MSP #13 ALLOWABLE LIVING EXPENSE (ALE) STANDARD: The IRS's Development and Use of ALEs Does Not Adequately Ensure Taxpayers Can Maintain a Basic Standard of Living for the Health and Welfare of Their Households While Complying With Their Tax Obligations

RESPONSIBLE OFFICIAL

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DEFINITION OF PROBLEM

Internal Revenue Code (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."[2] Most importantly, Congress instructed the IRS to analyze the facts of each case involving these allowances and stipulated that if application of the allowances results in a taxpayer not being able to provide for basic living expenses, then the allowances should not be used.[3] The resulting Allowable Living Expense (ALE) standards have come to play a major role in analyzing several types of IRS collection cases.[4] Moreover, the IRS ALEs have been incorporated into several non-tax government programs.[5]

The IRS allows an expense if it is "necessary to provide for a taxpayer's and his or her family's health and welfare and/or production of income."[6] In its efforts to base the allowed expenses on reliable and consistent data, the IRS relies heavily on the Bureau of Labor Statistics (BLS). In particular, the IRS uses the Consumer Expenditure Survey (CES), which gathers expenditure information for consumers.[7] Since this survey measures what people spend to live, it does not take into account what the goods or

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

3 IRC § 7122(d)(2)(B).

4 Form 433-A, *Collection Information Statement for Wage Earners and Self-Employed Individuals*, is used to determine monthly expenses and primarily relies on the ALE standards. This form is necessary for many types of case resolutions, including certain installment agreements and offers in compromise (OIC). Internal Revenue Manual (IRM) 5.15.1.1(3), *Overview and Expectations* (Nov. 17, 2014).

5 For instance, debtors filing for bankruptcy are instructed to use the IRS's ALE standards to calculate income and expenses. 11 U.S.C. § 707(b)(2). Additionally, when a debtor to a federal student loan is subject to a proposed wage garnishment, that debtor may object to the proposed garnishment by arguing it would create a financial hardship. 34 C.F.R. § 34.24(a). The debtor must provide credible documentation showing, among other things, his or her basic living expenses as established by the IRS's ALE standards. 34 C.F.R. § 34.24(e)(2).

6 IRM 5.15.1.7(1), *Allowable Expense Overview* (Oct. 2, 2012).

7 BLS, CES *Frequently Asked Questions*, http://www.bls.gov/cex/csxfaqs.htm#q1.

services actually cost to live. Taxpayers of limited means pay for what they can afford and thus may forego expenses otherwise determined by the IRS definition to be necessary.

By focusing on what expenses are *allowable* instead of *adequate*, the IRS has exercised its discretion in a way that does not comport with congressional intent, since "allowable" is not synonymous with "adequate" or "basic."[8] Instead, the IRS should adopt standards that allow for a *sufficient* or *adequate* standard of living.[9]

The National Taxpayer Advocate has the following concerns with the current ALE standards:

- Taxpayers of limited means are harmed because the current ALEs are based on data that reflect what taxpayers spend, rather than what they actually need to spend to maintain the health and welfare of their households;
- The current ALEs do not reflect an understanding of what amount of money is sufficient to maintain a basic lifestyle;
- The ALEs do not account for the income and expenditure fluctuations within and between income levels and other household demographics;
- The ALEs should be updated to include expenses necessary to maintain the health and welfare of households today, including an allocation for digital access and technology, child care, and retirement savings; and
- Alternative methods to measure household health and welfare provide better insight into necessary expenses and establish the expenses as a floor, rather than a cap.[10]

A reevaluation of the ALE standards is crucial, given the IRS's Future State initiative, which focuses on increasing online tools and reducing telephone and face-to-face interactions with taxpayers.[11] If the ALE standards do not reflect the financial realities of taxpayers, then increased use of online tools and automated programs based on these ALEs will exacerbate the financial harm to these taxpayers. IRC § 7122(d)(2)(B) requires that the IRS make decisions involving the ALE standards on a case-by-case basis. Heavy reliance on online accounts reduces the opportunity for a person-to-person exchange that will identify the financial circumstances necessary for a case-by-case analysis, and the appropriate application of, or deviation from, allowable expenses standards.

8 Congressional intent for maintaining an adequate and basic standard of living can be seen in how Congress has addressed "economic hardship" for IRS Collection purposes, which is defined as an inability to pay "reasonable basic living expenses." Treas. Reg. § 301.6343-1(b)(4).

9 "Sufficient" is defined as "adequate; of such quality, number, force, or value as is necessary for a given purpose." Whereas, "allowable" is defined as "acceptable according to the rules; permissible." Black's Law Dictionary (10th ed. 2014).

10 The National Taxpayer Advocate raised concerns about the ALE standards when Congress was contemplating the change to IRC § 7122 in 1998. As Executive Director of The Community Tax Law Project, the National Taxpayer Advocate testified that "The impact of the current standards is illustrated by a recent case in which I represented an individual who lived in a blighted inner-city neighborhood and used public transportation. The ACS [Automated Collection Service] employee refused to allow his bus fare for travel to a grocery store at the shopping mall, although he needed to go there in order to keep his food expenses within the IRS guidelines." *IRS Restructuring: Hearings Before the Comm. on Finance*, 105th Cong. 333 (1998) (statement of Nina E. Olson, Executive Director, The Community Tax Law Project).

11 IRS, *Future State Initiative*, https://www.irs.gov/uac/newsroom/future-state-initiative.

ANALYSIS OF PROBLEM

Background

As mentioned above, 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." Additionally, the pertinent section of Treasury Regulations reads as follows:

> A determination of doubt as to collectibility will include a determination of ability to pay. In determining ability to pay, the Secretary will permit taxpayers to retain *sufficient* funds to pay basic living expenses. The determination of the amount of such basic living expenses will be founded upon an evaluation of the individual facts and circumstances presented by the taxpayer's case. To guide this determination, guidelines published by the Secretary on national and local living expense standards will be taken into account.[12] (Emphasis added).

To fulfill Congress's mandate in IRC § 7122(d)(2)(A), the IRS developed a system of expenses which must meet the "necessary test." The IRS considers an expense to be necessary if it is "necessary to provide for a taxpayer's and his or her family's health and welfare and/or production of income."[13] The necessary test is an exercise of IRS discretion and is not found in the U.S. Tax Code or Treasury Regulations.

The IRS further divides expenses into three categories: ALEs, other necessary expenses, and other conditional expenses.[14] This discussion will focus on ALEs.

There are ALEs for items such as food and clothing, housing and utilities, and transportation.[15] Expenses for food, clothing, and other miscellaneous items, as well as for out-of-pocket healthcare expenses, are based on national standards. These standards come from the Bureau of Labor Statistics (BLS) Consumer Expenditure Survey (CES).[16] For these expenses, the taxpayer is allowed the total national standard without questioning the amount he or she actually spends (as long as the taxpayer does not spend more than the standard amount).[17]

Housing and utility expenses and transportation costs are based on Census and BLS data by county.[18] One downside to using county-based measurements is that there can be wide variations in cost within one county. In 2014, one report found that rents for one and two bedroom apartments in Orange County,

12 Treas. Reg. § 301.7122-1(c)(2)(i).

13 IRM 5.15.1.7(1), *Allowable Expense Overview* (Oct. 2, 2012).

14 "Other necessary expenses" are expenses that meet the necessary expense test and are normally allowed. This is the category for child care costs, which are allowed if they are "reasonable," making them subject to an individual IRS employee's judgment. Conditional expenses are expenses which may not meet the necessary expense test, but may be allowed based on the circumstances of an individual case. IRM 5.15.1.7(1), *Allowable Expense Overview* (Oct. 2, 2012).

15 IRM 5.15.1.7, *Allowable Expense Overview* (Oct. 2, 2012).

16 The BLS is part of the United States Department of Labor. United States Department of Labor, *About BLS*, http://www.bls.gov/bls/infohome.htm. Out-of-pocket healthcare expenses are based on Medical Expenditure Panel Survey data, which comes from the U.S. Department of Health and Human Services. IRM 5.15.1.7 (Oct. 02, 2012). The CES program "consists of two surveys, the Quarterly Interview Survey and the Diary Survey, that provide information on the buying habits of American consumers, including data on their expenditures, income, and consumer unit (families and single consumers) characteristics." BLS, CES, http://www.bls.gov/cex/ (last visited Sept. 9, 2015).

17 IRM 5.15.1.7(3), *Allowable Expense Overview* (Oct. 2, 2012).

18 IRM 5.15.1.7(4), *Allowable Expense Overview* (Oct. 2, 2012). In addition to mortgage or rent, housing expenses include such things as utilities (gas, electricity, water, etc.), garbage removal, cable television, internet service, telephone, and cell phone.

California varied between $858 to more than $2,000 in Santa Ana and between $1,325 to more than $3,000 in Lake Forest.[19]

Transportation costs consist of nationwide figures for loan or lease payments and additional amounts for operating costs broken down by Census Region and Metropolitan Statistical Area. Taxpayers are generally allowed the local standard or what they actually pay each month, whichever is less.[20] If the amount claimed is more than the total allowed by the standards, the taxpayer must provide documentation to substantiate those expenses are necessary.[21] Thus, the local standards for housing and transportation expenses serve as a cap on what taxpayers can claim.

Taxpayers of Limited Means Are Harmed Because the Current ALEs Are Based on Data That Reflect What Taxpayers Spend, Rather Than What They Actually Need to Spend to Maintain the Health and Welfare of Their Households

Deviation from application of the standards is allowed when, based on a taxpayer's facts and circumstances, such application would create an economic hardship for the taxpayer.[22] However, commentators and practitioners observe that many IRS employees do not exercise flexibility in determining when to make a deviation. For instance, the Internal Revenue Service Advisory Council (IRSAC) noted that employees in Automated Collection Service (ACS) seem less likely to be flexible than revenue officers, but Appeals employees are "more likely" to deviate from the standards.[23] The National Taxpayer Advocate has also addressed concerns with the use and application of ALE standards in individual taxpayer cases.[24]

One tax attorney testified before Congress that a strict adherence to ALE standards can cause taxpayers to file bankruptcy unnecessarily.[25] The harm that taxpayers experience when a deviation does not occur was also seen in *Leago v. Commissioner*.[26] In *Leago*, the taxpayer did not contest that he owed a tax liability of approximately $94,433. However, Mr. Leago suffered from a brain tumor that required surgery estimated to cost $100,000. Mr. Leago had no health insurance. As part of a collection due process (CDP) hearing in response to a proposed levy, Mr. Leago requested that his liability be classified as currently not collectable (CNC) due to financial hardship and health problems, which the IRS did not agree to do.[27] The Tax Court remanded the case back to Appeals for a supplemental CDP hearing. The settlement officer excluded any expenses for health care because Mr. Leago was not currently paying these expenses

19 Internal Revenue Service Advisory Council (IRSAC), *General Report* 80 (Nov. 19, 2014).

20 IRM 5.15.1.9, *Local Standards* (Nov. 17, 2014).

21 IRM 5.15.1.9(1)(a), *Local Standards* (Nov. 17, 2014).

22 IRC § 7122(d)(2)(B); IRM 5.15.1.1(7) (Nov. 17, 2014).

23 IRSAC, *General Report* 83 (Nov. 19, 2014). *See also* IRS, Small Business/Self Employed (SB/SE) Research, *Final Report: Assessing the Impact of the Allowable Living Expense Standards Focus Group*, NCH0160 (Dec. 2010).

24 National Taxpayer Advocate Objectives Report to Congress Fiscal Year (FY) 2017 131-35 (Area of Focus: *The IRS Should Reevaluate How It Develops and Uses Allowable Living Expense Standards*); National Taxpayer Advocate 2006 Annual Report to Congress 83-109 (Most Serious Problem: *IRS Collection Payment Alternatives*); National Taxpayer Advocate 2005 Annual Report to Congress 270-91 (Most Serious Problem: *Allowable Expense Standards for Collection Decisions*).

25 *Practices and Procedures of the Internal Revenue Service: Hearings Before the Comm. on Finance*, 105th Cong. 39 (1997) (statement of Robert Schriebman, tax attorney).

26 T.C. Memo. 2012-39.

27 Prior to levying a taxpayer's property, in most instances, the IRS must provide the taxpayer with an opportunity to have a hearing before Appeals. During this hearing, the taxpayer may raise various issues, including alternative collection options to the levy. IRC § 6330.

and instead offered him a partial-pay installment plan (PPIA) in the amount of $200 per month. Mr. Leago declined to accept this payment plan.[28]

Throughout the process, the IRS failed to acknowledge the cost of a life-saving surgery for Mr. Leago because he simply could not afford it. That is, because Mr. Leago was not currently paying toward the cost of having brain surgery, the IRS refused to include the necessary expense in its calculation of basic living expenses, thereby placing payment of a federal debt above the necessary (future) expenses to preserve the taxpayer's health and ensuring the taxpayer would not be able to afford a necessary surgery. Today, this IRS action would violate the taxpayer's *right to privacy*, which ensures that IRS enforcement action will be no more intrusive than necessary. Additionally, another taxpayer with the ability to pay for the surgery could have received a different outcome in his or her financial analysis than Mr. Leago, in violation of Mr. Leago's *right to a fair and just tax system*.

As it is now, the standards are based on the average or median expenditures derived from U.S. government data sources (*e.g.*, U.S. Census Bureau or the BLS) representing the actual expenditures of broad segments of the population and not what individual goods and services actually cost. While this approach may seem reasonable at first glance, the National Taxpayer Advocate previously expressed concerns that, in reality, the application of these standards to individual taxpayer cases may lead to erroneous conclusions regarding the appropriate use of reasonable collection payment alternatives.[29]

By focusing on what expenses are *allowable* instead of *adequate*, the IRS has exercised its discretion in a way that does not comport with Congressional intent, since "allowable" is not synonymous with "adequate" or "basic."

By focusing on what taxpayers actually pay instead of what a "basic living" service or good actually costs, the financial circumstances of some taxpayers, such as those who must forego paying certain basic living expenses to make ends meet, are not fully realized. If a taxpayer does not have sufficient funds to meet all of his or her necessary costs of living, the taxpayer should not be treated differently than a taxpayer who can afford to pay for all of his or her necessary costs of living.[30]

Alternatively, some taxpayers may incur expenses that are higher than the average.[31] These taxpayers should not be forced to reduce their standard of living to the poverty level in order to pay their taxes. Without knowing what constitutes the standard of living required to maintain the health and welfare of a household, it is not possible to determine if a taxpayer has paid too little or too much for an expense.

28 Subsequently, Mr. Leago proposed an OIC based on doubt as to collectibility with special circumstances. In his collection information sheet (CIS), he reported $3,100 per month for future expenses related to his brain surgery. T.C. Memo. 2012-39 at 4. The settlement officer who reviewed this offer again denied the future medical expense because it represented an amount Mr. Leago was not currently paying. T.C. Memo. 2012-39 at 5. The court again remanded the case. T.C. Memo. 2012-39 at 9. The court opinion does not shed light on the outcome for Mr. Leago after the second remand.

29 National Taxpayer Advocate 2005 Annual Report to Congress 270-91; National Taxpayer Advocate 2006 Annual Report to Congress 83-109.

30 It may seem that trying to survive below basic living standards is a situation reserved for only a small population of taxpayers. In fact, the opposite is true. One estimate is that 59 percent of Americans will encounter a year or more of poverty by the time they are 75 years old. Mark Rank, *Rethinking the Scope and Impact of Poverty in the United States*, 6 Conn. Pub. Int. L.J. 165, 171 (2007).

31 The ALE standards may also fail to acknowledge that some taxpayers "need to maintain higher professional standards in their dress, personal appearance, and vehicle, so that for production of income, a realtor, corporate executive, or physician may have different 'necessary expenses.'" IRSAC, *General Report* 84 (Nov. 19, 2014).

The Current ALEs Do Not Reflect an Understanding of What Amount of Money Is Sufficient to Maintain a Basic Lifestyle

Before the IRS can establish a standard for living expenses, it must understand what amount of money is sufficient for a basic standard of living. The IRS has not established how much it costs to maintain a basic standard of living. As a baseline, the United States often uses the poverty threshold to determine if a person has enough money to survive day-to-day. A person is considered to be living in poverty if his or her family's income falls below an income threshold set up by family size and composition.[32] The current method for determining the poverty level was developed between 1963 and 1964 by Mollie Orshansky, an economist at the Social Security Administration (SSA).[33] The official measure multiplies by three the cost of a minimum food diet from 1963 prices in today's prices.[34] The poverty threshold is not a measure of a sufficient standard of living.

In 2010, the Census Bureau introduced the Supplemental Poverty Measure (SPM) which extends the official poverty measure by taking into consideration government benefits and expenses that are not in the official measure.[35] The SPM was the result of mounting concerns over the inadequacy of the official poverty measure.[36] Instead of focusing on minimal food costs from 1963, the SPM considers the "mean of expenditures on food, clothing, shelter, and utilities (FCSU) over all two child consumer units in the 30th to 36th percentile range multiplied by 1.2."[37] Additionally, income is not measured just by pre-tax cash income but also includes noncash government benefits, taxes, and expenses related to work.[38] The SPM serves as an acknowledgement that the current poverty threshold cannot be used on its own to measure poverty.

What was sufficient to maintain a basic, healthy standard of living in 1963 has evolved over time. In 1963, families spent one-third of their budget on food. By 2004, it was reported that food expenditures had fallen to about one-seventh of total expenditures.[39] Currently, food represents only ten percent of a family's expenses.[40]

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32 U.S. Census Bureau, *How the Census Bureau Measures Poverty*, http://www.census.gov/topics/income-poverty/poverty/guidance/poverty-measures.html. U.S. Census Bureau, *Measuring America: How Census Measures Poverty* (Jan. 2014), http://www.census.gov/library/visualizations/2014/demo/poverty_measure-how.html.

33 Gordon M. Fisher, *The Development and History of the Poverty Thresholds*, 55 Soc. Sec. Bull. 3 (Winter 1992).

34 U.S. Census Bureau, *Measuring America: How Census Measures Poverty* (Jan. 2014), http://www.census.gov/library/infographics/poverty_measure-how.html. Food was chosen as the original standard of adequacy because it was the only generally accepted standard available at the time. Mollie Orshansky, *Counting the Poor: Another Look at the Poverty Profile*, 28 Soc. Sec. Bull. 5 (1965). The multiplier of three for costs of food was used since research at the time showed that families spent one-third of their budget on food. *Id*. at 9. For a discussion on how Ms. Orshansky came to this decision, see Gordon M. Fisher, *The Development and History of the Poverty Thresholds*, 55 Soc. Sec. Bull. 5 (Winter 1992).

35 U.S. Census Bureau, *The Supplemental Poverty Measure: 2014*, 1 (Sept. 2015).

36 *Id*.

37 *Id.* at 2.

38 *Id*.

39 Douglas J. Besharov and Peter Germanis, *Reconsidering the Federal Poverty Measure*, 9 (June 14, 2004).

40 The Pew Charitable Trusts, *Household Expenditures and Income*, 5 (Mar. 2016).

The IRS's recent decision to decrease some ALE standards highlights the difficulties in identifying and measuring what it costs to maintain a basic standard of living.[41] The IRS decreased the amounts for some of the allowable expenses based on "current data showing a decline in expenditures."[42] Between 2015 and 2016, the expenses allowed for out-of-pocket healthcare and transportation decreased, as did the national standards for food, clothing, housekeeping supplies, and miscellaneous.[43] TAS is unaware of how IRS assumptions can be tested using the current system of ALE standards, since the standards are based on averages spent by consumers, rather than an analysis of what individuals and families actually need in order to provide for a basic living.

It is not apparent that expenditures have actually declined. One source has reported on the impact of the Great Recession. It found that from 2004 to 2008, median household income grew by 1.5 percent while median expenditures grew by 11 percent.[44] However, the 2014 median income has *decreased* by 13 percent from 2004 levels while expenditures increased by nearly 14 percent.[45]

As an example, the cost of child care expenses has increased. Average weekly child care expenses for families with working mothers who paid for child care rose more than 70 percent from 1985 ($87) to 2011 ($148).[46] This increase is felt to varying degrees based on income. Families with employed mothers whose monthly income was $4,500 or more paid an average of $163 a week for child care, representing 6.7 percent of their family income. Families with monthly income of less than $1,500 paid much less ($97 a week on average) but that represented 39.6 percent of their family income.[47]

The ALEs Do Not Account for the Income and Expenditure Fluctuations Within and Between Income Levels and Other Household Demographics

The BLS, which is a primary source for ALE data, advises caution in interpreting its consumer expenditure data when relating averages to individual circumstances. The warning reads:

> Caution should be used in interpreting the expenditure data, especially when relating averages to individual circumstances. The data shown in the published tables are averages for demographic groups of consumer units. Expenditures by individual consumer units may differ from the average even if the characteristics of the group are similar to those of the

41 IRS, *Collection Financial Standard* (March 2016), https://www.irs.gov/businesses/small-businesses-self-employed/collection-financial-standards?_ga=1.142286002.1851601558.1476275435. Also in 2015, the IRS announced plans to deviate from normal procedures in Automated Collection System (ACS), Automated Collection System Support (ACSS), and Compliance Services Collection Operations (CSCO) cases that involve collection information statements (CIS). IRS, *Memorandum For SBSE Directors, Collection Policy And Campus Collection* (Dec. 17, 2015). The deviation affected PPIAs, non-streamlined installment agreements, and CNC determinations. The deviation allowed employees in some cases to disregard the need for taxpayers to substantiate what they reported on the CIS and instead rely on internal verification (unless a discrepancy was identified). This deviation was done to address a backlog of work, not to study ALE standards. The IRS tracked cases in the deviation to ensure that procedures of the deviation were followed. The IRS did not track details of cases, such as how it was resolved or which expenses were allowed a deviation, so TAS is unable to ascertain how this deviation impacted taxpayers. However, the IRS has plans to track cases with an extension of the deviation planned for FY 2017.

42 IRS, *Collection Financial Standards* (March 2016), https://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Collection-Financial-Standards.

43 TAS Research analysis of IRS 2015 ALE Standards and IRS 2016 ALE Standards. Housing costs also decreased in 2,314 counties out of 3,221 counties. *Id*.

44 The Pew Charitable Trusts, *Household Expenditures and Income*, 3 (Mar. 2016).

45 *Id*.

46 Pew Research Center, *Rising Cost of Child Care May Help Explain Recent Increase in Stay-at-Home Moms* (Apr. 8, 2014), http://www.pewresearch.org/fact-tank/2014/04/08/rising-cost-of-child-care-may-help-explain-increase-in-stay-at-home-moms/.

47 *Id*.

individual consumer unit. Income, family size, age of family members, geographic location, and individual tastes and preferences all influence expenditures.[48]

The standards are based on inexact projections of the amounts that people spend on a given item. A number of the IRS standards are based on average annual expenditures reported by people who responded to a survey (*e.g.*, the CES). Thus, there is a good chance the taxpayer's expense is greater than what was reported in the survey (or the IRS standards). On the other hand, there is also a similar chance the taxpayer's spending will be less than the survey average. In situations where the taxpayer has an expense greater than the standard, the IRS should be aware that the money to pay this expense will affect the taxpayer's ability to pay expenses in the other categories. Moreover, while some of this greater spending may be a matter of taste and preference, some above-average spending may be necessary to maintain the health and welfare of the household (or for the production of income). In situations where the taxpayer has an expense less than the standard, the taxpayer may need to make greater expenditures for the health and welfare of his household but cannot do so because of limited means.

The IRS also cannot assume that spending habits are consistent over income levels. For instance, while housing costs now account for about 25 percent of a family's pre-tax income, among low income renters, some may spend up to half of their pre-tax income on rent.[49] And while low income families may spend less for transportation costs, what they do spend takes up more of their income. Low income families spent 16 percent of their income on transportation expenses while middle income households spent 11 percent.[50] In this case, the IRS needs to know what expenditures the taxpayer is not making in order to meet their rent obligations.

Low income workers often struggle to make ends meet. It has been noted that achieving this balance each month could be "ephemeral in the event of any increased need or drop in income."[51] Of course, this strain is not felt only by low income families. When income levels are broken into thirds, the typical household in the middle third found its financial slack drop from $17,000 in 2004 to $6,000 in 2014.[52] This means that middle income families now have less opportunity to create a cushion for unexpected expenses, bouts with unemployment or long-term illness, or to make long-term savings a reality.

Additionally, the ALE standards are not sensitive to the fact that certain characteristics may make a person more susceptible to falling below the poverty line. For instance, while children represented 23.3 percent of the population in 2014, they compromised 33.3 percent of the people living in poverty.[53] Age and gender interact to create higher poverty rates among women over 65. The poverty rate for women aged 65 and older was 12.1 percent, while the poverty rate for men aged 65 and older was 7.4 percent.[54] The poverty rate for White Americans of non-Hispanic origin was 10.1 percent while the poverty rate among Blacks was 26.2 percent.[55] Professor Mark Rank, of Washington University in St. Louis, has suggested that to understand the scope of poverty in the United States, we ought to consider the risk that each

48 BLS, *CES Frequently Asked Questions*, http://www.bls.gov/cex/csxfaqs.htm#q13.

49 The Pew Charitable Trusts, *Household Expenditures and Income*, 7 (Mar. 2016).

50 *Id*. at 8.

51 Gregory Acs and Austin Nichols, The Urban Institute, *Working to Make Ends Meet: Understanding the Income and Expenses of America's Low-Income Families*, 30 (Sept. 2005).

52 The Pew Charitable Trusts, *Household Expenditures and Income*, 11 (Mar. 2016). The financial slack of the bottom third actually fell into the negative during the same time period, from $1,500 in 2004 to negative $2,300 in 2014.

53 Carmen DeNavas-Walt and Bernadette D. Proctor, U.S. Census Bureau, *Income and Poverty in the United States: 2014*, 14 (Sept. 2015).

54 *Id*. at 15.

55 *Id*. at 14.

American will face poverty at some point during his or her adulthood. He explains, "Just as we have acquired increasing knowledge regarding the likelihood that an individual, for example, may develop heart disease during their lifetime, so too can we ask what is the life course risk of encountering an economic event such as poverty?"[56]

The ALE Standards Should Be Updated to Include Expenses Necessary to Maintain the Health and Welfare of Households Today, Including an Allocation For Digital Technology Access, Child Care, and Retirement Savings

A major critique of the current poverty measures has been that the recognized expenses are out of date.[57] When Ms. Orshanksy developed the poverty standards, she recognized the need for updating her method. She remarked, "as yesterday's luxuries become tomorrow's necessities, who can define for today how much is enough?"[58] The IRS should follow Ms. Orshanksy's guidance and update the expenses that are necessary for a basic, healthy standard of living today.[59]

Before the IRS can establish a standard for living expenses, it must understand what amount of money is sufficient for a basic standard of living.

Currently, the IRS treats child care costs as an "other expense," subject to individual IRS employee judgment, even though it is difficult to imagine a working family getting by without child care expenses.[60] While being treated as an "other expense" does not mean that claims for child care are likely to be denied, it does mean there is no uniform application, or a national or local standard for amount. Other categories of expenses that have become universally accepted for a 21st century basic standard of living, such as an allotment for basic digital technology in the household and retirement savings, are not acknowledged at all by the ALE standards or poverty threshold.

The current ALE standards allow for internet services as part of housing and utility costs. However, there is no provision for a computer or other tool to access the internet, such as a tablet.[61] Also, the IRS explicitly does not allow retirement savings as a necessary expense.[62] One survey by the Board of Governors of the Federal Reserve found that 31 percent of non-retired respondents had no retirement savings or pension.[63] This deficit in retirement savings is important to consider because Social Security benefits account for only about 40

56 Mark Rank, *Rethinking the Scope and Impact of Poverty in the United States*, 6 Conn. Pub. Int. L.J. 165, 169 (2007).

57 Diana Pierce and Jennifer Brooks, Wider Opportunities for Women, *The Self-Sufficiency Standard for the Washington, D.C. Metropolitan Area*, 2 (Fall 1999).

58 Mollie Orshanksy, *Counting the Poor: Another Look at the Poverty Profile*, 28 Soc. Sec. Bull. 5 (1965).

59 These adjustments have occurred in non-IRS venues. As mentioned above, Congress has adopted the use of the IRS's ALE standards in bankruptcy cases. 11 U.S.C. § 707(b)(2)(A)(ii)(I). However, Congress has allowed for additional expenses beyond the ALE standards. Notably, debtors may deduct expenses for protection from family violence and an extra five percent for food and clothing (if the extra expense is necessary). 11 U.S.C. § 707(b)(2)(A)(ii)(I). Debtors may also deduct expenses for care and support of an "elderly, chronically ill, or disabled" family member. 11 U.S.C. § 707(b)(2)(A)(ii)(II). And unlike the ALE standards, debtors may deduct up to $1,500 per year in educational expenses for a minor. 11 U.S.C. § 707(b)(2)(A)(ii)(IV).

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

61 IRM 5.15.1.7(4), *Allowable Expense Overview* (Oct. 2, 2012).

62 IRM 5.15.1.27(2), *Retirement or Profit Sharing Plans* (Nov. 11, 2014).

63 Board of Governors of the Federal Reserve System, *Report on the Economic Well-Being of U.S. Households in 2014*, 38-39 (May 2015). According to the survey, the rate of retirement savings is tied directly to an individual's income. Eighty-two percent of the respondents making over $100,000 per year had at least some retirement savings or pension. Meanwhile, among respondents making under $40,000 per year, only 42 percent had any retirement savings. *Id*.

percent of retirees' total income, meaning Americans should be funding retirement plans to make up the shortfall.[64]

Alternative Methods to Measure Household Health and Welfare Provide Better Insight into Necessary Expenses and Establish the Expenses As a Floor Rather Than a Cap

The current ALE system allows for a consistent approach for analyzing taxpayers' expenses. However, this system does not meet the needs of taxpayers who cannot afford to pay for all of the allowable expenses and it does not take into consideration all necessary expenses. In light of the above information, the IRS needs to consider alternative approaches to determining household health and welfare.

Family Budgets

Family budgets are a relative measure of what a particular family needs to live modestly in a certain community.[65] The concept differs from the poverty threshold in two ways: it allows for more consumption of goods and services, and it adds the various costs of each budget component without adjusting for income.[66] Applying this concept to the ALE standards would help ensure that all taxpayers have sufficient expenses for a basic standard of living and that each taxpayer receives equitable treatment.

The Self-Sufficiency Standard

Another option to consider is the self-sufficiency standard. Here, the IRS would ask "at what point does a family have sufficient income and resources (such as health benefits) to meet their needs adequately, without public or private assistance?"[67] Unlike the poverty threshold, which is based on the cost of a single item (food) and assumes a fixed ratio, the self-sufficiency standard considers the cost of each item independently, which allows each category to increase at different rates.[68] The self-sufficiency standard also varies by geographic location and includes more modern expenses.[69]

The self-sufficiency standard highlights why the ALE standards need to establish a floor, rather than a cap on expenditures. Since families have unique circumstances, they will incur different expenses. For instance, a family with a handicapped child may have additional expenses related to specialized education or housing needs. The current system, which is based on allowable expenses that are capped, does not acknowledge that taxpayers' lives cover a spectrum of circumstances.

64 *See* Social Security Administration, http://www.ssa.gov/policy/docs/ssb/v65n3/v65n3p1.html; Association for the Advancement of Retired Persons, *Affording Retirement: Social Security Alone Isn't Enough*, http://www.aarp.org/work/social-security/info_06_2010/ss_isnt_enough.html.

65 Sylvia Allegretto, *Basic Family Budgets: Working Families' Incomes Often Fail to Meet Living Expenses Around the United States*, 36 Int'l J. Of Health Serv. 3, 444-45 (2006).

66 James Lin and Jared Bernstein, Economic Policy Institute, *What We Need to Get By*, 1 (Oct. 29, 2008).

67 Diana Pierce and Jennifer Brooks, Wider Opportunities for Women, *The Self-Sufficiency Standard for the Washington, D.C. Metropolitan Area*, 3 (Fall 1999).

68 *Id.*

69 University of Washington Center for Women's Welfare, *Measuring Poverty*, http://selfsufficiencystandard.org/node/91.

CONCLUSION

Congress intended that taxpayers be allowed a sufficient amount of living expenses to provide for the health and welfare of their households and for the provision of income, prior to resolving IRS liabilities. The current ALE standards do not fulfill this intent. The current standards are based on outdated measurements and assumptions and are implemented in a way that keeps some taxpayers in poverty or reduced circumstances in order to meet their taxpaying obligations.

Taxpayers have a responsibility to pay their taxes. However, this responsibility should not come at the cost of not being able to afford basic living expenses. When something like the situation in *Leago* occurs, it is proof that the current standards do not take into account the taxpayer's specific facts and circumstances, clearly violating the taxpayer's *right to a fair and just tax system*.

To meet the intent of Congress, the IRS needs to reevaluate how it develops and uses the ALE standards. Before the IRS can start that process, however, it must understand what it costs to maintain the health and welfare of a household in the 21st century. The costs must be updated to include such things as child care, technology, and retirement savings. Furthermore, the standards must reflect the minimum amount necessary to maintain the health and welfare of a household, not the maximum. In doing so, the IRS will ensure that every taxpayer is allowed sufficient expenses for maintaining the health and welfare of his or her household while meeting his or her tax-paying obligations.

RECOMMENDATIONS

The National Taxpayer Advocate recommends that the IRS:

1. In conjunction with TAS, consider the family budget or self-sufficiency standard as an alternative method to calculate the cost of providing for the health and welfare of households. The alternative method should not be a cap to allowable expenses, but should represent the floor for what can be claimed.
2. Expand the standard to include additional expenses for basic technology in the household, child care, and retirement savings.
3. Reconsider the recent decrease in ALE standards for national standards, out-of-pocket healthcare, housing, and transportation.