

MSP
#17**INSTALLMENT AGREEMENTS (IAs): The IRS Is Failing to Properly Evaluate Taxpayers' Living Expenses and Is Placing Taxpayers in IAs They Cannot Afford****RESPONSIBLE OFFICIALS**

Mary Beth Murphy, Commissioner, Small Business/Self-Employed Division
Debra Holland, Commissioner, Wage and Investment Division

TAXPAYER RIGHTS IMPACTED¹

- *The Right to Pay No More Than the Correct Amount of Tax*
- *The Right to Finality*
- *The Right to Privacy*
- *The Right to a Fair and Just Tax System*

DEFINITION OF PROBLEM

Internal Revenue Code (IRC) § 6159 authorizes the IRS to enter into an agreement with a taxpayer to pay any tax due in installments to facilitate full or partial collection of the tax.² Collectively, these agreements are known as installment agreements (IAs), of which the IRS offers several types to assist taxpayers in resolving their tax liabilities.³ Across all types of IAs, the default rate — the rate at which taxpayers fail to make payments as agreed — is over 13 percent in fiscal year (FY) 2016.⁴ This seemingly low overall default rate masks issues with certain types of IAs and economic hardship for taxpayers who continue to pay IAs despite not having enough income to support the payments proposed by the IRS. TAS review of IRS data found:

- Partial Pay Installment Agreements (PPIAs) have a default rate of nearly 28 percent;⁵
- IAs worked by IRS field employees and Automated Collection Services (ACS) defaulted at rates of 26 and 20 percent, respectively;⁶

1 See Taxpayer Bill of Rights (TBOR), www.TaxpayerAdvocate.irs.gov/taxpayer-rights. The rights contained in the TBOR are now listed in the Internal Revenue Code (IRC). See Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, Division Q, Title IV, § 401(a) (2015) (codified at IRC § 7803(a)(3)).

2 IRC § 6159.

3 Internal Revenue Manual (IRM) 5.14, *Installment Agreements* (Jan. 7, 2016).

4 IRS, *Installment Agreement (IA) Default Rate Report* (Oct. 6, 2016). Overall, 13.23 percent of all IAs defaulted in FY 2016.

5 IRS, *IA Default Rate Report* (Oct. 6, 2016). PPIAs defaulted at a rate of 27.84 percent in FY 2016.

6 *Id.* Field worked IAs defaulted at a rate of 26.24 percent and Automated Collection Services (ACS) IAs defaulted at a rate of 20.11 percent in FY 2016.

- Nearly 300,000 taxpayers who should have qualified for currently not collectible (CNC) status had entered into installment agreements in calendar year 2014 despite their income being below the IRS allowable living expense (ALE) standards;⁷ and
- Over 46,000 taxpayers with balances due of greater than \$10,000, whose incomes were less than their ALEs, and who entered into IAs in 2014 subsequently defaulted by FY 2016.⁸ This is about 43 percent of the taxpayers with these characteristics.

The higher rates of default on certain types of IAs and the number of taxpayers who may be paying their IAs at the expense of necessary living expenses indicates that the IRS is not conducting appropriate financial analysis or providing the tools for taxpayers to conduct an analysis before entering into streamlined IAs and is placing taxpayers in IAs that they cannot afford. The consequences to the taxpayer and the IRS of placing taxpayers in unaffordable IAs include:

- Rework for the IRS when a taxpayer defaults;
- Wasted IRS resources;
- The inability of a taxpayer to qualify for another guaranteed IA in the subsequent five year period;⁹ and
- An additional user fee for the taxpayer if the taxpayer requests a reinstatement of a defaulted IA.¹⁰

The IRS has the data available to determine if a taxpayer has the appropriate income to support payments under an IA and should use this data in making determinations about the taxpayer's ability to pay and appropriate collection alternatives for each taxpayer in order to prevent rework for the IRS, reduce burden and frustration for taxpayers, and craft individual taxpayer solutions that encourage current and future compliance.¹¹ As the IRS moves on its "Future State" plans, it should focus on using data and technology to assist taxpayers entering into realistic and affordable payment arrangements instead of relying upon a one-size-fits-all strategy.

ANALYSIS OF PROBLEM

Background

Taxpayers are required to pay their taxes throughout the year in a pay as they go fashion, either through income tax withholding from their paychecks or through quarterly estimated tax payments. However, in Tax Year 2015, the IRS received over 27 million returns with balances due; of those, over seven million did not include full payment with the return.¹² The IRS generally has ten years from the date

7 Research Study: *The Importance of Financial Analysis in Installment Agreements (IAs) in Minimizing Defaults and Preventing Future Payment Noncompliance*, vol. 2, *infra*. TAS research found 286,141 taxpayers who entered into an IA in 2014 despite TPI less than ALEs after eliminating accounts where abatements were at least half of the balance (including accruals), refund offsets that were at least 95 percent of the balance, or cases where the IRS classified a taxpayer prior to CNC subsequent to the initial TDA in 2014.

8 Research Study: *The Importance of Financial Analysis in Installment Agreements (IAs) in Minimizing Defaults and Preventing Future Payment Noncompliance*, vol. 2, *infra*. TAS research found that 42.8 percent of taxpayers with total positive income (TPI) less than their ALEs who had balances due of greater than \$10,000 and entered into IAs in FY 2014 defaulted by FY 2016.

9 IRM 5.14.11.5(2)(b) (Jan. 1, 2015).

10 IRM 5.19.1.5.4.6(4) (Sept. 29, 2014).

11 TAS, *Importance of Financial Analysis in Installment Agreements Research Study* (2016).

12 IRS, *Individual Returns Transaction File* (Dec. 20, 2016); IRS, *Compliance Data Warehouse* (Dec. 20, 2016).

TAS research suggests that the IRS is placing taxpayers into Installment Agreements (IA) where their total positive income is less than their Allowable Living Expenses. Taxpayers may agree to an IA they can't afford out of fear of the IRS, a misunderstanding of the options available, or out of obligation to repay their debts at any costs.

of assessment to collect the tax due — known as the collection statute expiration date (CSED).¹³ There are a variety of payment options for taxpayers that depend on factors such as the amount owed and the taxpayer's compliance history.¹⁴

IAs are offered as a collection alternative mutually beneficial to taxpayers and the IRS — taxpayers can make payments to the IRS over time and spread out the burden of paying their tax accounts, and the IRS can increase revenue by collecting portions of tax due rather than nothing.¹⁵ The IRS offers several types of IAs.¹⁶ Congress has recognized the value of IAs, and in the IRS Restructuring and Reform Act of 1998 (RRA 98), it required the IRS to accept an IA proposal from a taxpayer if the taxpayer owed less than \$10,000, had not failed to file a required tax return in the previous five years, failed to pay any tax shown on such return or entered into an IA, could not full pay the liability when due, and would full pay the tax due within three years of the agreement.¹⁷ This is known as a “guaranteed” IA.

Subsequently, the IRS administratively created a “streamlined” IA by increasing the limit of tax due allowed under “guaranteed” IAs and the length of time granted to the taxpayer to repay the debt.¹⁸ Today, streamlined IAs are available to taxpayers with balances due of \$50,000 or less which will be repaid in installments in six years or less.¹⁹ Other IAs, such as regular (non-streamlined) IAs and PPIAs require financial analysis and the completion of a Collection Information Statement (CIS) and generally require user fees and result in the filing of a Notice of Federal Tax Lien (NFTL).²⁰

13 IRC § 6502(a).

14 See, e.g., IRC § 6159; IRC § 7122.

15 When a taxpayer enters into an IA, interest continues to accrue daily on the balance due from the due date of the first IA payment. IRC § 6601(b). A taxpayer who fails to pay the full balance due on the return is subject to the failure to pay (FTP) penalty under IRC § 6651 at a rate of 0.5 percent of the balance due per month or fraction of a month up to 25 percent of the total tax due. While the FTP penalty continues to accrue for the duration of an IA, Congress has encouraged the use of IAs by reducing the penalty to 0.25 percent per month or fraction of month on balances due where the taxpayer has entered into an IA. IRC § 6651(h).

16 IRM 5.14, *Installment Agreements* (Jan. 7, 2016).

17 IRS Restructuring and Reform Act of 1998, Pub. L. No. 105-206, § 3467, 112 Stat. 685 (1998) (codified at IRC § 6159(c)). This legislation codified the IRS's standard practice. Conf. Rep. No. 105-599, at 292-93 (1998). “Streamlined,” “guaranteed,” and “in-business trust fund express” IAs are all very similar and none of them require an analysis of the taxpayer's ability to pay. See IRM 5.14.5.1 (May 23, 2014).

18 See Memorandum from Assistant Commissioner (Collection), *Increase in Streamlined Installment Agreement Dollar Authority* (Mar. 31, 1998), reprinted as, *Memo on Streamlined Installment Agreements Released*, 1999 TNT 111-26 (June 10, 1999). See also IRM 5.14.2.2 (Oct. 18, 1999); Memorandum from Assistant Commissioner (Collection), *Increase in Streamlined Installment Agreement Authority* (Mar. 17, 1999), reprinted as, *Memo on Streamlined Installment Agreements Released*, 1999 TNT 111-24 (June 10, 1999). However, this guidance contemplated a conversation between the IRS and taxpayers. *Id.* (noting “[t]axpayers should be questioned on the amount they can pay every month...”).

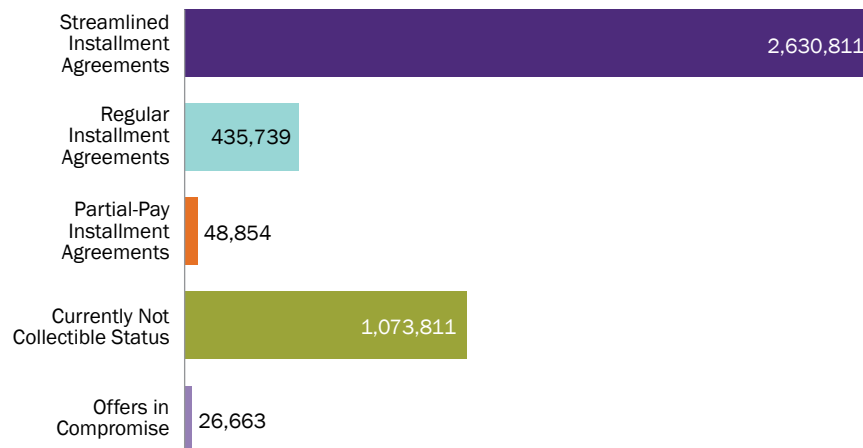
19 IRM 5.14.5, *Streamlined Installment Agreements* (Dec. 23, 2015).

20 IRM 5.14.1.2, *Installment Agreements and Taxpayer Rights* (Jan. 1, 2016). See, e.g., National Taxpayer Advocate 2012 Annual Report to Congress 403-25; National Taxpayer Advocate 2011 Annual Report to Congress 109-28; National Taxpayer Advocate 2010 Annual Report to Congress 302-10; National Taxpayer Advocate 2009 Annual Report to Congress 17-40. See also Taxpayer Assistance Directives (TADs) 2010-1 and 2010-2 (Jan. 20, 2010). For copies of the TADs, see National Taxpayer Advocate Fiscal Year 2011 Objectives Report to Congress, Appendix VIII, <http://www.irs.gov/pub/irs-utl/nta2011objectivesfinal.pdf>. However, under IRC § 6323(j)(1)(B), the IRS may withdraw a Notice of Federal Tax Lien (NFTL) if the taxpayer enters into an IA, causing unnecessary burden and delay for the taxpayer to then request the withdrawal of an NFTL issued in concurrence with an IA.

The IRS granted over 3,000,000 IAs of all types in FY 2016.²¹ This includes 2,630,811 streamlined IAs compared to 48,854 PPIAs, and 435,739 regular IAs.²² In contrast, the IRS approved 26,663 offers in compromise (OICs) and placed 1,073,811 accounts into CNC status in FY 2016.²³ IAs, and in particular, streamlined IAs, are the most frequently used collection alternative at the IRS.

FIGURE 1.17.1

Alternative Collection Arrangements in FY 2016



Allowable Living Expenses May Not Reflect the True Ability of Taxpayers to Make Installment Agreement Payments

Expenses are allowable if they are “necessary to provide for a taxpayer’s and his or her family’s health and welfare and/or production of income.”²⁴ IRC § 7122(d)(2)(A) mandates that the IRS “develop and publish schedules of national and local allowances designed to provide that taxpayers entering into a compromise have an adequate means to provide for basic living expenses.”²⁵ These ALEs are used to calculate a taxpayer’s ability to make IA payments. However, the standard of “necessary” is not defined in this context in the IRC or Treasury Regulations; instead, the IRS has determined what are “necessary” expenses using its own discretion. In fact, the Treasury Regulations relating to ALEs specifically state that taxpayers shall retain “sufficient” income to pay basic living expenses and this amount should be determined based on the individual taxpayer’s circumstances.²⁶

ALEs are based on both national and localized costs using data from the Bureau of Labor Statistics and the Census Bureau.²⁷ Notably, ALEs have not been updated to include expenses that many families

21 IRS, Collection Activity Report 5000-6 (Oct. 3, 2016). The IRS granted 3,115,404 IAs of all types in FY 2016.

22 *Id.*

23 IRS, Collection Activity Reports 5000-108 (Oct. 4, 2016), 5000-149 (Oct. 3, 2016).

24 IRM 5.15.1.7(1), *Allowable Expense Overview* (Oct. 2, 2012). For a full discussion of the National Taxpayer Advocate’s concerns about ALEs, see Most Serious Problem: *The IRS Should Reevaluate How It Develops and Uses Allowable Living Expense (ALE) Standards to Ensure Taxpayers Can Maintain a Basic Standard of Living for the Health and Welfare of Their Household While Complying with Their Tax Obligations*, *supra*.

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

26 Treas. Reg. § 301.7122-1(c)(2)(i).

27 IRM 5.15.1.7 (Oct. 2, 2012).

Nearly 300,000 taxpayer accounts that should have qualified for currently not collectible status ... (69 percent) are being resolved by the taxpayer making payments, not because of abatements by the IRS or offsets of the taxpayers' refunds, indicating that the taxpayers are paying their accounts despite having total positive income less than Allowable Living Expenses, suggesting the taxpayers are prioritizing paying the IRS over meeting their necessary living expenses.

consider necessary to function in today's society. For example, the IRS considers childcare to be an "other expense" rather than a necessary expense, even where both parents are employed full time, thus leaving it to the determination of the individual IRS employee as to whether the expense will be considered necessary.²⁸ It would be counter-productive for this expense to be disallowed where both parents are working and would be better able to pay their tax liability with two incomes.²⁹

TAS research suggests that the IRS is placing taxpayers into IAs where their total positive income (TPI) is less than their ALEs. Taxpayers may agree to an IA they can't afford out of fear of the IRS, a misunderstanding of the options available, or out of obligation to repay their debts at any costs. Nearly 300,000 taxpayer accounts that should have qualified for currently not collectible (CNC) status had entered into installment agreements in calendar year 2014 despite their income being below the IRS ALEs.³⁰ These taxpayer accounts (69 percent) are being resolved by the taxpayer making payments, not because of abatements by the IRS or offsets of the taxpayers' refunds, indicating that the taxpayers are paying their accounts despite having TPI less than ALEs, suggesting the taxpayers are prioritizing paying the IRS over meeting their necessary living expenses.³¹ By the IRS's definition, taxpayers who cannot meet their necessary living expenses are experiencing economic hardship.³² These taxpayers would therefore qualify for a mandatory release of an IRS levy, yet the IRS accepts IAs from these taxpayers despite the payments causing economic hardship.³³ Additionally, TAS research found higher default rates for taxpayers with TPI less than ALEs. Taxpayers with TPI less than ALEs and balances due of \$1,001 to \$10,000 who entered into IAs in FY 2014 defaulted at a rate of nearly 25 percent by FY 2016, compared to an overall default rate in this income category of less than 23 percent. Similarly, taxpayers with TPI less than ALEs and balances due of greater than \$10,000 who entered into IAs in FY 2014 defaulted at a rate of almost 43 percent by FY 2016 compared to an overall default rate in this category of less than 38 percent.³⁴

28 IRM 5.15.1.10(3), *Other Expenses* (Nov. 17, 2014).

29 The latest Census Bureau Report found that nearly 33 percent of children age five and under in 2011 were in non-relative care. Census Bureau, *Who's Minding the Children?* (Apr. 2013).

30 Research Study: *The Importance of Financial Analysis in Installment Agreements (IAs) in Minimizing Defaults and Preventing Future Payment Noncompliance*, vol. 2, *infra*. TAS research found 286,141 taxpayers who entered into an IA in 2014 despite TPI less than ALEs after eliminating accounts where abatements were at least half of the balance (including accruals), refund offsets that were at least 95 percent of the balance, or cases where the IRS classified a taxpayer prior to CNC subsequent to the initial TDA in 2014.

31 *Id.*

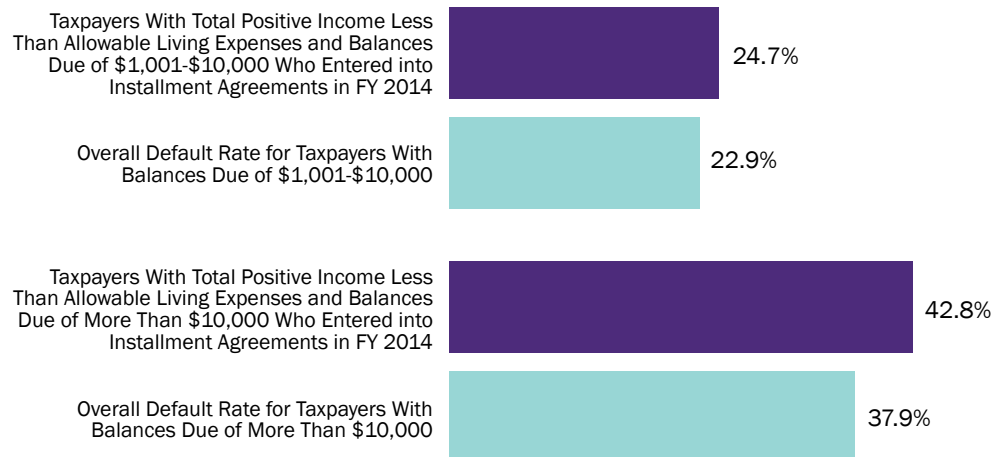
32 IRM 5.11.2.3.1.4, *Economic Hardship* (Apr. 15, 2014).

33 *Id.*

34 TAS, *Importance of Financial Analysis in Installment Agreements* (2016).

FIGURE 1.17.2

Default Rates by Balance Due



Certain Types of Installment Agreements Have Higher Rates of Default

Taxpayer in PPIAs Default at a Higher Rate Than All Other Types of IAs

The American Jobs Creation Act of 2004 amended IRC § 6159(a) to permit the IRS to accept IAs in full or partial collection of tax.³⁵ Such partial collection IAs, which will not full pay the tax liability before the statutory period for collection expires (referred to, in the IRS, as the collection statute expiration date or CSED), are known as PPIAs. The IRS may grant a PPIA where the taxpayer cannot full pay the liability before the CSED, but has some ability to pay.³⁶ In order to obtain a PPIA, the taxpayer must submit a full CIS in order for the IRS to assess ability to pay.³⁷

Although IRS employees are required to determine ability to pay using the CIS, which relies on ALEs, PPIAs have a higher default rate than all other IA types.³⁸ PPIAs default at a rate of nearly 28 percent compared to 13 percent for all IAs.³⁹ By definition, these taxpayers are not able to full pay their liability in the IRS's determination. With such a high default rate, the financial analysis completed to determine the ability of the taxpayers under PPIAs to pay may not be capturing the true ability of these taxpayers to pay the amount determined. One factor that may contribute to this default rate is the disallowance of "conditional" expenses for PPIAs.⁴⁰ Taxpayers in regular IAs are allowed conditional expenses if they can full pay the liability in six years and within the CSED.⁴¹ For example, education and legal fees (those not related to professional representation in matters before the IRS) are deemed conditional.⁴² A taxpayer working towards completing a college degree would be required to stop attending classes which

35 The American Jobs Creation Act of 2004 (Pub.L. 108-357).

36 IRM 5.14.2.1 (Mar. 11, 2011).

37 IRM 5.14.2.1.1, *Streamlined Installment Agreement Requirements* (Sept. 19, 2014).

38 IRS, *IA Default Rate Report* (Oct. 6, 2016).

39 *Id.*

40 IRM 5.14.2.1.1 (Sept. 19, 2014).

41 IRM 5.19.13.1.2.7, *Conditional Expenses* (Nov. 25, 2014).

42 *Id.*

may trigger repayment requirements for student loans, further impacting the taxpayer's ability to pay. Or, if a taxpayer was involved in a custody suit over a minor child, legal fees would not be permitted. The taxpayer's custody suit would not go away as a result of a tax debt and the taxpayer would need to continue paying an attorney to proceed with the suit, possibly resulting in a default on the IA.

Taxpayers in IAs Worked by the Field or in ACS Default at Higher Rates Than Those Worked by Other Groups

Most contact employees across the IRS can set up IAs with taxpayers; including employees in the Small Business/Self-Employed Division (SB/SE) Campus Collection Operations, ACS employees, Automated Collection System Support (ACSS) employees, Compliance Services Collection Operations (CSCO) employees, as well as Collection Field function Revenue Officers & Taxpayer Assistance Center (TACs) employees, and Tax Compliance Officers and Revenue Agents in the Examination Division, who can set up IAs at the completion of an audit as well as Wage and Investment (W&I) employees who answer the National Taxpayer Advocate Toll-Free Line.⁴³ In TAS, Intake Advocates and Case Advocates as well as Customer Service Representatives also have the delegated authority to set up streamlined IAs.⁴⁴

Field and ACS worked IAs have higher default rates than all IAs overall and higher default rates than IAs worked by other IRS work groups.⁴⁵ Field IAs default at a rate of 26 percent and ACS IAs at a rate of 20 percent. This is in comparison to an overall IA default rate of 13 percent, a default rate of only about nine percent for CSCO, and a rate of 11 percent for Exam-worked IAs.⁴⁶

The disparate default rates for IAs worked by different IRS work groups should be studied. The IRS may find that the taxpayer populations served by different IRS working groups have unique characteristics and needs. Such information would allow the IRS to tailor training on all alternative collection methods to the particular working group and taxpayer populations served and potentially increase collectibility.⁴⁷

The IRS Needs to Focus on Realistic and Affordable Resolution of a Tax Account Based on a Thorough Financial Analysis of the Taxpayer's Ability to Pay Upfront

The goal of an IA should be to create a payment plan that is realistic for the taxpayer given the taxpayer's individual circumstances. If an IA is not the best solution for the taxpayer and the IRS, alternatives such as OICs should be explored. For example, field employees may work with more noncompliant taxpayers where special strategies are needed to ensure that the taxpayers come into and remain in compliance throughout the IA process. Developing training aimed at creating strategies to address the issues in these taxpayer populations may assist these employees in crafting IAs that will help these taxpayers remain compliant or in placing the taxpayer in a different, more suitable collection arrangement given the circumstances, such as an OIC.

43 IRS, *Streamlined Processing of Installment Agreements*, <https://www.irs.gov/businesses/small-businesses-self-employed/streamlined-processing-of-installment-agreements> (last visited Dec. 20, 2016).

44 IRM 13.1.4.2.3.9 (Oct. 31, 2004). See also TAS, *Authority of Taxpayer Advocate Service Employees to Perform Certain Tax Administration Functions* (July 27, 2015).

45 IRS, *IA Default Rate Report* (Oct. 6, 2016).

46 *Id.*

47 National Taxpayer Advocate 2015 Annual Report to Congress vol. 2, 37 (Research Study: *IRS Collectibility Curve*).

Congress has long viewed the OIC as a viable collection alternative to bring taxpayers back into compliance, writing in the RRA 98 Conference Report:

The conferees believe that the IRS should be flexible in finding ways to work with taxpayers who are sincerely trying to meet their obligations and remain in the tax system. Accordingly, the conferees believe that the IRS should make it easier for taxpayers to enter into offer-in-compromise agreements, and should do more to educate the taxpaying public about the availability of such agreements.⁴⁸

Proper financial analysis upfront may point to the OIC being a better option than a lengthy IA such as an extended six-year IA or a PPIA. Additionally, an OIC has the added benefit of bringing finality to the taxpayer and the IRS as requiring five years of tax compliance from the taxpayer.⁴⁹ When taxpayers default on IAs, it results in an endless cycle of IRS rework and taxpayer burden, which could be avoided if the IRS used the data it has available prior to accepting an IA and only placed those taxpayers with demonstrated ability to pay in IAs

Training on IAs, ALEs, and alternative collection solutions should be developed based on specific taxpayer populations and delivered to these employees. Focusing on determining the ability to pay, and ensuring that employees allow all necessary expenses when determining the payment amount for the IA may help create IAs that these taxpayers can afford. As a general policy, the IRS should not accept IAs that cause economic hardship. It could avoid this result by developing a screening algorithm that will identify when a taxpayer's income is less than his or her ALEs. In order to prevent creating economic hardship in such cases, the IRS would be required to pursue alternate collection solutions crafted to the taxpayer's unique circumstances, including CNC-hardship or an OIC.⁵⁰ All IRS employees authorized to enter into IAs should utilize this filter, and it should be incorporated into the online IA tool on irs.gov.

CONCLUSION

Taxpayers who enter into IAs they cannot afford risk defaulting on the agreement and being subject to further collection efforts. Alternatively, they may attempt to pay the IRS at the expense of meeting their basic living needs. Further compounding this problem are ALEs where the analysis leaves major household expenses up to the individual discretion of an IRS employee and ALEs that are based on standard expenses that do not reflect the reality of today's society. Setting taxpayers up to fail at compliance does not comport with taxpayers' rights, specifically the *right to finality* and *the right to a fair and just tax system*. More comprehensive financial analysis, including the development of an ability-to-pay estimator that uses the taxpayer's most recent income data, revised and updated ALEs, expanded use of OICs, and targeted employee training will assist the IRS and taxpayers in ensuring the success of IAs and the compliance of taxpayers who enter into IAs.

48 H.R. REP. NO. 105-599, at 288-89 (1998) (Conf. Rep.).

49 IRS, *Form 656 Offer in Compromise* (Feb. 2016).

50 IRM 5.11.2.3.1.4, *Economic Hardship* (Apr. 15, 2014).

RECOMMENDATIONS

The National Taxpayer Advocate recommends that the IRS:

1. Modify the ALEs in accordance with the recommendations in the Most Serious Problem on ALEs.
2. Develop an internal ability-to-pay estimator that will populate with the most current taxpayer income information for use by all employees offering IAs.
3. Revise IRMs and employee training to require use of the estimator even in streamlined IA applications and provide employees with a decision tree indicating where other collection alternatives are more appropriate than IAs.