, the IRS conducted an additional study in response to the fact that up to 60% of taxpayers who claimed the EITC and received an examination letter failed to respond. Many of these taxpayers requested an audit reconsideration and abatement. Many of these taxpayers failed to file returns in the subsequent year even when they were due a refund. The IRS analyzed the subsequent filing behavior of a sample of 1998, 1999, and 2000 taxpayers and found:

- Fewer than 5% of the EITC taxpayers in the sample and 4% of the non-EITC taxpayers in the sample requested an audit reconsideration. However, 84% of the EITC reconsideration requests and 97% of the non-EITC reconsideration requests resulted in a full or partial abatement of the tax assessed.
- 54% of EITC taxpayers, and 64% of non-EITC taxpayers filed returns for both of the subsequent years.
- 43% of the EITC taxpayers and 53% of the non-EITC taxpayers paid the assessments in full for both subsequent years.
- The number of taxpayers failing to file a return increased with each successive year.
- When Information Return Program (IRP) data was available for Form W-2 and Form 1099 information, it showed that 61% of the EITC taxpayers and 51% of the non-EITC taxpayers who did not file returns would have been due a refund.
- The sample of taxpayers decreased their claimed EITC and the number of exemptions in subsequent years. Of the taxpayers who claimed EITC in 1998, 52% did not claim EITC in 1999, and 60% did not claim EITC in 2000. The number of exemptions claimed by EITC taxpayers also declined in subsequent years. In addition, the number of EITC taxpayers who claimed head of household status dropped from 87% in 1998 to 50% in 1999 and 41% in 2000.

The IRS concluded that, since fewer than 5% of the taxpayers requested an audit reconsideration, the correspondence examinations were correct. Since the EITC, head of household filing status, and exemptions claimed also decreased, the IRS concluded that taxpayer behavior also changed as a result of the examination.

The Taxpayer Advocate noted that even though it is clear that IRS examinations influence taxpayer behavior, the IRS does not know whether this influence also changes the behavior of compliant taxpayers as well.

In 2003, the IRS conducted a test by mailing 6,000 notices to taxpayers that included a Spanish language offer to provide a Spanish language service or a Spanish version of the notice through a toll-free number. Since only 14 taxpayers requested their audit package be remailed in Spanish, this test does not appear to materially affect the response rate.

The Taxpayer Advocate's recommendations follow:

1. Advertise through public service announcements the importance of notifying the IRS of an address change using Form 8822, and insert a hyperlink to the form on the IRS website home page.
2. Further simplify IRS notices, letters, and reports.
3. Provide the tax examiner's name and direct telephone number in all correspondence.
4. Provide toll-free direct telephone lines to the examiners, so taxpayers can reach examiners without incurring additional expense.
5. Give reasonable timeframes for gathering the necessary documents to substantiate the issues under audit.
6. Ensure that all taxpayer correspondence is promptly associated with the taxpayer's case file.
7. Provide a list of Low-Income Taxpayer Clinics, where taxpayers can receive professional help during the audit process.
8. Capture more accurate information to calculate the total cost of no-response audits.

The Taxpayer Advocate concluded that any extra costs incurred to provide additional service would be offset by the savings realized by having fewer audit reconsiderations.

TAXPAYER ASSISTANCE CENTERS

In 2003, the IRS made several changes to the Taxpayer Assistance Centers (TACs), formerly known as walk-in offices:

- Designating certain smaller offices for closing,
- Limiting the hours of operation for offices,
- Restricting access to assistance, and
- Strictly defining the scope of direct service, while creating a referral system for all out-of-scope inquiries.

The potential closure of offices was stopped by Commissioner Mark Everson following inquiries by members of Congress. The IRS mentioned a goal of having a TAC within commuting distance for 85% of all taxpayers.

Some complaints were received from taxpayers who found there was a quota of tax returns prepared or ITIN applications accepted per day. From 2002 to 2003, changes in the criteria for return preparation assistance (income and complexity levels) reduced the number of returns prepared by 10%. Although current measures of TAC customer satisfaction does not indicate a problem with accessibility, the Taxpayer Advocate indicated the satisfaction surveys are only conducted with customers using the TAC offices, and do not include feedback from taxpayers who may have found an office closed, or who were told to return another day for help.

The Taxpayer Advocate recommends the following:

1. Any reduction in TAC service must be supported by a compelling business case, including a process that would enable stakeholders to judge whether the change contributed to a service delivery improvement.
2. As the IRS modifies local services, it should develop customer satisfaction methods that accurately poll the customers affected.

CRIMINAL INVESTIGATION FREEZES

When the Criminal Investigation (CI) division of the IRS suspects that a fraudulent return is filed, a freeze is placed on the taxpayer's account, preventing the release of a refund while the return is validated, and the potential fraud is investigated.

When a CI freeze delays a refund, and the taxpayer inquires about his refund status, the taxpayer receives a statement indicating the return is still under review. CI is not required to advise taxpayers that their return is under investigation. To protect investigations, IRS employees are not allowed to explain why the refund has not been released. Even the Taxpayer Advocate representative cannot provide information about a CI freeze, and generally cannot speed up an issuance of the refund.

Over the past several years, the number of CI freezes has increased dramatically. Nearly 200,000 taxpayers had their accounts frozen in 2003, up more than 50% from 2002. The Taxpayer Advocate case receipts involving a CI freeze nearly tripled in 2003. Fraudulently filed returns increased 152% from 2000 to 2003, to more than 88,600 returns. Electronically filed fraudulent returns increased more than 450% to nearly 55,000 in 2003.

Since the required employer verification of Form W-2s on a suspected fraudulent return slows down the process, the IRS suggests that an exchange of data from the National Directory of New Hires database (currently maintained by Health and Human Services) might increase the timeliness of the verification process.

In its report, the Taxpayer Advocate expressed concern for innocent taxpayers caught in schemes devised by their tax preparers. A CI freeze, even when the refund is released for one year, may stay on the taxpayer's account for two additional years, subjecting future returns to review and delays.

The Taxpayer Advocate also suggests that a letter notifying the taxpayer of the refund delay would not jeopardize criminal investigations, and would fall under the category of standard courtesy to a taxpayer.

APPEALS INVENTORY DELAYS

Taxpayers and their representatives often experience delays in the:

1. Time between requesting an appeals conference and the first contact from the Office of Appeals,
2. Lead time required to schedule an appeals hearing, and
3. Amount of time to complete the appeals process.

The Office of Appeals' inventory is divided between docketed and nondocketed cases. Prior to the enactment of the Restructuring and Reform Act of 1998, cases in Appeals declined. After the act's enactment, cases increased from 55,000 to over 98,000 in 2003. This reflects the increase in service center and collection cases over the last six years. Cases received from Examination Division decreased from over 23,000 in 1998 to below 10,000 in 2002, while cases from the Service Center campuses and from collection more than doubled.

Appeals has tracked inventory and cycle times (the time span from receipt to closure).

- Nondocketed cases between 1997 and 2001: 220 days
- Nondocketed cases in 2003: 285 days
- Innocent spouse cases in 2003 (the longest cycle time): 446 days
- Examination cases in 2003 (second longest cycle time): 372 days
- Offers in compromise cases in 2003 (third longest cycle time): 313 days

Although receipts of cases increased greatly from 1997 to 2003, the total staffing with direct contact on cases is slightly lower than the 1997 level of 1062. The types of cases being appealed have also changed. In 2003, nearly 40% of receipts were Collection Due Process (CDP) cases.

In a 2003 customer satisfaction survey (conducted by an outside firm) the following was noted:

- 68% of dissatisfied customers wanted to hear from Appeals within 30 days of their cases arriving in Appeals, and 67% thought that the entire case should be resolved in two months.
- 33% of customers said that it took 91 days or more to assign the case to an Appeals officer from the time an appeal was requested. The changing workload of CDP cases has affected these results.

The Office of Appeals established procedures stating that CDP taxpayers will be sent acknowledgment letters no later than 30 days after receipt by Appeals. The number of CDP cases more than six months old declined in 2003 to 27%. However, the decrease in overage cases in this area was offset by increases in overage cases in other areas. Since the compliance function of SBSE is increasing the number of examinations of nonfilers, tax schemes, and abusive trusts, this will increase the Appeals workload. Fortunately, time per case is decreasing in all areas.

The Taxpayer Advocate recommended a 30-day timeliness standard for CDP cases and stated other timeliness standards need to be developed for other case types to ensure taxpayers are notified initially, and provided continued contacts throughout the process.

FAILURE-TO-DEPOSIT PENALTY

Note. Information on payroll tax penalties can be found in the *2003 University of Illinois Federal Tax Workbook*, pages 321–329.

In 2002, the IRS issued approximately 150,000 notices informing taxpayers that their Schedule B (where employers report employment tax liability and deposit requirements) was missing, incomplete, or illegible. Additional IRS data revealed that monthly depositors were assessed more Failure to Deposit (FTD) penalties than semiweekly depositors. Consequently, the IRS began to include penalty calculations in their notices and use less complicated language.

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In 2004, the IRS started mailing notice CP236 (Reminder to deposit semi-weekly) as an early intervention notice. The Electronic Federal Tax Payment System (EFTPS) made it easier for taxpayers to schedule, pay, and track their employment tax deposits, since incomplete coupons and misapplied payments are eliminated. The IRS also initiated a one-time penalty refund for coupon depositors if EFTPS is used to make deposits for four consecutive quarters. This relief will apply to a penalty assessed in 2004. These taxpayers receive an abatement of the last paid FTD penalty, with the credit that was used to pay the penalty becoming a refundable credit.

In 2005, a major revision is planned for Form 941, and the Record of Federal Tax Liability that should make filing simpler.

NOTICES AND NOTICE CODES

The IRS mails thousands of notices each year to taxpayers. Almost all notices use standard language. Taxpayers and practitioners are often confused by the wording of these notices because they use standard paragraphs and terms which may not completely apply to the taxpayer. Taxpayers may read through the entire notice and be confused about the true purpose or contents of the notice. All notices are numbered with computer paragraphs and are more commonly known by the CP number, which is shown at the beginning and/or the end of the letter.

The taxpayer and practitioner should determine from the tax return or payment history why a notice was sent. An explanation may be in the body of the letter or notice, but if the change is not satisfactorily explained, the taxpayer or practitioner should contact the IRS.

Normally there is a contact phone number on the notice. The taxpayer, practitioner with power of attorney, or authorized third-party designee can also visit a local IRS office for help. Documentation should be brought to the office to explain any potentially changed items. The following are the most common notices (in numerical order) and a brief explanation of the purpose of the letter:

- CP 03** — Informs the taxpayer that he may be eligible for a lower capital gains rate
- CP 11** — First notice indicating the taxpayer had a computation error on his return resulting in a balance due over \$5
- CP 12** — First notice indicating the taxpayer had a computation error on his return resulting in an overpayment of \$1 or more
- CP 13** — First notice indicating the taxpayer had a computation error resulting in an even balance
- CP 11A, 12A, and 13A** —Indicates EITC is disallowed due to SSN issues
- CP 14** — First notice indicating the taxpayer has a balance due with no math errors
- CP 15** — Informs the taxpayer that a civil penalty has been assessed
- CP 16** — First notice indicating a taxpayer had a computation error resulting in an overpayment of \$1 or more, and part or all of that overpayment was used to offset another individual tax liability (prior year, for instance)
- CP 18** — Advises the taxpayer that a portion of his refund is being withheld due to an unallowable item on the return
- CP 19** — Informs the taxpayer that there were one or more unallowable items on his return and there is a balance due
- CP 23, 24, 25** —Indicates estimated tax credits claimed on the return do not agree with the payments posted to the taxpayer's account on the individual master file (IMF) — balance due of \$5 or more (23), overpayment of \$1 or more (24), or under either of these amounts (25)
- CP 27** — Informs a low-income taxpayer of potential EITC
- CP 29** — Issued to a taxpayer to request information pertaining to the original return filed when an amended return is received and there is no record of the original return on the master file

- CP 39 — Informs the taxpayer that an overpayment from a secondary (spouse) SSN account has been applied to the balance due
- CP 42 — Informs the taxpayer that an overpayment has been used to offset a balance due in a secondary SSN account
- CP 49 — Notifies a taxpayer that an IMF overpayment has been applied to an unpaid IMF liability or liabilities
- CP 75 — Informs a taxpayer that his refund for EITC is being held while a decision is being made as to whether his return will be examined
- CP 79 and 79A — Informs a taxpayer of his obligation to recertify for EITC with a Form 8862 on the next return in which he claims EITC, or that he is banned from claiming the EITC for two years and must recertify after the ban has been lifted
- CP 90 — Final notice, notice of intent to levy, and notice of rights to a hearing
- CP 2000 — Requests verification for unreported income, payments, or credits (probably the most common and well-known notice)
- CP 2005 — Acknowledges the receipt of information concerning a taxpayer's tax liability and closing his account from the underreporter unit (CP 2006 acknowledges receipt of information, but is not a closing letter)
- CP 2501 — Initial contact notice to resolve discrepancy between income, credits, and/or deductions claimed on a taxpayer's tax return and those reported by payers on information returns

Notices between 100 and 300 relate to business master file returns. Many notices are also available in Spanish. There are hundreds of math error notices regarding all schedules and tax computation methods.

In the summer of 2004, the IRS added a new link on its website under the Tax Professionals section called "Understanding Your Notice." The taxpayer or practitioner can find an explanation of the notice as found in the internal IRS manual.

CHANGE IN IRS EXAMINATIONS

The Small Business/Self-Employed (SBSE) division of the IRS has begun a reengineering effort to improve the quality and consistency of income tax examinations, according to a spring 2004 news release. SBSE began training for tax compliance officers and revenue agents in 2004, with all training scheduled to be completed in fiscal year 2004. The IRS stated that the reengineered audit process will benefit taxpayers and practitioners because the examinations will be:

- **Better focused on relevant issues,**
- **Expectations between the examiner and taxpayer will be clearly communicated, and**
- **The time it takes to complete an examination may be reduced.**

Some of the features of the reengineered field examination process include the following:

1. Clearly communicated expectations of both the taxpayer and field agent through mandatory discussions between them regarding:
 - The specific examination issues,
 - Required documentation, and
 - A mutually agreed upon date to complete the examination.

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2. At the beginning of each examination, field agents and their managers meet to discuss:
 - The agent's approach to the examination,
 - The plan to close the examination, and
 - The mutual commitment date arrived at with the taxpayer.
3. Field agents will:
 - Use standardized templates for every examination issue to gather the information necessary to resolve issues,
 - Use a standardized guide to decide if additional issues need to be added to the examination, and
 - Explain to the taxpayer if any additional issues are included in the examination.
4. In the office examination process, the examiners will:
 - Arrive at expectations of the taxpayer and the examiner prior to the initial appointment,
 - Provide the taxpayer with focused document requests that specifically identify the information needed,
 - Have improved flexibility in the scheduling process to reduce the time it takes to complete an examination, and
 - Have standardized templates and guides to assist in the scope and depth of the examination.

ELECTRONIC FILING

IRS statistics from the 2004 filing season set new records in various electronic categories. Commissioner Everson predicts that half of all individual returns will be filed electronically in 2005. Statistics reported through the end of April 2004 include:

- Of all Form 1040 returns filed, approximately 50% were filed electronically.
- Computer e-filed returns rose 17.2% to 55,987,000, and TeleFile returns decreased 6.4% to 3,758,000. Returns prepared electronically by practitioners increased 15.8% to 41,724,000, and taxpayer-prepared electronic returns increased 21.7% to 14,263,000.
- The 89.3 million refunds totaled \$184 billion, for an average refund of \$2,063. This is a 5% increase. Approximately 47 million refunds were elected under direct deposit. This is an increase of 11%. The average direct deposit refund was \$2,430, which is a 3.6% increase from 2003.
- In its second year, use of the Free File partnership between the IRS and the group of tax software companies increased 26% to 3.4 million returns.
- Over 19.2 million taxpayers inquired about the status of their refund using the IRS website and its "Where's My Refund?" link.

ABUSIVE TAX AVOIDANCE TRANSACTIONS

The IRS on their internal intranet site has set up an Abusive Tax Avoidance Transactions (ATAT) home page. On this page, examiners can read news releases by newspapers and the Department of Justice to keep up to date on the status of the many individuals who have been indicted under the ATAT program. Examiners can also get information on specific promotions such as the following:

- Anderson's Ark
- Aegis, a promoter group
- ADA (Americans with Disabilities Act) schemes, where promoters promise tax credit for various equipment citing IRC §44, the disabled access credit
- Basis shifting schemes
- Charitable foundations, charitable remainder trusts, charitable lead trusts, charitable family limited partnerships, etc.
- Claim of right under IRC §1341
- Common trust fund straddle tax shelters
- Corporation sole schemes (a one-person religious organization)
- Executive compensation schemes
- Home-based businesses selling a "tax relief system"
- Innovative Financial Consultants (a promoter group)
- Lease stripping schemes
- Off-shore employee leasing and off-shore deferred compensation plans
- Producer-owned reinsurance companies
- Questionable W-4 program
- Reparations schemes (slavery, etc.)
- IRC §351 contingent liabilities
- IRC §419 plans (using employee welfare, long-term care plans, malpractice and disability arrangements and other "donor-directed funds" or Voluntary Employees Beneficiary Associations (VEBA) to avoid taxes)
- IRC §861 schemes
- Son of Boss transactions and proposed settlements issued in summer 2004

According to the North American Securities Administrators Association, during 1999 through 2001, con artists in 27 states have taken advantage of at least 90,000 investors who lost more than \$1.8 billion due to religious "affinity fraud" schemes. Following are the main reasons that promoters use these schemes:

- Charitable entities have less chance of being audited.
- Ease of obtaining tax-exempt status.
- Double benefit — deferring or exempting income and also creating a tax deduction.

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- Trusts claiming a charitable deduction because the deduction is unlimited and the contribution can be made to a foreign entity.
- Rules are complex and easily manipulated.
- Artificial charitable intent makes taxpayers feel good about giving to needy causes.
- It is a sensitive area for IRS to manage.

Note. Additional information can be found in Chapter 13, Rulings and Cases, Tax Fraud Section.

EFTPS EXPRESS ENROLLMENT

The IRS launched a new program for new business taxpayers designed to boost electronic payment of taxes. This development offers some taxpayers new, quicker access to an electronic payment system.

This initiative will be available using the electronic federal tax payment system (EFTPS), a service offered free by two bureaus of the U.S. Department of the Treasury, the IRS, and the Financial Management Service (FMS). In fiscal year 2003, the Treasury collected more than \$1.5 trillion in electronic tax payments through EFTPS. The launch of this new initiative will help increase growth in tax year 2004. EFTPS enables taxpayers and tax professionals to make federal tax payments electronically online, by phone, or with batch provider software for professionals.

EFTPS Express Enrollment for New Businesses will affect all businesses receiving a new employer identification number (EIN). Business taxpayers with a federal tax obligation will be automatically pre-enrolled in EFTPS to make all their federal tax deposits.

In addition to receiving their EINs, taxpayers will also receive a separate mailing containing an EFTPS PIN and instructions for activating their enrollment. New business taxpayers will activate their enrollment by calling a toll-free number, entering their banking information, and completing an authorization for EFTPS to transfer funds from their account to the Treasury's account for tax payments per their instructions.

“There are approximately 250,000 new EINs issued every year. With EFTPS Express Enrollment, we are making it even easier for business taxpayers to make their business payments electronically,” said IRS Commissioner Mark W. Everson.

“Paying taxes using EFTPS means 19 times greater accuracy,” said Dick Gregg, FMS Commissioner. “Greater accuracy means fewer penalties. I encourage individuals and businesses to enroll today.”

Taxpayers can enroll in EFTPS by visiting the EFTPS-Online website at www.eftps.gov, or by calling EFTPS Customer Service at 1-800-555-4477 or 1-800-945-8400 to receive an enrollment form by mail.

EFTPS EXPRESS ENROLLMENT: FREQUENTLY ASKED QUESTIONS AND ANSWERS

Question 1. What is Express Enrollment for New Business?

Answer 1. Express Enrollment for New Businesses allows business taxpayers with a federal tax obligation to begin making their federal tax deposits (FTDs) more quickly and accurately through EFTPS. When they receive an EIN from the IRS, they will be pre-enrolled in EFTPS allowing them to make all payments electronically, online or by phone.

Question 2. How does Express Enrollment for New Businesses work?

Answer 2. Beginning in January 2004, all businesses issued a new EIN will be pre-enrolled in EFTPS to make their federal tax payments if they will have federal tax obligations. In addition to receiving their EIN, they will also receive a separate mailing containing instructions for activating their EFTPS enrollment.

Question 3. Who can use Express Enrollment for New Businesses?

Answer 3. After January 1, 2004, all businesses requesting a new EIN that also indicate federal tax obligations and receive the EFTPS enrollment activation mailing (including their PIN), can use Express Enrollment for New Businesses.

Question 4. Can businesses still use FTD coupons?

Answer 4. The taxpayer will receive from the IRS its EIN, IRS Notice (CP575), and one coupon. Thereafter, taxpayers will have the option to order FTD coupons from the IRS if they wish to make additional payments by check. Coupons arrive by mail within five to six weeks.

Question 5. How does this differ from regular EFTPS?

Answer 5. Usually taxpayers enroll in EFTPS by completing a paper enrollment Form 9779, or by going online (www.eftps.gov) to enter their information. Once the taxpayer's enrollment information is received by EFTPS, it takes approximately two weeks to process. Express enrollment completes the enrollment step in advance for new businesses with tax obligations. Once taxpayers activate their EFTPS enrollment, they can make payments by phone. If they choose to obtain an Internet password, they can also make payments online.

Question 6. How do taxpayers activate their EFTPS enrollment?

Answer 6. Taxpayers receive instructions by mail shortly after receiving their EIN. They are instructed to follow these steps to activate their EFTPS enrollment. The taxpayers:

1. Call the toll-free number listed in their EFTPS PIN package and follow the instructions from the voice response system.
2. Enter their financial institution information (bank and account number).
3. Choose to have the bank verify that the entered account number is valid.

Note: If taxpayers choose not to have their bank account number verified, they can begin making payments after all the activation steps have been completed by calling the EFTPS payment number. If they wish to have their account verified, it will delay making a payment by approximately six business days. Taxpayers are responsible for the accuracy of the number they enter. If it is incorrect, their financial institution may return the payment and the taxpayer may incur an IRS penalty for late payment.

4. Authorize withdrawals of electronic payments from their account.
5. Enter their phone number.
6. Write down the EFTPS confirmation number.
7. Decide if they want the option of obtaining an Internet password to make payments online.
8. Receive an EFTPS Confirmation/Update package by mail within seven to ten days that contains a Confirmation/Update Form, an EFTPS Payment Instruction Booklet, and an Internet password brochure.

EFTPS dedicated Customer Service numbers are listed for taxpayers to call with any questions, 24 hours per day, seven days per week: 1-800-555-4477 or 1-800-945-8400.

Question 7. Can taxpayers use the Internet right away to make payments?

Answer 7. Yes. Once taxpayers activate their enrollment and obtain an Internet password by phone, they can make payments immediately (online or by phone) if they chose not to have their bank account verified. If they chose to have their bank account number verified, they will need to wait an additional six business days for completion of the verification process.

Question 8. How will taxpayers know if their payments have been made?

Answer 8. For each payment made through EFTPS, the taxpayer receives an immediate acknowledgment number that can be used to track the payment and communicate with the IRS. This acknowledgment number acts as a receipt for the payment. Taxpayers can go online or call EFTPS Customer Service to verify payments and review up to 16 months of their payment history.

Question 9. What if a business taxpayer chooses not to activate his EFTPS enrollment?

Answer 9. While the taxpayer has the option not to activate their EFTPS enrollment, EFTPS will periodically encourage taxpayers, via mail, to consider using EFTPS.

FEDERAL TAX DEPOSIT (FTD) PENALTY RELIEF

The IRS announced nationwide implementation of the FTD-EFTPS penalty refund offer. This offer allows paper coupon users who were assessed a Form 941 deposit penalty the opportunity to receive a one-time penalty refund. To qualify, the employer must:

- Use EFTPS for one year (four consecutive quarters)
- Make all Form 941 payments on time, and
- Fully pay the penalty.

In April 2005, after the returns are filed for the fourth quarter of 2004, the IRS will automatically determine which employers have achieved the four quarters of EFTPS compliance and reverse the taxpayer's most recent full-paid FTD penalty. The refunds will be issued on a quarterly basis following the scheduled Form 941 due dates.

The IRS computer will look back up to four quarters prior to the four-quarter compliance period for a fully paid FTD penalty to refund. Therefore, taxpayers will want to enroll and use EFTPS for four quarters before their most recent penalty is too far in the past to be refunded. The IRS computer will automatically refund the penalty if they qualify. For example, if they use EFTPS for all four quarters in 2004, the computer will look back as far as the quarter beginning January 1, 2003, for a full paid FTD penalty.

Every quarter, beginning in early 2005, the IRS computer will look for accounts that have met the qualifications and automatically refund the most recent penalty incurred prior to the start of the taxpayer's four-quarter EFTPS compliance period.

Federal Tax Deposit (FTD) Penalty Relief- Frequently Asked Questions and Answers

Question 1. Why should a taxpayer use EFTPS?

Answer 1. It's fast, easy, accurate, and secure. There are verification steps along the way that eliminate 90% of paper coupon errors. It is available 24 hours a day, seven days a week, even when the taxpayer is away from home. In addition, the taxpayer receives an Electronic Funds Transfer (EFT) Acknowledgement Number, and he can review all electronic payments made within the last 16 months.

Question 2. Does the IRS have access to the taxpayer's checking account?

Answer 2. No. The IRS does not have access to the account when the employer initiates tax payments through EFTPS. The Financial Management Service, a separate division of the Department of Treasury, operates EFTPS. What is sent to the IRS is confirmation that the payment has been made, so that the credit can be posted to the taxpayer's account.

Question 3. Does a taxpayer have to start using EFTPS at the beginning of the calendar year in order to qualify for the refund?

Answer 3. No. The first quarter counted toward his four-quarter EFTPS use does not have to be at the beginning of the calendar year. If he does not enroll in time to use EFTPS for that quarter, he can start his four-quarter EFTPS use at the beginning of any later quarter.

Question 4. The taxpayer is in a seasonal business, and, in some quarters, he does not have any employees. Will these quarters still count for EFTPS use?

Answer 4. Seasonal employees must use EFTPS for four quarters too, but those four quarters may be spread out over more than 12 months.

Question 5. Does the taxpayer have to pay the penalty that was assessed?

Answer 5. Yes. However, if she qualifies for the refund, IRS will refund the money with interest. The penalty won't be refunded if she does not pay the penalty in full.

Question 6. Which penalty will be refunded?

Answer 6. The most recent penalty incurred prior to the start of the taxpayer's four-quarter compliance period will be refunded. The computer will look back up to four quarters to find a full-paid FTD penalty.

Question 7. If a taxpayer receives a penalty refund and stops using EFTPS, can he qualify a second time?

Answer 7. No. This is a one-time offer.

Question 8. If a taxpayer stops using EFTPS before the four-quarter compliance period ends, can she start over?

Answer 8. Yes. A taxpayer can start her new four-quarter compliance period at the beginning of the next quarter.

Question 9. How will a taxpayer get her penalty refund?

Answer 9. IRS will issue a check.

Question 10. How long will it take to receive the refund?

Answer 10. The first refunds are scheduled for late April of 2005 after IRS has finished processing the Form 941 returns for the 4th quarter of 2004. However, if the taxpayer has outstanding tax liabilities, the refund will first be applied to those liabilities and the excess, if any, will be refunded.

Question 11. Some quarters the taxpayer sends the IRS a check with her return. Will she still qualify for the penalty refund?

Answer 11. No. To qualify for a refund, she must use EFTPS to pay all Form 941 taxes for all four quarters. This includes any payments that are due with the return.

Question 12. If a taxpayer is already signed-up for and using EFTPS for all his Form 941 payments, will he qualify for the refund if he was assessed an FTD penalty before he started using EFTPS?

Answer 12. Yes. Employers who began using EFTPS prior to the opening of the offer won't be disqualified. When the first batch of refunds is issued in 2005, the IRS computer will look for quarters of EFTPS use. Each consecutive "extra" quarter (up to four) will extend the refund look-back period by a quarter- provided the statute of limitations for issuing the refund is not expired.

Question 13. A taxpayer is required to use EFTPS. Will she qualify for a refund?

Answer 13. No. The offer is open to voluntary EFTPS users. However, if she begins her four quarters of EFTPS compliance before she is required to use EFTPS, she will not be disqualified.

Question 14. What if a taxpayer has additional questions about the penalty refund offer?

Answer 14. First, review IRS Publication 4048, *Special IRS Penalty Refund Offer Effective January 2004*. If there are additional questions about the Penalty Refund Program, the taxpayer can call the Business and Specialty Tax Lines at 800-829-4933 or TPS Customer Service at 800-555-4477 or 800-945-8400. Taxpayer's can learn more about EFTPS at www.irs.gov or www.eftps.gov.

MODERNIZED e-FILE (MeF) AND EMPLOYMENT TAX ADDRESSES

MODERNIZED e-FILE (MeF) INTERNET FILING

IRS *e-file* has been modernized and has new electronic filing options. Forms 1120, 1120S, 990, 990EZ, 1120-POL, and 8868 can be filed through the Internet.

Taxpayers who have already registered and applied as an authorized IRS *e-file* provider will login to modernized e-file (MeF) Internet filing to transmit returns and retrieve acknowledgements.

If a taxpayer does not have an e-service's user name or password or has not applied to be an Internet filer, he must go to the e-services web page to register and apply to be an Internet filer.

For additional information on MeF Internet filing, refer to Pub. 4164, *Modernized e-File Guide for Software Developers and Transmitters*.

FORM 1120 (U.S. CORPORATION INCOME TAX RETURN) AND FORM 1120S (U.S. INCOME TAX RETURN FOR AN S CORPORATION) e-FILE

What:

The IRS has enhanced the electronic filing process to include Forms 1120 and 1120S under the IRS *e-file* program. The 1120/1120S *e-file* program was launched in February 2004. The 1120 *e-file* program includes file and pay capabilities, and returns are processed on a transaction basis rather than in batch mode. Release 1 contains 53 forms and schedules, and Release 2 (scheduled mid 2004), will have the remaining 43 forms.

Why:

1. Its convenient
 - Fast electronic acknowledgement of return receipt
 - Easy to understand error messages in plain language
 - Tax preparation work is automated with return preparation software that performs calculations and highlights needed forms and schedules
 - Electronic Form 8453, *U.S. Individual Income Tax Declaration for an IRS e-file Return*, can be included as a PDF attachment
2. Fast
 - Information is quickly available to IRS Customer Service sites
3. Accurate
 - Fewer risks of transcription errors
 - 99% accuracy rate

4. Safe

- Tax information is secure
- Only authorized users have access to the system

Who:

Any business taxpayer who files Form 1120/1120S may e-file their return through an Authorized IRS *e-file* provider. A listing of 1120/1120S *e-file* approved providers is now available. Additional providers are added as they become available.

How:

Tax professionals who plan to file Forms 1120/1120S electronically must submit a new or revised Application to Participate in the IRS *e-file* Program at www.irs.gov/efile, go to the Tax Professional page and click on e-services. Form 8633 Frequently Asked Questions.

Tax preparers are encouraged to talk to their software provider to see if they plan to include the new 1120/1120S *e-file* program in their tax preparation software packages.

If the corporate taxpayer wants to participate in 1120/1120S *e-file*, he should talk to his preparer to determine whether the preparer plans to offer the service to her clients.

ADDITIONAL INFORMATION

Taxpayers and tax practitioners can read Publication 4163, *Modernized e-file Information for Authorized IRS e-file Providers of Forms 1120/1120S* for additional information.

Forms and Schedules for 1120/1120S e-file

The following forms are either available for e-file now or will be in the near future.

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Form Name	Title
1120	U.S. Corporation Income Tax Return
Schedule D (Form 1120)	Capital Gains and Losses
Schedule H (Form 1120)	Section 280H Limitations for a Personal Service Corporation (PSC)
Schedule N (Form 1120), Foreign Operations of U.S. Corporations	Schedule N (Form 1120), Foreign Operations of U.S. Corporations
Schedule PH (Form 1120)	U.S. Personal Holding Company (PHC) Tax
Form 851	Affiliations Schedule
Form 926	Return by a U.S. Transferor of Property to a Foreign Corporation
970	Application to Use LIFO Inventory Method
972	Consent of Shareholder to Include Specific Amount in Gross Income
973	Corporation Claim for Deduction for Consent Dividends
982	Reduction of Tax Attributes Due to Discharge of Indebtedness (and Sec 1082 Basis Adjustment)
Schedule F (Form 1040)	Profit or Loss from Farming
1118	Foreign Tax Credit — Corporations
Schedule I (Form 1118)	Reduction of Oil and Gas
Schedule J (Form 1118)	Adjustments to Separate Limitation Income (Loss) Categories for Determining Numerators of Limitation Fractions
1122	Authorization and Consent of Subsidiary Corporation to be Included in a Consolidated Income Tax Return
2220	Underpayment of Estimated Tax by Corporations
2439	Notice to Shareholder of Undistributed Long-Term Capital Gains
3115	Application for Change in Accounting Method
3468	Investment Credit
3800	General Business Credits
4136	Credit for Federal Tax Paid on Fuels
4255	Recapture of Investment Credit
4466	Corporation Application for Quick Refund of Overpayment of Estimated Tax
4562	Depreciation and Amortization
4626	Alternative Minimum Tax — Corporations
4684	Casualties and Thefts
4797	Sale of Business Property
5452	Corporate Report of Nondividend Distributions

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Form Name	Title
5471	Information Return of U.S. Persons With Respect to Certain Foreign Corporations
Schedule J (Form 5471)	Accumulated Earning and Profits (E&P) of Controlled Foreign Corporation
Schedule M (Form 5471),	Transactions Between Controlled Foreign Corporation and Shareholders or Other Related Persons
Schedule O (Form 5471),	Organization or Reorganization of Foreign Corporation and Acquisitions and Dispositions of its Stock
5472	Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business
5712-A	Election and Verification of the Cost Sharing or Profit Split Method Under Section 936(h)(5)
5713	International Boycott Report
Schedule A (Form 5713)	International Boycott Factor (Sec 999(c)(1))
Schedule B (Form 5713)	Specifically Attributable Taxes and Income (Sec 999(c)(2))
Schedule C (Form 5713)	Tax Effect of the International Boycott Provisions
5735	Computation of Possessions Corporation Tax Credit (Under Sections 936 and 30A)
Schedule P (Form 5735)	Allocation of Income and Expenses Under Section 936(h)(5)
5884	Work Opportunity Credit
6198	At-Risk Limitations
6252	Installment Sale Income
6478	Credit for Alcohol Used as Fuel
6765	Credit for Increasing Research Activities
6781	Gains and Losses from Sec 1256 Contracts and Straddles
8050	Direct Deposit of Corporate Tax Refund
8082	Notice of Inconsistent Treatment or Amended Return
8271	Investor Reporting of Tax Shelter Registration Number
8275	Disclosure Statement
8275-R	Regulation Disclosure Statement
8283	Noncash Charitable Contributions
8586	Low-Income Housing Credit
8594	Asset Acquisition Statement
8609	Low-Income Housing Credit Allocation Certificate
Schedule A (Form 8609)	Annual Statement — Low Income Housing Credit Allocation
8611	Recapture of Low-Income Housing Credit

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Form Name	Title
8621	Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund
8697	Interest Computation Under the Look-Back Method for Completed Long-Term Contracts
8716	Election To Have a Tax Year Other Than a Required Tax Year
8810	Corporate Passive Activity Loss and Credit Limitations
8816	Special Loss Discount Account and Special Estimated Tax Payments for Insurance Companies
8820	Orphan Drug Credit
8824	Like-Kind Exchanges
8825	Rental Real Estate Income & Expenses of a Partnership or an S Corporation
8826	Disabled Access Credit
8827	Credit for Prior Year Minimum Tax — Corporations
8830	Enhanced Oil Recovery Credit
8832	Entity Classification Election
8833	Treaty-Based Return Position Disclosure Under Sec 6114 or 7701(b)
8834	Qualified Electric Vehicle Credit
8835	Renewable Electricity Production Credit
8838	Consent To Extend the Time To Assess Tax Under Sec 367 — Gain Recognition Agreement
8844	Empowerment Zone Employment Credit
8845	Indian Employment Credit
8846	Credit for Employer Social Security and Medicare Taxes Paid on Certain Employees
8847	Credit for Contributions to Selected Community Development Corporations
8860	Qualified Zone Academy Bond Credit
8861	Welfare-to-Work Credit
8865	Return of U.S. Persons With Respect to Certain Foreign Partnerships
Schedule K-1 (Form 8865)	Partner's Share of Income, Credits, Deductions, etc.
Schedule O (Form 8865)	Transfer of Property to a Foreign Partnership
Schedule P (Form 8865)	Acquisitions, Dispositions, and Changes of Interests in a Foreign Partnership
8866	Interest Computation Under the Look-Back Method for Property Depreciated Under the Income Forecast Method
8873	Extra-territorial Income Exclusion

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Form Name	Title
8874	New Markets Tax Credit
8881	Credit for Small Employer-Pension Plan Startup Costs
8882	Credit for Employer-Provided Child Care Facilities and Services
8883	Asset Allocation Statement Under Section 338
8884	New York Liberty Zone Business Employee Credit
8886	Reportable Transaction Disclosure Statement
Form T	Timber & Forest Activities Schedules
1120S	U.S. S Corporation Income Tax Return
1120S Sch D	S Corporation Capital Gains and Losses
1120S Sch K-1	S Corporation Section 280H Limitations for a Personal Service Corporation (PSC)

e-FILE FOR CHARITIES AND NON-PROFITS

What:

The IRS new modernized e-file process includes options for Form 990/990EZ under the IRS *e-file* program, which began in February 2004. The National Association of State Charity Officials (NASCO) has partnered with the IRS to ensure that state requirements are considered. Currently, 37 states/local governments currently accept Form 990/990EZ to satisfy their filing or registration requirements.

Form 990 is used by tax-exempt organizations including charities, private foundations and non-profit organizations to provide disclosure of releasable data to the public as provided by law. Release I includes Forms 990, 990EZ, 1120 POL and 8868. The remaining Form 990 types will be included in a later release.

Why:

1. It's Convenient
 - Fast electronic acknowledgement that Form 990 has been received for processing
 - Exempt organizations can file Form 990 at a location using a multi-purpose form
 - Tax preparation is automated with return preparation software that performs calculations, and highlights needed forms and schedules
 - Easily understandable error messages
2. Fast
 - Information is quickly available to IRS Customer Service sites
 - Quick processing time

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3. Accurate

- Less risks of transcription errors
- 99% accuracy rate

4. Safe

- Tax information is secure
- Only authorized users have access to the system

Who:

Any exempt taxpayer who files Form 990/990EZ may participate. Tax professionals who plan to participate, must complete a new or revised Application to Participate in the IRS *e-file* Program at www.irs.gov/efile.

How:

The *Approved IRS e-file Providers* listing contains links to companies who offer 990 e-file. Answers to taxpayer questions regarding application procedures, including revising or submitting a new *Application to Participate in the IRS e-file Program*, are contained in the Form 8633, *Frequently Asked Questions (FAQ)*.

ADDITIONAL INFORMATION:

The following additional information can be found on the IRS website at www.irs.gov.

- e-file for Tax Professionals
- e-file for Software Developers & Transmitters
- Tax Information for Charities & Other Non-Profits
- e-file for Business and Self-Employed Taxpayers

WHERE TO FILE ADDRESSES FOR 2004

Filing addresses can also be found on the IRS website by searching for the following topics:

- Where to File Addresses for Individual Taxpayers By State
- Where to File Addresses for Tax Professionals By State
- Where to File Addresses for Individual Taxpayers by Return Type
- Where to File Addresses for Tax Professionals By Return Type
- Where to File Business Forms and Filing Addresses