National Taxpayer Advocate

# 2013 Annual Report to Congress

VOLUME TWO:
TAS Research &
Related Studies

TAXPAYER ADVOCATE SERVICE

YOUR VOICE AT THE IRS

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December 31, 2013

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# Do Accuracy-Related Penalties Improve Future Reporting Compliance by Schedule C Filers?

SECTION ONE

# Do Accuracy-Related Penalties Improve Future Reporting Compliance by Schedule C Filers?[1]


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1 The principal authors of this study are Tom Beers, Senior Research Advisor, Jeff Wilson, Research Director, Mike Nestor, Research Analyst, Amy Ibbotson, Research Analyst, Joseph Saldana, Research Analyst, and Eric LoPresti, Senior Attorney Advisor, of the Office of the Taxpayer Advocate.

## EXECUTIVE SUMMARY

Accuracy-related penalties are supposed to promote voluntary compliance. Congress has directed the IRS to develop better information concerning the effects of penalties on voluntary compliance, and it is the IRS's official policy to recommend changes when the Internal Revenue Code (IRC) or penalty administration does not effectively do so. The objective of this study was to estimate the effect of accuracy-related penalties on Schedule C filers (*i.e.,* sole proprietors) whose examinations were closed in 2007. TAS compared their subsequent compliance to a group of otherwise similarly situated "matched pairs" of taxpayers who were not penalized. TAS used Discriminant Function (or "DIF") scores — an IRS estimate of the likelihood that an audit of the taxpayer's return would produce an adjustment — as a proxy for a taxpayer's subsequent compliance.

While all groups of Schedule C filers who were subject to an examination assessment improved their reporting compliance (as measured by reductions in their DIF scores), those subject to an accuracy-related penalty had no better subsequent reporting compliance than those who were not. Thus, accuracy-related penalties did not appear to improve reporting compliance among the Schedule C filers who were subject to them. Further, penalized taxpayers who were also subject to a default assessment or who appealed their assessment had smaller reductions in DIF scores, suggesting lower reporting compliance five years later as compared to similarly situated taxpayers who were not penalized.[2] Similarly, those whose penalty was abated had smaller reductions in DIF scores, suggesting lower reporting compliance five years later as compared to taxpayers whose penalty was not abated.

Prior research suggests that a taxpayer's perception of the fairness of the tax law, the IRS and the government drive voluntary compliance decisions, and the findings of this study are consistent with that research. Taxpayers subject to default assessments may be more likely to feel the penalty assessment process was unfair, which may have caused lower levels of future compliance. Similarly, those who appeal may be more likely to feel that the actual result was unfair, which may have caused lower levels of future compliance. Finally, those subject to a penalty assessment that is later abated may also feel that the IRS initially sought to penalize them unfairly, potentially causing lower levels of future compliance.

These findings have a number of policy implications. First, the IRS should revise its procedures to ensure that it does not propose a penalty before exhausting efforts to communicate with a taxpayer to determine whether a penalty actually applies.[3] By design, automated procedures — those that presume a penalty applies unless a taxpayer explains and documents why it does not — are likely to generate more default assessments and penalty abatements than other examination methods. As taxpayers who were penalized after default assessments or whose penalties were abated had smaller reductions in DIF scores, suggesting lower levels of voluntary compliance after five years than those who were not, these automated procedures may be inconsistent with the IRS's goal of promoting voluntary compliance.

Second, the IRS's Appeals function should consider doing more to objectively evaluate and then explain its determinations, particularly when it sustains a penalty. As taxpayers who were penalized after an

2 Except as otherwise indicated, all differences discussed in this report are statistically significant (with 95 percent confidence). We note, however, that the DIF is an approximate measure of reporting compliance, and small differences, although statistically significant, may not indicate a real difference in reporting compliance.

3 For examples of such failures, see National Taxpayer Advocate 2013 Annual Report to Congress vol. 1, *supra* (Most Serious Problem: *The IRS Inappropriately Bans Many Taxpayers From Claiming EITC*) and National Taxpayer Advocate 2007 Annual Report to Congress 275 (Most Serious Problem: *The Accuracy-Related Penalty in the Automated Underreporter Units*).

appeal had smaller reductions in DIF scores, suggesting lower levels of compliance after five years than those who were not penalized, it is possible that they did not perceive Appeals as fairly evaluating whether the penalty should apply. Finally, in the case of penalties that taxpayers generally regard as unfair (*e.g.*, where a reasonable cause exception does not apply, or where it may be interpreted so narrowly as to, in effect, create a strict liability penalty), the IRS should consider applying a broader reasonable cause exception (or work with the Treasury Department to propose one) that is simple, fair, transparent, and easy to administer.

## INTRODUCTION

According to Congress and IRS policy, the IRS should administer civil tax penalties to promote voluntary compliance.[4] An IRS task force expressly rejected other purposes such as raising revenue, punishing noncompliant behavior, and reimbursing the government for the cost of compliance programs, because policies designed to fulfill other purposes may conflict with the primary goal of enhancing voluntary compliance.[5]

In 1989, Congress recommended that the IRS "develop better information concerning the administration and effects of penalties."[6] In addition, the IRS's official policy is to collect information "to determine the effectiveness of penalties in promoting voluntary compliance… [and recommend] changes when the Internal Revenue Code or penalty administration does not effectively promote voluntary compliance… ."[7] Accordingly, this report investigates the effect of penalties on future compliance, as proposed in the National Taxpayer Advocate 2012 Annual Report to Congress.[8]

Because different penalties apply to different conduct and different taxpayer populations might respond differently, TAS had to choose a particular penalty and taxpayer segment to study. The single largest component of the tax gap — the gap between the amount of tax due and the amount voluntarily and timely paid — is underreporting of business income by individuals.[9] Thus, this study focuses on the effect of accuracy-related penalties, which apply to underreporting, on Schedule C filers.

In light of the IRS's increasing use of automated processes (*e.g.*, correspondence examinations and the automated underreporter or AUR process) to assess penalties before communicating with the taxpayer (*i.e.*, penalties assessed based on incomplete information and that may not be warranted) one hypothesis was that "default" penalty assessments might have a different effect on future compliance than other penalty assessments. For similar reasons, TAS separately analyzed assessments that were later abated or appealed.

## BACKGROUND

### Accuracy-related penalties may provide an incentive to report income accurately.

A taxpayer may be subject to a 20 percent accuracy-related penalty on the portion of any underpayment attributable to (1) the taxpayer's negligence or disregard of rules or regulations, or (2) a "substantial

4 Both Congress and the IRS reached the same conclusion in the late 1980s after extensive study, research, and comment from the public. *See, e.g.*, Executive Task Force for Internal Revenue Commissioner's Penalty Study, *A Philosophy of Civil Tax Penalties* (Discussion Draft), *reprinted in* 111 DTR L-1 1988, 9-10 (June 9, 1988) [hereinafter "IRS Task Force Report I"]; H.R. Rep. No. 101-386 at 661 (1989) (Conf. Rep.) (stating that, in connection with significant civil tax penalty reform, "the IRS should develop a policy statement emphasizing that civil tax penalties exist for the purpose of encouraging voluntary compliance"). Pursuant to IRS policy, "[P]enalties are used to enhance voluntary compliance. " Policy Statement 20-1 (Formerly P–1–18), *reprinted at* IRM 1.2.20.1.1(1)-(2) (June 29, 2004).

5 *See* IRS Task Force Report I at 9-10.

6 H.R. Rep. No. 101-386, at 661 (1989) (Conf. Rep).

7 Policy Statement 20-1 (June 29, 2004).

8 National Taxpayer Advocate 2012 Annual Report to Congress vol. 2, 151-157 (Research Prospectus: *When Do Accuracy-Related Penalties Improve Future Reporting Compliance by Schedule C Filers?*). For a broader discussion of penalties, see National Taxpayer Advocate 2008 Annual Report to Congress vol. 2, 2 (*A Framework for Reforming the Penalty Regime*).

9 *See* IRS Research, Analysis & Statistics, *Federal Tax Compliance Research: Tax Year 2006 Tax Gap Estimation* (Mar. 2012), http://www.irs.gov/pub/irs-soi/06rastg12workppr.pdf.

understatement" of income tax.[10] A taxpayer may be subject to the "negligence" penalty if he or she fails to make a reasonable attempt to comply with the internal revenue laws; does not exercise ordinary and reasonable care in preparing his or her tax return; or fails to keep adequate books and records or substantiate items properly.[11] In assessing a penalty, the IRS may also consider factors such as the taxpayer's compliance history; actions taken by the taxpayer to ensure the tax was correct and timely filed; and the taxpayer's explanation for any inaccuracies.[12]

An individual may be subject to a "substantial understatement" penalty if the understatement exceeds the greater of $5,000 or ten percent of the tax required to be shown on the return.[13] Generally, an "understatement" is the difference between (1) the correct amount of tax and (2) the amount reported on the return, reduced by any rebate.[14] Understatements are usually reduced by any portion attributable to (1) an item for which the taxpayer had substantial authority; or (2) any item for which the taxpayer adequately disclosed the relevant facts affecting the item's tax treatment, provided the taxpayer had a reasonable basis for such treatment.[15]

A taxpayer generally is not subject to an accuracy-related penalty if he or she establishes a "reasonable cause" for the underpayment and acted in good faith.[16] The most important factor in establishing reasonable cause is the extent of the taxpayer's effort to determine the correct tax liability.[17] Thus, the combination of accuracy-related penalties and reasonable cause exceptions may provide an incentive for taxpayers to make reasonable and good faith efforts to report their income accurately.

**Accuracy-related penalties may promote compliance by deterring noncompliance, setting expectations, influencing norms, and increasing the perceived fairness of the tax system.**

Penalties obviously deter some people from cheating,[18] but others comply voluntarily for a variety of other reasons.[19] Penalties may help taxpayers understand what compliance requires.[20] So-called "tax morale"

10 IRC § 6662(b)(1) (negligence or disregard of rules or regulations); IRC § 6662(b)(2) (substantial understatement). Although the IRS may assess more than one accuracy-related penalty, the total penalty rate cannot exceed 20 percent (or 40 percent in certain circumstances) because the penalties are not "stackable." Treas. Reg. § 1.6662-2(c). There are several accuracy-related penalties, but this discussion focuses on the accuracy-related penalties for negligence and substantial understatements because they are the most common.

11 IRC § 6662(c); Treas. Reg. § 1.6662-3(b).

12 Internal Revenue Manual (IRM) 4.10.6.2.1 (May 14, 1999).

13 IRC § 6662(d)(1)(A)(i)-(ii). For corporations (other than S corporations or personal holding companies), an understatement is substantial if it exceeds the lesser of ten percent of the tax required to be shown on the return or $10,000. IRC § 6662(d)(1)(B)(i), (ii).

14 IRC § 6662(d)(2)(A).

15 IRC § 6662(d)(2)(B). No reduction is permitted, however, for any item attributable to a tax shelter. IRC § 6662(d)(2)(C)(i).

16 IRC § 6664(c)(1).

17 Treas. Reg. § 1.6664-4(b)(1).

18 *See, e.g.*, Richard Lavoie, *Flying Above the Law and Below the Radar: Instilling a Taxpaying Ethos in Those Playing by Their Own Rules*, 29 Pace L. Rev. 637, 640-42 (2009) (summarizing research concerning tax compliance); Sarah B. Lawsky, *Probably? Understanding Tax Law's Uncertainty*, 157 U. Pa. L. Rev. 1017 (2009); Eric A. Posner, *Law and Social Norms: The Case of Tax Compliance*, 86 Va. L. Rev. 1781 (2000) (summarizing deterrence theory).

19 *See, e.g.*, National Taxpayer Advocate 2012 Annual Report to Congress vol. 2, 1-28 (*Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results*).

20 *See Internal Revenue Service Commissioner Lawrence Gibbs' Prepared Statement on Civil Tax Penalties, Including Executive Summary of Report by IRS Task Force on Civil Penalties, Hearing Before the House Ways and Means Oversight Subcommittee* (Feb. 21, 1989), *reprinted in* 34 DTR L-18, 1989 (Feb. 22, 1989). *See also* Michael Doran, *Tax Penalties and Tax Compliance*, 46 Harv. J. Legis. 111, 113 (Winter 2009). Similarly, the IRS's 1998 Penalty Policy Statement acknowledged "the Service uses penalties to encourage voluntary compliance by …helping taxpayers understand that compliant conduct is appropriate and that non-compliant conduct is not." *See* Policy Statement P-1-18 (Aug. 20, 1998), *superseded by* Policy Statement 20-1 (June 29, 2004).

may play a role for those who value integrity, honesty, and the benefits of government;[21] and "social norms" may play a role for those who want to comply because they believe that other similar taxpayers do. Those motivated by reciprocity may be influenced by their perception of whether the government or the IRS is respecting the basic elements of procedural justice by acting with impartiality, honesty, fairness, courtesy, and respect for taxpayer rights.[22] Indeed, recent research finds a correlation between perceptions of fairness and voluntary compliance.[23] Moreover, the IRS generally acknowledges that such perceptions drive compliance and excessive or undeserved penalties can discourage it.[24]

### Reasonable cause penalty exceptions may also increase compliance, if properly applied.

As noted above, a penalty generally will not apply to a taxpayer who can show a good faith "reasonable cause" for the failure to comply.[25] To the extent that a reasonable cause exception reduces the perceived likelihood that noncompliance will trigger a penalty, it may reduce the incentive to comply. If properly applied, however, a reasonable cause exception should motivate taxpayers to use good faith efforts to comply with tax laws because it reassures them that their efforts will pay off (*i.e.*, a penalty will not apply so long as the taxpayer makes a reasonable good faith effort to comply, even if he or she fails). Properly applying the exception also promotes the perception that the penalties are fair.[26] Thus, the IRS's application of a penalty may affect the extent to which it promotes or discourages voluntary compliance.

### Accuracy-related penalties may not have the same effect on compliance when assessed by default, appealed, or abated.

The IRS sometimes proposes penalties automatically, before performing a careful analysis of the relevant facts and circumstances.[27] As shown by the following table, the IRS may use different levels of effort to locate taxpayers and ascertain the reason for the apparent discrepancy, depending on the type of examination.

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21 A similar theory is that taxpayers comply because of their "self-concept" as being honest. *See, e.g.*, Nina Mazar, *The Dishonesty of Honest People: A Theory of Self-Concept Maintenance*, 45 J. Mkt'g Res. 633-644 (2008).

22 See National Taxpayer Advocate 2012 Annual Report to Congress vol. 2, 1-28 (*Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results*) (finding that sole proprietors who believe the government, the IRS, and the tax laws are fair may be more likely to comply). *Accord* Nina Mazar, *The Dishonesty of Honest People: A Theory of Self-Concept Maintenance*, 45 J. Mkt'g Res. 633-644 (2008).

23 National Taxpayer Advocate 2012 Annual Report to Congress vol. 2, 1-28.

24 IRM 20.1.1.2.1(10) (Nov. 25, 2011) ("Penalties best aid voluntary compliance if they support belief in the fairness and effectiveness of the tax system."); IRM 4.26.16.4(4)-(5) (July 1, 2008) ("examiners should consider whether the issuance of a warning letter and the securing of delinquent FBARs, rather than the assertion of a penalty, will achieve the desired result of improving compliance in the future … [D]iscretion is necessary because the total amount of penalties that can be applied under the statute can greatly exceed an amount that would be appropriate in view of the violation."); IRM 20.1.1.1.3(4) (Dec. 11, 2009) ("A wrong [penalty] decision, even though eventually corrected, has a negative impact on voluntary compliance.").

25 *See, e.g.*, IRC § 6664(c).

26 According to the IRM, "[v]oluntary compliance is achieved when a taxpayer makes a good faith effort to meet the tax obligations defined by the Internal Revenue Code." IRM 20.1.1.2.1(6) (Nov. 25, 2011). If so, then penalizing taxpayers who have made a good faith effort does not promote voluntary compliance very effectively because it penalizes some who have done so.

27 *See e.g.*, National Taxpayer Advocate 2013 Annual Report to Congress vol. 1, *supra* (Most Serious Problem: *The IRS Inappropriately Bans Many Taxpayers From Claiming EITC*); National Taxpayer Advocate 2007 Annual Report to Congress 275 (Most Serious Problem: *The Accuracy-Related Penalty in the Automated Underreporter Units*); National Taxpayer Advocate 2010 Annual Report to Congress 198 (Most Serious Problem: *The IRS's Over-Reliance on Its "Reasonable Cause Assistant" Leads to Inaccurate Penalty Abatement Determinations*).

**TABLE 1: Procedures for Proposing Accuracy-Related Penalties by Exam Program**

| Program | Significant address research? [28] | Common letter to propose penalty | Examiner's contact information on letter? [29] | Examiner discusses reason(s) for the discrepancy before penalty asserted? [30] | Penalty assessed if taxpayer not located? [31] |
|---|---|---|---|---|---|
| Field Exam | Yes | Letter 950[32] | Yes | Yes | Not usually |
| Office Exam | Yes | Letter 915[33] | Yes | Yes | Not usually |
| Corr. Exam | No | Letter 525[34] | No | No | Yes |

Automatic penalties — those assessed based on a presumption that they apply before obtaining all relevant information from the taxpayer to determine whether they actually apply — seemingly ignore direction from Congress that the IRS should "make a correct substantive decision in the first instance rather than mechanically assert penalties with the idea that they will be corrected later."[35] Other stakeholders have expressed similar concerns.[36] From the taxpayer's perspective, penalties that the IRS proposes automatically (as well as default assessments) and similar assessments that the taxpayer appeals may not take the taxpayer's effort to comply into account, and may be less likely to promote the sense that the tax system is fair.[37] For this reason, default penalty assessments and those later appealed or abated may not have the same positive effect on voluntary compliance as other penalty assessments. Thus, TAS analyzed these taxpayer segments separately.

28 *Compare* IRM 4.10.2.7.2 (Apr. 2, 2010) (describing how field and office exam employees may use asset locator services, postal traces, credit reports, internet searches, IDRS searches, third party contacts, research of related TINs, and personal visits to locate the taxpayer) *with* IRM 4.19.13.13 (Jan. 1, 2013) (discussing how corr. exam employees research addresses using IDRS).

29 *See* IRM 4.10.1.5.3.2(4) (May 14, 1999) ([For field and office exams] "[A]ll correspondence must contain an employee name, contact telephone number, employee identification number, and signature"). While corr. exam letters include a general number, an examiner may not be assigned to a case in corr. exam unless the IRS receives a response to its computer-generated letters. *See, e.g.*, IRM 4.19.20.1(1) (Jan. 1, 2013). Accordingly, the IRS cannot list the examiner's name or number.

30 For field and office exams, employees are required to communicate with the taxpayer before asserting penalties. *See* IRM 4.10.6.3.5 (May 14, 1999) ("To ensure the proper consideration and appropriate application of penalties, it is very important to solicit the taxpayer's explanation for adjustments"); IRM 4.10.6.4(3) (May 14, 1999) ("The assertion of penalties, including alternative positions, should be discussed with the taxpayer and/or representative prior to issuing an examination report"). These requirements do not apply in corr. exam. *See, e.g.*, IRM 4.19.13.5.3 (Jan. 1, 2013) ("[when documenting penalties on a lead sheet] the taxpayer's position must be addressed [only] if the taxpayer responds to the Exam report and addresses the underpayment in the response.").

31 *Compare* IRM 4.10.2.7.2.7 (Apr. 2, 2010) (for field and office exams a penalty is not assessed unless non-assessment would undermine compliance) *with* IRM 20.1.5.7.1(5)(a) (Jan. 24, 2012) (indicating corr. exam will assert the negligence penalty even if a taxpayer is not located).

32 IRM 4.10.8.11 (Aug. 11, 2006).

33 *Id*.

34 IRM 4.19.10.1.6 (Feb., 24, 2011).

35 H.R. Conf. Rep. No. 101-386, at 661 (1989).

36 American Institute of Certified Public Accountants (AICPA), *Report on Civil Tax Penalties: The Need for Reform* (Aug. 28, 2009) ("[I]ncreasingly, penalties are assessed using automated processes … without the benefit of pre-assessment rights to pursue reasonable cause and other defenses. In many instances, taxpayers pay penalties even if they are unwarranted because it is so difficult and costly to challenge a penalty once it is assessed."). American Bar Association (ABA) Tax Section, *Comments Concerning Possible Changes to Penalty Provisions of the Internal Revenue Code* (1999), http://www.americanbar.org/groups/taxation/policy/public_policy/provisions12.html ("Automatic assertion, followed by abatement, is far less satisfactory than assertion after inquiry, because taxpayers resent being penalized first and then having to prove compliance, and because many penalties that are asserted and paid probably should never have been assessed."). Similarly, the IRS's penalty handbook states, "[E]rroneous penalty assessments and incorrect calculations confuse taxpayers and misrepresent the overall competency of the IRS." IRM 20.1.1.2.2(1)(b) (Nov. 25, 2011).

37 Surveys consistently find that taxpayers report that personal integrity is the strongest factor influencing tax compliance. *See, e.g.*, *IRS Oversight Board, 2012 Taxpayer Attitude Survey* (Feb. 2013), http://www.treasury.gov/irsob/reports/2013/IRSOB~TAS%202012~FINAL.pdf.

## METHODOLOGY

### TAS identified sole proprietors subject to audit adjustments in 2007 and used changes in their "DIF" scores as a proxy for changes in their reporting compliance.

TAS sought to determine how accuracy-related penalty assessments affect subsequent reporting compliance by sole proprietors (*i.e.*, those who file Form 1040, *U.S. Individual Income Tax Return,* with a Schedule C, *Profit or Loss from Business*).[38] TAS focused on those subject to an examination adjustment in 2007 for tax year (TY) 2003 or later.[39] TAS gauged reporting compliance using the IRS's computer algorithms (called a Discriminant Function or "DIF" score) that estimate the likelihood that an audit of the taxpayer's return would produce an adjustment (*i.e.*, a higher DIF generally corresponds to lower reporting compliance).[40]

Because DIF scores are computed separately for taxpayers in each "exam activity code" (EAC) each year, the scores of those in one EAC are not comparable to the scores of those in another EAC or to DIF scores computed for different tax years. To compare taxpayers in different EACs and for different years, TAS scaled the DIF scores. For each year, TAS first sorted all of the taxpayers in each EAC by DIF, and then assigned the taxpayers a scaled DIF score based on the decile into which they fell. For example, TAS assigned those in the first decile a scaled DIF score of 1 and those in the 10th decile a scaled DIF score of 10. TAS used changes in the taxpayer's scaled DIF score as a proxy for changes in reporting compliance.[41]

### TAS identified matched pairs of similarly situated taxpayers — those subject to a penalty and those not subject to a penalty.

If the IRS consistently assessed an accuracy-related penalty against all similarly situated taxpayers, then it would be difficult to determine whether differences in future compliance were due to differences in the taxpayers, the audit, or the penalty itself. In technical terms, the analysis would suffer from "selection bias." To minimize this problem, TAS sought to analyze matched pairs of similarly situated taxpayers that were different in only one respect: One was assessed a 20 percent accuracy-related penalty and the other

38 TAS pulled examination results data from the Automated Information Management System (AIMS), and merged it with data from the Individual Returns Transaction File (IRTF), and the IRS Master File. TAS relied on IMF transaction codes 240 (assessment) and 241 (abatement) with an accuracy-related penalty reference number of 680 to determine if penalty assessments or abatements had been made. TAS removed tax returns from the study where a 40 percent accuracy-related penalty was assessed so that we could focus on the 20 percent penalty. Only 25 returns were removed on this basis.

39 TAS focused on Schedule C filers whose returns were examined and adjusted in 2007 (rather than 2012 or 2013) so that we could analyze the taxpayer's future compliance. TAS eliminated taxpayers with adjustments to pre-2003 tax returns as potentially anomalous. TAS also excluded the low income taxpayers claiming the earned income tax credit (EITC) because they may present a unique set of tax compliance issues.

40 *See, e.g.*, IRM 4.19.11.1.4 (Nov. 9, 2007). The IRS selects some returns for examination using the Discriminant Function (DIF) computer scoring system. IRM 4.1.1.2.6 (Oct. 24, 2006). It develops DIF scores based on information obtained and periodically updated from National Research Program examinations. Returns with high DIF scores generally have a higher probability of being adjusted on audit than other returns of the same type. IRM Exhibit 4.1.7-1(12) (May 19, 1999). The IRS classifies tax returns into mutually exclusive groups called examination "activity codes" ("EAC"), and develops a separate compliance risk scoring algorithm (*i.e.*, a DIF algorithm) for each activity code. For Schedule C filers, the activity codes reflect the amount of gross receipts reported on the Schedule C and the taxpayer's total positive income (TPI), which is the taxpayer's positive income (*i.e.*, excluding negative income and losses) from all sources before adjusting for deductions and exemptions. For a more detailed discussion of the DIF score methodology, see National Taxpayer Advocate 2012 Annual Report to Congress vol. 2 (*Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results*).

41 This analysis assumes, for example, that taxpayers who fall into the 7th DIF decile for EAC 77 in TY 2007 have reporting compliance similar to taxpayers in who fall into the 7th DIF decile for EAC 76 in TY 2008.

was not.[42] Otherwise, the paired taxpayers were similar. They were in the same EAC (*e.g.*, had similar levels of positive income and receipts), subject to the same type of examination (*e.g.*, a field examination, office examination, or correspondence examination), and subject to an adjustment of a similar dollar amount (*i.e.*, in the same quartile).

## FINDINGS

### Accuracy-related penalties had no significant effect on the subsequent reporting compliance (as measured by DIF) of those subject to them.

Reporting compliance (as measured by scaled DIF score) significantly improved following an examination assessment, potentially suggesting that examinations generally improve subsequent reporting compliance.[43] However, reporting compliance by those also subject to an accuracy-related penalty was no higher following the examination than the compliance of similarly situated taxpayers who were not penalized. In other words, an accuracy-related penalty assessment in 2007 had no statistically significant effect on future (TY 2007 or TY 2011) DIF-measured reporting compliance by those who were penalized, as shown on the following table.

**TABLE 2: Changes in DIF Following an Examination Assessment**

| Tax Year | No Penalty | | | Penalty | | | Difference in Scaled DIF[45] |
|---|---|---|---|---|---|---|---|
| | Taxpayers | Scaled DIF | Change from Base Year[44] | Taxpayers | Scaled DIF | Change from Base Year | |
| **Base[46]** | 22,372 | 8.57 | n/a | 22,372 | 8.59 | n/a | -0.02 |
| **2007** | 20,509 | 7.31 | -14.8% | 20,020 | 7.34 | -14.5% | -0.03 |
| **2011** | 16,781 | 7.09 | -17.3% | 15,939 | 7.13 | -16.9% | -0.04 |

The positive effect of some penalties on reporting compliance may have offset the negative effect of other penalties on voluntary compliance, as further discussed below. Thus, this finding may suggest that the way the IRS administers accuracy-related penalties impairs or enhances their effectiveness.

42 For a more detailed description of the matched pair methodology, see National Taxpayer Advocate 2011 Annual Report to Congress vol. 2, 92, 99 (*Estimating the Impact of Liens on Taxpayer Compliance Behavior and Income*). For those with a technical interest, TAS used a "5-> 1 Greedy" matching technique to form the matched pairs by performing a logistic regression. In the logistic regression, the presence or absence of a penalty assessment was the dependent variable and the characteristics (listed above) were the independent variables. The regression produced a "propensity score" for each taxpayer in each group, reflecting the likelihood that he or she would be penalized based solely on the independent variables. TAS then paired taxpayers with similar scores from each group (*i.e.*, those who were penalized and those who were not), as described in Lori S. Parsons, Ovation Research Group, Seattle, WA, Working Paper 214-26, *Reducing Bias in a Propensity Score Matched-Pair Sample Using Greedy Matching Techniques* (2001).

43 For each group of taxpayers that TAS analyzed, the scaled DIF score was significantly lower in TY 2007 than in the base year, as described below. Unless otherwise indicated, TAS performed all statistical tests using a 95 percent level of confidence.

44 In each of the tables, figures in the "Change from Base Year" column are calculated at three decimal places and rounded to one decimal place.

45 The differences in scaled DIF scores between the two groups are not statistically significant. In other words, the nominal differences shown on the table may be due to random variations rather than any statistically significant differences in the scores. For all of the tables in this analysis, only the differences that are highlighted are statistically significant at a 95-percent level of confidence.

46 For each of the figures in this discussion, the "base year" DIF score is the score for the tax year of the return that the IRS initially selected for examination (*i.e.*, TY 2003, TY 2004, TY 2005, or TY 2006).

**Accuracy-related penalties did not improve reporting compliance (as measured by DIF) among taxpayers subject to default assessments or who appealed, and five years later these taxpayers appeared less compliant than those not subject to penalties.**[47]

Among taxpayers who were subject to a default assessment or who appealed examination's determination, those subject to penalties were no more compliant (than similar taxpayers who were not penalized) immediately following the assessment. In addition, five years later they were significantly less compliant than those who were not penalized, as shown in the following tables.[48]

**TABLE 3: Changes in DIF Following a Default Assessment**

| Tax Year | No Penalty | | | Penalty | | | Difference in Scaled DIFs |
|---|---|---|---|---|---|---|---|
| | Taxpayers | Scaled DIF | Change from Base Year | Taxpayers | Scaled DIF | Change from Base Year | |
| **Base** | 2,462 | 8.65 | n/a | 2,462 | 8.77 | n/a | -0.12 |
| **2007** | 1,814 | 7.40 | -14.5% | 1,908 | 7.51 | -14.4% | -0.11 |
| **2011** | 1,207 | **7.03** | -18.8% | 1,255 | **7.29** | -16.9% | **-0.27** |

**TABLE 4: Changes in DIF Following an Examination Assessment Against Taxpayers who Appealed**

| Tax Year | No Penalty | | | Penalty | | | Difference in Scaled DIFs |
|---|---|---|---|---|---|---|---|
| | Taxpayers | Scaled DIF | Change from Base Year | Taxpayers | Scaled DIF | Change from Base Year | |
| **Base** | 905 | 8.29 | n/a | 905 | 8.40 | n/a | -0.11 |
| **2007** | 867 | 7.33 | -11.5% | 838 | 7.35 | -12.5% | -0.02 |
| **2011** | 715 | **6.89** | -16.8% | 685 | **7.27** | -13.4% | **-0.38** |

By design, in cases where the IRS assesses a penalty by default — without ever communicating with the taxpayer — it is more likely to assess a penalty that would not apply if it knew all of the relevant facts. Moreover, in the case of both default assessments and assessments after an appeal, taxpayers may be more likely to feel that they do not deserve to be penalized (in the case of an appeal) or that the process by which it was imposed (in the case of a default assessment) was unfair. These findings are consistent with prior research (cited above) showing a correlation between noncompliance by Schedule C filers and the view that the IRS or the tax system is unfair. They are also consistent with the theory (described above) that a penalty may reduce the incentive to comply if it is applied even in cases where the taxpayer made a reasonable good faith effort to do so.[49]

47 As noted above, the DIF score was used as a proxy for reporting compliance. The DIF is an approximate measure of reporting compliance, and small differences, although statistically significant, suggest but do not definitively indicate a real difference in reporting compliance.

48 TAS could not determine whether taxpayers were appealing the Examination Division's proposed tax or penalty.

49 Someone might infer that the IRS correctly identified and penalized the "bad" taxpayers — although no different in any measurable way from the relatively "good" taxpayers who were not penalized — and these "bad" taxpayers were more likely to become noncompliant after the exam than the relatively "good" taxpayers who were not penalized. If this explanation were true, however, we would expect to see the same pattern among taxpayers overall (*i.e.*, including those who were not penalized by default and who did not appeal), but we did not. Moreover, we did see the same pattern (long term noncompliance) among "good" taxpayers who were assessed penalties that the IRS later abated, as discussed below.

In addition, these findings suggest that the IRS should reconsider the automated way in which it imposes penalties, particularly in cases where they may not apply. For example, in cases where the taxpayer's specific facts and circumstances need to be examined, the automatic, automated, or even formulaic application of penalties should be avoided.

These findings may also suggest that the IRS could improve voluntary compliance by doing more to make taxpayers feel that the penalty assessment process is fair. Specifically, Appeals should consider doing more to explain why its determination is correct and fair. Further, in the case of penalties that taxpayers generally regard as unfair (*e.g.*, where reasonable cause does not apply or is so narrowly interpreted as to, in effect, create a strict liability penalty), the IRS should apply a broader reasonable cause exception (or work with the Treasury Department to propose one) that is simple and easy to administer in a way that will be perceived as fair and transparent.[50]

### Accuracy-related penalties did not improve reporting compliance (as measured by DIF) among taxpayers whose penalties were later abated, and five years later these taxpayers appeared less compliant than those whose penalties were not abated.

Taxpayers subject to an accuracy-related penalty that was assessed and abated had the same level of DIF-measured reporting compliance as taxpayers whose penalties were not abated in the year after their cases were closed (in TY 2007). However, their DIF-measured reporting compliance was significantly lower than that of those whose penalties were not abated five years later (in TY 2011), as shown on the following table.

### TABLE 5: Changes in DIF Following an Examination Assessment Against Taxpayers whose Penalties were Abated

| Tax Year | Penalty Abated in Full | | | Penalty Not Abated[51] | | | Difference in Scaled DIFs |
|---|---|---|---|---|---|---|---|
| | Taxpayers | Scaled DIF | Change from Base Year | Taxpayers | Scaled DIF | Change from Base Year | |
| **Base** | 488 | 8.35 | n/a | 488 | 8.63 | n/a | -0.28 |
| **2007** | 442 | 7.17 | -14.1% | 440 | 7.01 | -18.9% | 0.17 |
| **2011** | 370 | **7.10** | -14.9% | 348 | **6.74** | -22.0% | **0.37**[52] |

50 *See, e.g.*, National Taxpayer Advocate 2008 Annual Report to Congress 419-422 (Legislative Recommendation: *Modify Internal Revenue Code Section 6707A to Ameliorate Unconscionable Impact*); National Taxpayer Advocate 2012 Annual Report to Congress 134 (Most Serious Problem: *The IRS's Offshore Voluntary Disclosure Programs Discourage Voluntary Compliance by Those Who Inadvertently Failed to Report Foreign Accounts*); National Taxpayer Advocate 2011 Annual Report to Congress 544-547 (Legislative Recommendation: *Amend the Erroneous Refund Penalty to Permit Relief in Case of Reasonable Cause for Claim to Refundable Credits*); National Taxpayer Advocate 2013 Annual Report to Congress vol. 1, *supra* (Most Serious Problem: *The IRS Assessed Penalties Improperly, Refused to Abate them, and Continues to Assess them Automatically, Violating Taxpayer Rights and Reducing Respect for the Law*); National Taxpayer Advocate 2013 Annual Report to Congress vol. 1, *supra* (Most Serious Problem: *The IRS Inappropriately Bans Many Taxpayers From Claiming EITC*). *See also* National Taxpayer Advocate 2008 Annual Report to Congress vol. 2 1, 21 (*A Framework for Reforming the Penalty Regime*).

51 TAS could identify the taxpayers who obtained penalty abatement, but not those whose penalty abatement request was denied.

52 Due to the low sample size of these groups, the difference in DIF between those granted full penalty abatement and a matched set of similar taxpayers who did not is only statistically significant at a 90 percent level of confidence.

The finding that undeserved penalty assessments do not promote reporting compliance (as measured by DIF) — and may actually discourage it in the long term — is not surprising.[53] Although some people might try to avoid further entanglement with the IRS by taking more conservative positions in the future, undeserved penalty assessments likely discourage some taxpayers from complying by communicating that the system is unfair and that the IRS may seek to penalize them even if they try to comply — and even if they actually have complied. It also lends further support to the suggestion (above) that the IRS should reconsider its automated approach to penalties as potentially inconsistent with its goal of promoting voluntary compliance.[54]

## CONCLUSION

Accuracy-related penalties are meant to improve reporting compliance. Knowing that tax reporting errors can trigger an IRS examination and penalties provides an incentive for taxpayers to carefully report tax liabilities to the IRS. Indeed, the results of this study suggest that *examination assessments* promote reporting compliance (as measured by scaled DIF scores) among Schedule C filers who are subject to them. However, it did not find that *accuracy-related penalty assessments* improve subsequent reporting compliance. This finding may suggest that the effect of penalties on compliance may depend upon whether the IRS is perceived as applying them fairly. Perhaps because automated penalty assessments and those that are later appealed or abated are more likely to be perceived as unfair, they do not appear to have a positive effect on reporting compliance. Worse, they may actually promote long-term noncompliance.

These findings have a number of policy implications. First, the IRS should revise its procedures to ensure that it does not propose a penalty before exhausting efforts to communicate with a taxpayer to determine whether a penalty actually applies. Automated procedures that presume a penalty applies unless a taxpayer explains and documents why it does not apply are likely to generate more default assessments and penalty abatements than other examination methods. As taxpayers who were penalized after default assessments or whose penalties were abated had smaller reductions in DIF scores, suggesting lower levels of voluntary compliance after five years than those who were not, these automated procedures may be inconsistent with the IRS's goal of promoting voluntary compliance.

Second, the IRS's Appeals function should consider doing more to objectively evaluate and then explain its determinations, particularly when it sustains a penalty. As taxpayers who were penalized after an appeal had smaller reductions in DIF scores, suggesting lower levels of compliance after five years than those who were not, it is possible that they did not perceive Appeals as fairly evaluating whether the penalty should apply.

Finally, in the case of penalties that taxpayers generally regard as unfair (*e.g.*, where a reasonable cause exception does not apply, or where it may be interpreted so narrowly as to, in effect, create a strict liability penalty), the IRS should consider applying a broader reasonable cause exception (or work with the Treasury Department to propose one) that is simple, fair, transparent, and easy to administer.

53 TAS did not evaluate whether any IRS employee applied the IRS's procedures improperly in assessing or abating these penalties.

54 To the extent these results suggest that perceived unfairness erodes long term voluntary compliance, they may also support the National Taxpayer Advocate's legislative proposal to clarify taxpayer rights and provide a remedy to taxpayers whose rights are violated, as these changes might increase the perceived fairness of the tax system. *See, e.g.*, National Taxpayer Advocate 2012 Annual Report to Congress, vol. 2, 131.

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# A Comparison of Revenue Officers and the Automated Collection System in Addressing Similar Employment Tax Delinquencies

SECTION TWO

# A Comparison of Revenue Officers and the Automated Collection System in Addressing Similar Employment Tax Delinquencies[1]


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1 The principal authors of this study are Jeff Wilson, Research Director, Joseph Saldana, Research Analyst, Mike McDermitt, Senior Collection Technical Liaison, and Eric LoPresti, Senior Attorney Advisor, of the Office of the Taxpayer Advocate.

## EXECUTIVE SUMMARY

When a taxpayer does not pay his or her tax liability after receiving a stream of delinquency notices, the IRS may assign the collection case to a revenue officer (RO) in the Collection Field function (CFf), to a group of Automated Collection System (ACS) employees in centralized call sites, or to the queue to wait until collection resources become available to work the case. Thus, the IRS must decide which cases to assign to ROs, ACS, or the queue, and which to prioritize.

Direct comparisons between ACS employees and ROs present challenges, in part, because ACS generally works "fresh" and comparatively low-dollar cases. Moreover, although the vast majority of all payments (including late payments) come in as a result of voluntary compliance, the IRS does not measure or compare the effect of CFf or ACS on the taxpayer's future compliance.

In an effort to address these knowledge gaps, TAS compared the IRS's performance in working similar types of collection cases initially assigned to an RO, ACS, or the queue. As employment tax delinquencies are a high priority for the IRS and can easily lead to future delinquencies, TAS focused on taxpayers with newly-delinquent employment tax deposit "modules" (*i.e.*, those with three or fewer delinquent quarters) that were first assigned to ACS, the queue, or CFf during 2003-2004. In an apples-to-apples comparison, TAS found:

- The CFf collected more dollars and resolved delinquencies more quickly than ACS, regardless of the size of the delinquency.
- ACS transferred more tax modules, particularly medium- and high-dollar modules (over $1,500), to the queue and CFf, reducing the IRS's speed and effectiveness in addressing them.
- CFf collected more on high-dollar modules initially assigned to the queue when it received them quickly. Thus, the IRS should consider limiting its use of the queue as an inventory management tool, particularly for high-dollar modules, as recommended by the National Taxpayer Advocate.[2]
- Taxpayers with low-dollar modules (*i.e.*, $1,500 or less) reduced their delinquencies more than those with higher-dollar modules while they were in the queue.
- Taxpayers initially assigned to the queue appeared somewhat responsive to the notices they received after the initial notice stream. Thus, the IRS should consider sending additional notices to taxpayers assigned to the queue, particularly notices that emphasize payment alternatives and the impact of late payment penalties and daily compounded interest, as recommended by the National Taxpayer Advocate.[3]
- IRS data suggests the IRS's collection functions had very little success in promoting future compliance, regardless of the collection channel. It also suggests that collection employees closed about 24 percent of their cases while the taxpayers in question were falling behind on or about to fall behind on their taxes (or tax filings). Thus, both ACS and CFf should do more to resolve all compliance issues and ensure the taxpayer is able to comply in future periods before closing cases, and

2 *See, e.g.*, National Taxpayer Advocate 2010 Annual Report to Congress, vol. 2, 69 (*An Analysis of the IRS Collection Strategy: Suggestions to Increase Revenue, Improve Taxpayer Service, and Further the IRS Mission*).

3 *See* National Taxpayer Advocate 2013 Annual Report to Congress, vol. 1, *supra* (Most Serious Problem: *Inadequate Service Delivery in the IRS Collection Process Harms Business Taxpayers and Contributes to Substantial Amounts of Lost Revenue*).

regularly measure and report on future compliance, as previously recommended by the National Taxpayer Advocate.[4]

This study did not directly investigate why ROs are faster and more effective in resolving delinquencies than ACS employees, particularly on higher-dollar cases (those with modules of $1,500 or more). However, it may be because each RO is generally expected to address the cause of the noncompliance and then resolve his or her assigned cases rather than pass them along to another collection employee or the queue. It may also be because ROs communicate with the taxpayer by visiting or making outgoing calls, and actively assist the taxpayer with collection alternatives. If so, then the IRS should either avoid assigning these cases to ACS or empower ACS employees to operate more like ROs.

For example, ACS employees should be required to make more use of outbound calls, actively assist taxpayers in using collection alternatives (*e.g.*, installment agreements and offers in compromise), and be expected to fully resolve certain types of cases (rather than pass them along to another employee or the queue). These changes would make ACS employees responsible for case outcomes. If adopted, taxpayers could also work with one person who is familiar with their circumstances. However, such changes are unlikely to improve ACS's results unless ACS employees receive adequate training and authority, and the IRS executives responsible for managing them are regularly required to measure and report on ACS's performance in these areas.[5]

4 For a discussion of IRS measures, see, *e.g.*, National Taxpayer Advocate 2010 Annual Report to Congress 28-48 (Most Serious Problem: *IRS Performance Measures Provide Incentives that May Undermine the IRS Mission*).

5 *Id*.

## INTRODUCTION

The collection process generally involves three stages.[6] In the first stage, the IRS sends the taxpayer a series of notices.[7] In the second stage, the IRS typically routes the case to the Automated Collection System (ACS), though it sometimes routes them directly to a revenue officer (RO) in the Collection Field function (CFf) or to the queue where they wait for collection resources to become available.[8] In the final stage, the IRS routes cases that remain unpaid or unresolved in ACS or the queue to CFf.

ACS computers and employees generally send taxpayers demand notices, issue liens and levies, and answer calls from centralized sites. As described in prior reports, ACS began as a call center that devoted significant staff hours to outgoing calls, but now ACS employees spend only about two percent of their direct time making outgoing calls.[9] When ACS employees communicate with taxpayers, they focus on getting the taxpayer to full pay, rather than exploring collection alternatives (*e.g.*, installment agreements and offers in compromise), as appropriate, based on the taxpayer's individual circumstances.[10] ACS employees are not assigned caseloads, nor are they expected or required to routinely resolve cases during contacts with taxpayers. Unresolved cases may be worked by another ACS employee, or transferred to the queue or CFf. Moreover, taxpayers cannot work with the same ACS employee if they need to communicate with the IRS more than once in resolving a delinquency.

ROs working in field offices may also send letters, issue liens and levies, and answer calls. However, they are instructed that "[A]n effective initial [outgoing] contact is the cornerstone to timely and effective case resolution," and are supposed to "discuss" collection alternatives with taxpayers who cannot pay.[11] They also have a direct phone line, are aware of local economic conditions, and may even visit the delinquent business.[12] Moreover, they are generally expected to resolve their cases (rather than pass them along to another collection employee or the queue).

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6 The IRS collection process begins with an assessment, which can occur through three different methods: Self-assessment by the taxpayer when a return is filed; IRS assessment based on deficiency procedures and after the taxpayer has exhausted (or failed to exercise) all appeal rights; or an IRS-prepared "substitute for return" (SFR) where the taxpayer has failed to file a timely tax return. *See* IRC § 6020(b).

7 *See, e.g.*, IRC § 6303(a) (requiring a Notice and Demand for payment); IRM Exhibit 5.19.1-2 (Apr. 28, 2008). Delinquencies involving employment taxes reported on Form 941, *Employer's Quarterly Federal Tax Return*, usually receive two notices. In these cases, the IRS waits five weeks before sending the second notice, and an additional five to ten weeks (10-15 weeks total) after sending the second notice before moving the account to a delinquent status (*i.e.*, a tax delinquent account or TDA status). *See, e.g.*, IRM 5.19.1-2 (Oct. 18, 2013). For further discussion of the collection process, see, *e.g.*, National Taxpayer Advocate 2013 Annual Report to Congress, vol. 1, *infra* (Most Serious Problem: *Collection Procedures Harm Business Taxpayers And Contribute To Substantial Amounts Of Lost Revenue*); National Taxpayer Advocate 2011 Annual Report to Congress 336 (Most Serious Problem: *The IRS Does Not Emphasize the Importance of Personal Taxpayer Contact as an Effective Tax Collection Tool*).

8 *See, e.g.*, IRM Exhibit 5.19.5-10 (Dec. 1, 2007).

9 *See, e.g.*, National Taxpayer Advocate 2012 Annual Report to Congress 384 (Most Serious Problem: *The Automated Collection System Must Emphasize Taxpayer Service Initiatives to Resolve Collection Workload More Effectively*).

10 As discussed in volume 1 of this report, ACS employees do not have the authority to grant extensions to pay on in business trust fund (IBTF) accounts, will not discuss alternative payment options if the taxpayer has an unfiled return, and are not trained or authorized to enter into non-streamlined installment agreements (IAs) or offers for accounts involving business taxes. National Taxpayer Advocate 2013 Annual Report to Congress, vol. 1, *infra* (Most Serious Problem: *Collection Procedures Harm Business Taxpayers and Contribute to Substantial Amounts of Lost Revenue*) (citing IRM 5.19.1.5.3 (Oct. 18, 2013), IRM 5.19.1.5.4.2 (Oct. 18, 2013), and IRS response to TAS information request (Sept. 13, 2012)). Moreover, ACS issued only 29,246 business master file (BMF) IAs, representing only 5.5 percent of the BMF taxpayer cases received by ACS during FY 2013. *Id*. (citing IRS, Collection Activity Report, NO-5000-6, *Installment Agreement Report* (Sept. 2013) and IRS, Collection Activity Report, NO-5000-2, *Taxpayer Delinquent Accounts Report* (Sept. 2013).

11 IRM 5.1.10.3.2 (Oct. 28, 2011) (initial contact); IRM 5.1.10.3.2 (Oct. 28, 2011) ([if]"[T]ax is due and the taxpayer is unable to pay in full [and] the taxpayer does not qualify for a guaranteed, streamlined, or in-business trust fund express installment agreement… [then] discuss other collection alternatives").

12 IRM 5.1.10.4 (Apr. 20, 2010) (instructing ROs to check voice mail, leave business cards, and return calls).

Although the IRS assigns some cases directly to ROs in the CFf, ROs often work on cases initially assigned to the queue. The IRS has to decide which cases to assign to CFf, ACS, or the queue, and which to prioritize.

It is difficult for the IRS to compare ACS employees and ROs because it generally assigns them different types of cases. ACS often receives low-risk, low-dollar cases that have not aged, and therefore are easier to collect.[13] Moreover, the IRS does not measure the relative effects of each collection channel on long-term voluntary compliance, even though these effects are probably more important (and resource-saving) than how much the IRS collects in the short run. The objective of this study was to compare the effect on compliance of assigning an employment tax delinquency to the CFf, ACS, or the queue, as described in the National Taxpayer Advocate's 2012 Annual Report to Congress.[14]

## METHODOLOGY

TAS focused on newly-delinquent taxpayers with one or two employment tax delinquencies (called "taxpayer delinquency account" modules or TDAs) in 2003, and those with three delinquencies in 2003, provided they were not pyramiding (*i.e.*, there was a gap between the last two delinquencies).[15] TAS excluded those with three or more consecutive delinquencies in order to focus on taxpayers whose liabilities were not excessively pyramiding before being assigned.[16] By limiting the analysis to fresh delinquencies, and stratifying the results by the amount assessed, TAS sought to put each collection channel on a more equal footing – limiting the bias that might result from comparing aged delinquencies to fresh ones and large delinquencies to small ones.[17]

An analysis of each collection channel proved challenging because cases were often transferred among the channels (*e.g.*, from ACS to the queue to CFf and every other permutation). Thus, much of TAS's analysis stratifies results based on the initial collection channel to which the IRS assigned the case, even though it may have been transferred later.

Of the 452,353 taxpayers in the IRS's Accounts Receivable Dollar Inventory (ARDI) database with TDAs in 2003, only 44,351 taxpayers (50,790 modules) met TAS's criteria. Of these, 21,057 taxpayers (23,767 modules) were first assigned to ACS, 19,433 (22,596 modules) were first assigned to the queue, and 3,861 (4,427 modules) were first assigned to the CFf. Thus, the collection cases TAS analyzed were significantly different from typical collection cases — particularly those normally assigned to the CFf. For example, although the CFf typically receives aged cases from the queue, the CFf cases in TAS's sample were about the same age (77 days) as those received by ACS (81 days) and the queue (77 days).

13 The collection industry estimates that the probability of collecting unpaid accounts falls to 70 percent after three months, 52 percent after six months, and 23 percent after a year. *See, e.g.*, Treasury Inspector General for Tax Administration, Ref. No. 2011-30-112, *Reducing the Processing Time Between Balance Due Notices Could Increase Collections* 8 (Sept. 26, 2011) (citing collectability statistics based on a survey conducted by the Commercial Collection Agency Association).

14 National Taxpayer Advocate 2012 Annual Report to Congress, vol. 2, 142-148 (*Research Prospectus: Comparing the Effect of Revenue Officers and the Automated Collection System on Future Compliance*).

15 These employment taxes are typically reflected on Form 941, *Employer's Quarterly Federal Tax Return*.

16 Those with delinquencies in the last two quarters of 2003 could have continued to pyramid in 2004.

17 To see how modules eventually closed, TAS pulled data from the Accounts Receivable Dollar Inventory (ARDI) database on the Compliance Data Warehouse (CDW) in September 2013 for all of the modules through extract cycle 201324 (*i.e.*, week 24 of 2013). To look at future behavior, TAS pulled status history for these cases through post cycle 201325 (*i.e.*, week 25 of 2013).

TAS performed additional analysis on the cases with delinquencies that had been fully resolved during the 2003-2004 period within a single collection channel (*i.e.*, that were not transferred). TAS hoped to isolate the effect of each collection channel's resolution of these cases on future compliance.

Although TAS tried to analyze similar cases by initial collection channel, the IRS's case routing systems generally assign the most difficult collection cases to CFf or the queue, rather than to ACS.[18] Indeed, even among the cases in TAS's sample, those routed first to ACS had paid about 25 percent of the original assessment even before the cases were assigned to ACS, as compared to about two percent for those first routed to the queue, and eight percent for those first routed to CFf.[19] Thus, some of the differences between CFf and ACS could have been due to differences in the difficulty of the cases. However, ACS generally did not achieve superior results.

## FINDINGS

### CFf collected more than ACS.

On the surface, some of ACS's results appear superior. Of the modules initially assigned to ACS, it closed more as fully paid (64 percent) than CFf (54 percent) or the queue (25 percent). However, ACS generally received modules with smaller delinquencies ($1,369 on average) than CFf ($13,133) or the queue ($8,284), which were easier for any collection channel to close as fully paid. Indeed, even among modules of $1,500 or less, CFf closed a greater percentage (70 percent) as fully paid than ACS (69 percent) or the queue (38 percent), as shown on the following table.

**TABLE 1, Modules Closed as Fully Paid by Initial Collection Channel and Module Balance**

| Module Balance | ACS | Queue | CFf |
|---|---|---|---|
| $1,500 or less | 69% | 38% | 70% |
| $1,500-$5,000 | 42% | 26% | 57% |
| More than $5,000 | 38% | 19% | 48% |
| All Modules | 64% | 25% | 54% |

Overall, ACS appears to have closed a larger percentage than CFf as fully paid (64 vs. 54 percent) only because it received a larger number of low-dollar modules (19,663 vs. 666). Moreover, a broader look at the data shows that regardless of the size of the delinquency, CFf collected a greater percentage than ACS (or the queue), as shown on the following table.

18 *See, e.g.*, IRM 5.1.1.13.4.1 (Jan. 1, 2003) (procedures applicable during the period under study); IRM 5.1.20.2 (May 27, 2008) (current procedures).

19 Similarly, those first assigned to ACS voluntarily paid more while in notice status (34 percent of the amount collected), than those initially assigned to either the queue (21 percent) or CFf (21 percent). As described in more detail below, taxpayers with smaller module balances (*i.e.*, the kind often assigned to ACS) were generally more likely to pay while in notice status or before their cases were assigned to any collection channel.

**TABLE 2, Collection Results by Initial Collection Channel and Module Balance**[20]

| | ACS | | | Queue | | | CFf | | |
|---|---|---|---|---|---|---|---|---|---|
| Module Balance | Average Assessed | Average Paid | Paid to Assessed Ratio | Average Assessed | Average Paid | Paid to Assessed Ratio | Average Assessed | Average Paid | Paid to Assessed Ratio |
| $1,500 or less | $848 | $504 | 59% | $771 | $310 | 40% | $716 | $515 | 72% |
| $1,000–$5,000 | $2,772 | $897 | 32% | $2,728 | $714 | 26% | $2,957 | $1,615 | 55% |
| More than $5,000 | $7,172 | $2,252 | 31% | $21,685 | $3,030 | 14% | $23,771 | $10,147 | 43% |
| All modules | $1,369 | $630 | 46% | $8,284 | $1,367 | 17% | $13,133 | $5,759 | 44% |

These results are consistent with the notion that higher-graded ROs working in the CFf, who make outgoing calls and collect delinquencies in the field using a wider range of collection tools (including payment alternatives), are more effective than lower-graded ACS employees working remotely at a campus who primarily interact with taxpayers responding to systemically issued liens and levies. Notably, CFf surpassed ACS's collection results in every category, including low-dollar ($1,500 or less) modules where it collected 72 percent of the initial assessment as compared to ACS, which collected only 59 percent. As noted above, the overall data may be misleading because ACS surpassed CFf (albeit by a small margin) only because it received a larger number of low-dollar modules (19,663 vs. 666).

### CFf resolved delinquencies more quickly than ACS.

A superficial look at the data may suggest ACS resolved cases more quickly than CFf. On average, modules initially assigned to ACS spent 726 days in collection, as compared to 1,305 days for those initially assigned to the queue, and 1,189 days for those initially assigned to CFf. However, CFf receives more high-dollar modules, which may take longer to address.

In addition, these figures include the periods when the modules were being paid through installment agreements (IAs) and the periods during which they were deemed "currently not collectible" (CNC). Although both ACS and CFf might resolve delinquencies more quickly if they were empowered to accept more offers in compromise, an IA or CNC determination is an appropriate resolution for many accounts. Moreover, these resolutions add to the time cases spend in collection, and CFf may receive more cases where these resolutions are appropriate.[21] Moreover, even when they receive cases where IAs are appropriate, ACS employees are not trained or authorized to accept non-streamlined IAs from businesses.[22]

20 This table shows collections within the initial collection channel. Because of the way data is presented in the ARDI, payments may exceed the assessment at the time the case is first assigned to a collection channel. For example, abatements and additional accruals are not reflected in the initial assessment and offsets are not reflected as payments. Thus, we present the data as a ratio of payments to the average initial assessment, which may exceed 100 percent. Even if abatements were taken into account, CFf's ratio would be higher than ACS's in each module category — 86 vs. 70 percent for $1,500 or less, 61 vs. 38 percent for $1,500 to $5,000, and 49 vs. 37 percent for more than $5,000.

21 As noted above, ACS issued only 29,246 BMF installment agreements, representing only 5.5 percent of the BMF taxpayer cases received by ACS during FY 2013. *See* National Taxpayer Advocate 2013 Annual Report to Congress, vol. 1, *supra* (Most Serious Problem: *IRS Collection Procedures Harm Business Taxpayers and Contribute to Substantial Amounts of Lost Revenue*).

22 *See* National Taxpayer Advocate 2013 Annual Report to Congress, vol. 1, *supra* (Most Serious Problem: *Collection Procedures Harm Business Taxpayers and Contribute to Substantial Amounts of Lost Revenue)* (citing IRM 5.19.1.5.3 (Oct. 18, 2013), IRM 5.19.1.5.4.2 (Oct. 18, 2013), and IRS response to TAS information request (Sept. 13, 2012)).

Accordingly, TAS reanalyzed the data by omitting the periods cases were in IA or CNC status when comparing how long ACS and CFf took to resolve a delinquency.[23] When these periods were omitted and the data were stratified by module balance, it became clear that among the cases initially assigned to CFf or ACS, respectively, CFf resolved them more quickly than ACS, regardless of the amount of the delinquency, as shown by the following table.

**TABLE 3, Average Days in Collection by Initial Collection Channel and Module Balance[24]**

| Module Balance | ACS | Queue | CFf |
|---|---|---|---|
| $1,500 or less | 344 | 594 | 328 |
| $1,500–$5,000 | 442 | 591 | 372 |
| More than $5,000 | 537 | 794 | 497 |

CFf even closed low-dollar modules ($1,500 or less) initially assigned to it more quickly than ACS – within 328 days as compared to 344 days for ACS. These findings suggest that in allocating limited resources between ACS and collection, the IRS should not assume ACS resolves cases more quickly. Given that delinquencies become more difficult to collect over time, reallocating dollars from CFf to ACS may be quite costly. Moreover, CFf's ability to resolve delinquencies provides better customer service to taxpayers.

### ACS transferred more of its cases than CFf.

Modules initially assigned to ACS took longer to resolve, in part, because ACS transferred more of them to the queue than CFf. Overall, ACS transferred about 24 percent of the modules it was initially assigned — 22 percent to the queue and 2 percent to CFf. By comparison, CFf only transferred four percent to the queue and none to ACS, as shown in the following table.

**TABLE 4, Percentage of Modules Transferred from the Initial Collection Channel to Another Collection Channel**

| Transfers | From ACS | From Queue | From CFf |
|---|---|---|---|
| To ACS | 0% | 1% | 0% |
| To Queue | 22% | 0% | 4% |
| To CFF | 2% | 52% | 0% |
| **Total to Another Channel** | **24%** | **53%** | **4%** |

ACS transferred an even higher percentage of the higher-balance modules. It transferred more than half of those with a balance of $5,000 or more and 47 percent of the $1,500-$5,000 modules, as compared to 19 percent of those with a balance of $1,500 or less, as shown on the following table.

23 As noted above, TAS pulled ARDI data through post cycle 201324 (*i.e.*, week 24 of 2013). TAS computed the time to resolve a delinquency using extract cycle indicators for new (*i.e.*, rectype1=N) and resolved (*i.e.*, rectype1=R) cases. Most cases were resolved prior to 201324, but some remained unresolved (*e.g.*, because they were in IA or CNC status).

24 These figures omit the time modules spent in IA and CNC status.

**TABLE 5, Transfers from the Initial Collection Channel to Another Collection Channel by Module Balance**

| Transfers | From ACS | From Queue | From CFf |
|---|---|---|---|
| **Module Balance of $1,500 or Less** | | | |
| To ACS | 0% | 1% | 0% |
| To Queue | 18% | 0% | 3% |
| To CFf | 1% | 29% | 0% |
| **Total to Another Channel** | **19%** | **30%** | **3%** |
| **Module Balance of $1,500-$5,000** | | | |
| To ACS | 0% | 1% | 0% |
| To Queue | 42% | 0% | 4% |
| To CFf | 5% | 52% | 0% |
| **Total to Another Channel** | **47%** | **53%** | **4%** |
| **Module Balance of $5,000 or More** | | | |
| To ACS | 0% | 2% | 0% |
| To Queue | 44% | 0% | 5% |
| To CFf | 7% | 65% | 0% |
| **Total to Another Channel** | **51%** | **67%** | **5%** |

These results appear consistent with current ACS practices. Significantly more delinquent trust fund dollars pass through ACS with unresolved cases than ACS actually collects (including via refund offsets and installment agreements), as described in other sections of this report.[25] Thus, ACS may not have been equipped to handle many of the cases it received (*e.g.*, taxpayers with unfiled returns, other delinquencies, or requiring collection alternatives such as high-dollar installment agreements or offers in compromise).

### CFf collected more on high-dollar modules when it received them quickly.

When CFf received high-dollar modules (more than $5,000) directly, it collected more of the assessment (43 percent), than when the IRS assigned the modules to the queue first.[26] The CFf collected less (33 percent) when it received these high-dollar modules from the queue within two quarters, and even less (31 percent) when it received them from the queue later. Moreover, regardless of module balance, CFf collected a greater percentage on cases that were routed to the queue first when CFf received them within two quarters, as shown on the table below.

25 National Taxpayer Advocate 2013 Annual Report to Congress, vol. 1, *supra* (Most Serious Problem: *Inadequate Service Delivery in the IRS Collection Process Harms Business Taxpayers and Contributes to Substantial Amounts of Lost Revenue*) (citing IRS, Collection Activity Report, NO-5000-2, *Taxpayer Delinquent Accounts Report* (Sept. 2012)).

26 Assessment in this context means the assessment at the time the case was first assigned to the initial collection channel (*e.g.*, CFf or the queue), as reflected on ARDI.

**TABLE 6, CFf Collections on Modules by Balance and Time in the Queue**

| | Direct to CFf | | | Queue to CFf <= 2 Qtrs | | | Queue to CFf > 2 Qtrs | | |
|---|---|---|---|---|---|---|---|---|---|
| Module Balance | Average Assessed | Average Paid | Paid to Assessed Ratio | Average Assessed | Average Paid | Paid to Assessed Ratio | Average Assessed | Average Paid | Paid to Assessed Ratio |
| $1,500 or less | $716 | $515 | 72% | $732 | $592 | 81% | $660 | $515 | 78% |
| $1,500–$5,000 | $2,957 | $1,615 | 55% | $2,844 | $1,782 | 63% | $2,743 | $1,577 | 57% |
| More than $5,000 | $23,771 | $10,147 | 43% | $22,502 | $7,356 | 33% | $17,040 | $5,261 | 31% |

It is not surprising that the less time high-dollar modules spent in the queue, the more CFf collected. However, this finding may suggest the IRS could improve collection results, particularly on high-risk trust fund modules, by limiting its use of the queue as an inventory management tool, as recommended by the National Taxpayer Advocate.[27]

Although CFf did not collect more on low-dollar modules (*i.e.*, $5,000 or less) routed directly to it than on those first assigned to the queue, some of these modules may have been routed directly to CFf because they were deemed "high risk" for reasons other than a high module balance, potentially making them more difficult to collect.[28] In addition, if most taxpayers are trying to pay their delinquencies, then those with high-dollar modules may benefit more than those with low-dollar modules from the assistance that an RO can provide, as further discussed below.

### Taxpayers with smaller delinquencies paid more while their cases were waiting to be assigned to CFf.

While their cases were awaiting assignment to CFf, taxpayers paid more on low-dollar modules than on high-dollar modules. For example, on cases assigned directly to CFf, those with modules of $1,500 or less reduced their assessments by 56 percent before the cases were assigned to CFf. By comparison, on modules of $5,000 or more, taxpayers reduced their assessments by only six percent, as shown on the following table.

27 *See, e.g.*, National Taxpayer Advocate 2010 Annual Report to Congress, vol. 2, 69 (*An Analysis of the IRS Collection Strategy: Suggestions to Increase Revenue, Improve Taxpayer Service, and Further the IRS Mission*).

28 The IRS currently assigns various "high risk" cases directly to CFf, regardless of module balance. For example, these cases may include "non master file" cases, those resulting from informants, and certain repeaters, among others. *See, e.g.*, IRM Exhibit 5.19.5-10 (Dec. 1, 2007).

**TABLE 7, Change in Average Assessed Module Balances before Assignment to CFf by Balance and Time in the Queue**[29]

| Module Balance | Direct to CFf | Queue to CFf <= 2 Qtrs | Queue to CFf > 2 Qtrs |
|---|---|---|---|
| $1,500 or less | -56% | -76% | -78% |
| $1,500-$5,000 | -15% | -14% | -16% |
| More than $5,000 | -6% | +16% | -3% |

These findings suggest that most taxpayers are trying to pay voluntarily and the IRS should do more to help them. Taxpayers with larger module balances may have paid less while their cases were awaiting assignment because they were more likely to require deferred payment alternatives (*e.g.*, installment agreements and offers) and personal attention than those with smaller delinquencies. However, the IRS does not actively promote these collection alternatives to taxpayers assigned to the queue or ACS.[30] Indeed, modules first assigned to CFf were more often resolved using an installment agreement (eight percent) than those first assigned to ACS (three percent) or the queue (two percent), regardless of the module balance, as shown on the following table.

**TABLE 8, Percentage of Modules Closed Using an Installment Agreement by Initial Collection Channel and Module Balance**

| Module Balance | ACS | Queue | CFf |
|---|---|---|---|
| $1,500 or less | 3% | 2% | 4% |
| $1,500-$5,000 | 4% | 2% | 7% |
| More than $5,000 | 5% | 2% | 11% |
| **Overall** | **3%** | **2%** | **8%** |

Although the sample generally excluded accounts that were pyramiding before being assigned, some assessments actually increased while the module was waiting in the queue, as shown in Table 7 (above).[31] Specifically, delinquent modules of more than $5,000 assigned to the queue for less than two quarters generally had 16 percent higher balances by the time they were assigned to CFf. Thus, allowing accounts to age in the queue did not necessarily prompt taxpayers to reduce their assessments even if they were not initially pyramiding. Rather, as noted above, the probability of collecting a delinquency falls quickly over time.

### Taxpayers initially assigned to the queue were receptive to additional notices.

For modules first assigned to the queue, taxpayers voluntarily paid most of the dollars the IRS collected — when the case was in the queue (30 percent) or in notice status (21 percent). In addition, most payments received while in queue status were received within about 35 days of being placed in the queue, suggesting

29 The module balance categories are based on the balance when the modules are assigned to CFf. TAS used 183 days (or about two quarters) in the queue as the breakpoint because it was near the median for the cases being analyzed.

30 For further analysis of this problem, see National Taxpayer Advocate 2013 Annual Report to Congress vol. 1, *infra* (Most Serious Problem: *Inadequate Service Delivery in the IRS Collection Process Harms Business Taxpayers and Contributes to Substantial Amounts of Lost Revenue*).

31 As noted above, the sample excluded those with three or more consecutive delinquencies in 2003 in order to focus on those whose liabilities were not excessively pyramiding before being assigned. However, those with only two delinquencies in 2003 could have continued to pyramid in 2004.

that some resulted from a prior notice.[32] In other words, these taxpayers appeared to want to resolve their debts, but may not have received adequate service or time to do so during the initial notice stream. Thus, it might be worthwhile for the IRS to continue to send monthly delinquency notices to taxpayers assigned to the queue, particularly notices that emphasize payment alternatives and the consequences of interest and penalty accruals, as described elsewhere in this report.[33]

### None of the IRS's collection functions were very successful in promoting future compliance according to IRS data.

Among the taxpayers whose collection cases closed within a single collection channel in 2003 or 2004 (*i.e.*, without being transferred to another channel), 24 percent had not filed a return (*i.e.*, had a tax delinquency investigation or TDI) or had a new delinquency (*i.e.*, had a TDA) by 2005, according to IRS data.[34] This figure rose to 45 percent by 2009, and to 50 percent by 2012. The IRS's compliance data (*i.e.*, TDAs and TDIs) could be faulty, as some of the businesses that appeared to have future noncompliance may have discontinued operations instead.[35] TAS sought to address this concern by eliminating accounts deemed CNC, but some out-of-business taxpayers may not have been designated as CNC. Nonetheless, assuming the IRS's compliance data is accurate, the IRS's collection functions had very little success in promoting future compliance.

Although TAS hoped to be able to compare the performance of each collection channel in promoting future compliance, it is unclear whether the groups of taxpayers whose cases it resolved in a single collection channel were similarly situated enough to make valid comparisons. High-risk taxpayers whose cases were routed directly to CFf were more likely to become noncompliant (56 percent) than those initially routed to ACS (49 percent), and those routed to ACS were more likely to become noncompliant than those who paid while in the queue (47 percent), as shown on the following table.

**TABLE 9, Subsequent Noncompliance by Year and Collection Channel[36]**

| Collection Channel | Cumulative Subsequent Noncompliance Percentage by Year | | |
|---|---|---|---|
| | 2005 | 2009 | 2012 |
| ACS | 23% | 44% | 49% |
| Queue | 21% | 41% | 47% |
| CFf | 28% | 52% | 56% |
| **Total** | **24%** | **45%** | **50%** |

32 As noted above, the IRS waits five weeks before sending the second notice, and an additional five to ten weeks (10-15 weeks total) after sending the second notice before moving the account to a delinquent status (*i.e.*, a tax delinquent account or TDA status). *See, e.g.*, IRM 5.19.1-2 (Oct. 18, 2013).

33 Although the IRS may continue to send delinquency notices to taxpayers assigned to the queue, some receive a notice only once a year. *See* IRM 21.3.1.4 (Oct. 1, 2002) (describing various "annual" delinquency notices). For further discussion of the type of notice the IRS should send, see National Taxpayer Advocate 2013 Annual Report to Congress vol. 1, *supra* (Most Serious Problem: *Inadequate Service Delivery in the IRS Collection Process Harms Business Taxpayers and Contributes to Substantial Amounts of Lost Revenue*).

34 As noted above, TAS pulled status history for closed modules through post cycle 201325 (*i.e.*, week 25 of 2013) and sorted them by entity. To be identified as having a closed case, all of the entity's modules had to be reflected as resolved (rectype1=R) on ARDI. For example, an entity's modules could be resolved by a payment or an abatement.

35 If the IRS's compliance data is not accurate, it may be wasting significant resources in trying to address noncompliance by out of business taxpayers. However, both TDI and TDA data showed similar levels of future noncompliance. It may be unlikely that both TDI and TDA indicators are faulty to the same degree.

36 To reduce the bias that could occur as a result of including businesses that were no longer operating, TAS omitted taxpayers that the IRS deemed CNC.

More importantly, however, taxpayers whose cases took longer to close were more likely to become non-compliant, regardless of which channel closed their case, as shown on the following table.

**TABLE 10, Subsequent Noncompliance by Year, Collection Channel, and Time to Close**

| Collection Channel | Quarters to Close | Cumulative Subsequent Noncompliance Percentage by Year | | |
|---|---|---|---|---|
| | | 2005 | 2009 | 2012 |
| ACS | 0-1 | 21% | 42% | 48% |
| | 1-2 | 26% | 46% | 51% |
| | 2-3 | 29% | 50% | 55% |
| | 3+ | 31% | 52% | 57% |
| Queue | 0-1 | 19% | 40% | 46% |
| | 1-2 | 21% | 41% | 47% |
| | 2-3 | 22% | 44% | 50% |
| | 3+ | 27% | 47% | 52% |
| CFf | 0-1 | 24% | 46% | 52% |
| | 1-2 | 31% | 57% | 60% |
| | 2-3 | 33% | 54% | 59% |
| | 3+ | 38% | 61% | 66% |

These findings suggest that addressing delinquencies quickly not only improves direct collections, but also improves future compliance. Thus, sending cases to CFf sooner, where the root causes of the non-compliance are more likely to be addressed, may not only yield quicker, more satisfactory resolutions of the cases at hand, but also could reduce future non-compliance — thereby protecting substantial amounts of potentially lost revenue.

These findings also show that about half of all of the subsequent delinquencies arise within about a year after the IRS closed the collection case. Thus, the IRS appears to have closed cases while tax and filing delinquencies were developing on other tax periods or at least without doing enough to educate delinquent businesses and ensure that they were willing and able to stay compliant.[37]

To promote future compliance the IRS should address delinquencies quickly, but only close cases after completely addressing all issues and periods, and communicating with the taxpayer to ensure they are willing and able to remain compliant. Recidivists may benefit from ongoing monitoring and rapid and proactive follow-up. To measure the effectiveness of these efforts, IRS collection executives should establish metrics that show the effect of their operations on the future compliance of the taxpayers whose cases they close, as previously recommended by the National Taxpayer Advocate.[38]

37 For analysis of these issues, see, *e.g.*, National Taxpayer Advocate 2010 Annual Report to Congress, vol. 2, 69 (*An Analysis of the IRS Collection Strategy: Suggestions to Increase Revenue, Improve Taxpayer Service, and Further the IRS Mission*) and National Taxpayer Advocate 2012 Annual Report to Congress 358, 380 (Most Serious Problem: *The Diminishing Role of the Revenue Officer Has Been Detrimental to the Overall Effectiveness of IRS Collection Operations*).

38 *See, e.g.*, National Taxpayer Advocate 2012 Annual Report to Congress 358, 380 (Most Serious Problem: *The Diminishing Role of the Revenue Officer Has Been Detrimental to the Overall Effectiveness of IRS Collection Operations*) (recommending the IRS measure: "the number and percentage of taxpayers that remain in compliance for the five years following the collection treatment (long-term compliance)."). As this analysis shows, it is practical for the IRS to measure and analyze a taxpayer's future compliance. Indeed, given the speed within which future noncompliance occurs, a short-term future compliance measure (*e.g.*, two to three years) might even be feasible.

## CONCLUSION AND RECOMMENDATIONS

This study examined the results of assigning fresh employment tax delinquency modules to ACS or CFf. TAS's findings and recommendations are summarized below.

- **CFf collected a greater percentage of delinquencies initially assigned to it than those initially assigned to ACS and collected them more quickly, regardless of the size of the delinquency.**

  CFf surpassed ACS's collection results in every category, including low-dollar modules where it collected 72 percent of the initial assessment as compared to ACS, which collected only 59 percent. Similarly, CFf closed modules of every size more quickly than ACS, including low-dollar modules ($1,500 or less), which it closed within 328 days as compared to 344 days for ACS. Thus, the IRS should not shift resources from CFf to ACS based on the perception that ACS is faster or better at collecting certain delinquencies than CFf.

- **ACS transferred more delinquencies, particularly higher-dollar modules (over $1,500), reducing the IRS's speed and effectiveness in addressing them.**

  ACS transferred about 24 percent of the modules it was initially assigned — 22 percent to the queue and two percent to CFf. By comparison, CFf only transferred four percent to the queue and none to ACS. ACS transferred an even higher percentage of the high-balance modules. It transferred 47 percent of those with a module balance between $1,500 and $5,000, and more than half of those with a balance of $5,000 or more, as compared to 19 percent of those with a balance of $1,500 or less.

  To increase its speed and effectiveness in addressing delinquencies, the IRS should reduce ACS transfers while ensuring that ACS completely resolves all of the taxpayer's compliance issues through collection alternatives, if possible. Moreover, ACS may require significant restructuring and ongoing training, as described below. Alternatively, the IRS should not assign high-dollar modules (*e.g.*, more than $1,500) to ACS.

- **CFf collected more on high-dollar modules when it received them quickly.**

  When CFf received high-dollar modules (more than $5,000) directly, it collected more of the assessment (43 percent) than when it received a module that the IRS assigned to the queue first. CFf collected less (33 percent) when the IRS assigned these modules to the queue for up to two quarters before sending them to CFf, and even less (31 percent) when modules remained in the queue longer. Thus, the IRS should limit its reliance on the queue, particularly for high-risk high-dollar trust fund delinquencies.[39]

39 *See, e.g.*, National Taxpayer Advocate 2010 Annual Report to Congress, vol. 2, 69 (*An Analysis of the IRS Collection Strategy: Suggestions to Increase Revenue, Improve Taxpayer Service, and Further the IRS Mission*).

- **Taxpayers with smaller delinquencies paid more while their cases were waiting to be assigned to CFf.**

  Among cases assigned directly to CFf, taxpayers with modules of $1,500 or less reduced their assessments by 56 percent before the cases were assigned to CFf. By comparison, on modules of $5,000 or more (also routed directly to the CFf), taxpayers reduced their assessments by only six percent.

  While most taxpayers seemed to be trying to resolve their delinquencies, those with larger module balances may have been more likely to require collection alternatives, which the queue does not actively promote. This finding may lend support to the recommendation for the IRS to limit its reliance on the queue, especially for high-dollar or high-risk trust fund delinquencies.

- **Taxpayers initially assigned to the queue were responsive to the notices they received after the initial notice stream.**

  Taxpayers initially assigned to the queue voluntarily paid most of the dollars the IRS collected when the case was in the queue (30 percent) or in notice status (21 percent), and most of them did so within 35 days (the median) of receiving a notice. Thus, the IRS should consider sending additional notices to taxpayers assigned to the queue, particularly notices that emphasize payment alternatives and the economic impact of late payment penalties and daily-compounded interest, as recommended by the National Taxpayer Advocate.[40]

- **Regardless of the collection channel, IRS data suggest the IRS's collection functions had very little success in promoting future compliance.**

  Among the taxpayers whose collection cases closed within a single collection channel in 2003 or 2004 (*i.e.*, without being transferred to another channel), 24 percent had an unfiled return or a new delinquency (*i.e.*, had a TDI or TDA) by 2005, according to IRS data, a figure that rose to 50 percent by 2012. Taxpayers whose cases took longer to close were more likely to become noncompliant, a finding that lends further support to recommendations (above and below) to limit use of the ACS and the queue, which may delay resolution of higher-dollar delinquencies. Thus, both ACS and CFf should

  1) Resolve all compliance issues before closing cases — and take proactive measures to promote future compliance especially in cases involving recidivists;
  2) Offer collection alternatives and education to taxpayers to ensure they are willing and able to remain compliant; and
  3) Regularly measure and report on progress in promoting future compliance, as previously recommended by the National Taxpayer Advocate.[41]

40 See National Taxpayer Advocate 2013 Annual Report to Congress, vol. 1, *supra* (Most Serious Problem: *Inadequate Service Delivery in the IRS Collection Process Harms Business Taxpayers and Contributes to Substantial Amounts of Lost Revenue*).

41 For a discussion of IRS measures, see, *e.g.*, National Taxpayer Advocate 2010 Annual Report to Congress 28-48 (Most Serious Problem: *IRS Performance Measures Provide Incentives that May Undermine the IRS Mission*).

- **ACS may require significant restructuring and training to handle the higher-dollar modules it is assigned.**

  As noted above, ACS ultimately transfers most of its higher-dollar modules to another collection channel unresolved, and the resulting delays seemingly reduce the CFf's ability to collect the delinquency along with future compliance. Accordingly, the IRS should either avoid assigning such cases to ACS or empower ACS employees to handle more of the issues that may arise in them.

  Although this study did not directly address why ROs resolve cases more quickly and effectively than ACS employees, it may be because each RO is generally expected to resolve his or her assigned cases (rather than pass them along to another collection employee or the queue), communicate with the taxpayer (*e.g.*, by making outgoing calls), and actively assist the taxpayer with collection alternatives. If so, then ACS employees should make more use of outbound calls, actively assist taxpayers in using collection alternatives (*e.g.*, installment agreements and offers in compromise), and address all of the taxpayer's collection issues before closing or transferring a case.

  Further, the IRS should consider assigning certain types of cases to specific ACS employees, so the employees and their managers are responsible for assigned-case outcomes. If adopted, taxpayers would also be able to work with one person who is familiar with their circumstances. However, these changes are unlikely to improve ACS's results unless ACS employees receive adequate authority to resolve cases, training to do so properly, and the IRS executives responsible for managing ACS are required to measure and regularly report on ACS's performance in these areas.[42]

42 For a discussion of IRS measures, see, *e.g.*, National Taxpayer Advocate 2010 Annual Report to Congress 28-48 (Most Serious Problem: *IRS Performance Measures Provide Incentives that May Undermine the IRS Mission*).

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# Small Business Compliance: Further Analysis of Influential Factors

SECTION THREE

## Small Business Compliance: Further Analysis of Influential Factors[1]


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## INTRODUCTION

Because voluntary compliance by small businesses could significantly impact the tax gap, last year's Annual Report to Congress presented preliminary results from a survey of a national sample and selected community populations of small business proprietors concerning tax compliance and related socio-economic attitudes.[2] Essentially, this 2012 report identified correlations between questionnaire responses and tax compliance as measured for purposes of the survey. The preliminary report anticipated further analysis of the national survey based on multivariate statistical techniques. Consequently, factor and related analyses are discussed below.

The report also anticipated further analysis of the community survey with respect to geographic characteristics of compliant or low-compliant populations. Accordingly, geographic analysis is discussed below.

## METHODOLOGY FOR INFLUENTIAL FACTORS

For the 2012 Report, the Taxpayer Advocate Service (TAS) developed and administered a survey to a representative national sample of sole proprietors (*i.e.*, those filing Schedule C, *Sole Proprietorship,* of Form 1040, *U.S. Individual Income Tax Return*) to study the factors that appear to influence their compliance behavior.[3] TAS relied on internal IRS computer-generated estimates that an audit would produce an adjustment (called a Discriminant Index Function or "DIF" score) as a proxy for tax compliance.[4] TAS divided the DIF score into ten deciles.

- Taxpayers with returns in the first and second deciles have the lowest DIF scores for a low probability of audit adjustment and, accordingly, are assumed to be the most compliant.
- Those in the ninth and tenth deciles have the highest DIF scores for a high probability of audit adjustment and, accordingly, are assumed to be the least compliant.
- All other deciles are considered moderately compliant.

The national sample was large enough to support a confidence level of at least 95 percent that the results reflect the views of the population of taxpayers from which the sample was selected.[5]

The 2012 report assumed the existence of certain factors and the relevance of survey questions. Now we employ principal components analysis (PCA), a technique of exploratory factor analysis, to empirically analyze the factors underlying the survey questions. We then use logistic regression, a statistical method of estimating the relationship between dependent and independent variables, to determine whether the factors identified appear to influence taxpayer compliance behavior. The discussion below presents PCA first and logistic regression second.

In general, PCA uses computer algorithms to analyze the correlations among the values of a set of variables. The theory of PCA is that variables that are highly correlated all relate to a more general,

2 *See* National Taxpayer Advocate 2012 Annual Report to Congress, Vol. 2, § 1 at 1 (*Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results*).

3 TAS contracted with a research firm to administer the survey via telephone.

4 The DIF is based on data obtained and periodically updated from IRS National Research Program examinations. *See* National Taxpayer Advocate 2012 Annual Report to Congress, Vol. 2, § 1, n. 7 at 9.

5 *See* National Taxpayer Advocate 2012 Annual Report to Congress, Vol. 2, § 1, at 9 (discussing methodology to develop the national sample).

unobserved concept that subsumes them. Consequently, PCA is useful in identifying these underlying concepts, or components, also commonly referred to as factors.

Here, the variables are the questions contained in the survey. We used PCA to analyze the response patterns for the survey questions. Questions with response patterns that are highly correlated (either positively or negatively) come together in "factors." Thus, a group of questions represents a factor.[6] In addition, PCA can extract variables representing these factors that can then be used in regression analysis. We used PCA in both ways.

While researchers frequently use PCA to analyze survey data based on the Likert scale (*i.e.* a multiple choice, subjective series of responses),[7] PCA is designed for interval data. Interval data refers to equally spaced values for variables, *e.g.*, the space between $1 and $2 is exactly the same as that between $2 and $3. On the other hand, the Likert scale uses numbers to order the data values, but the size of the interval between values may vary. For example, the Likert scale may measure the level of agreement or disagreement with a statement, but the interval between "strongly agree" and "agree" may be different from that between "disagree" and "strongly disagree."[8]

To address the difference between interval and ordinal data, we first confirmed that our data were suitable for PCA using the Kaiser-Meyer-Olkin (KMO) statistic in software known as SPSS (Statistical Package for the Social Sciences).[9] We then conducted the analysis in software known as SAS (Statistical Analysis System) using a two-stage approach. In the first stage, we used the SAS PRINQUAL procedure to transform the data to make it suitable for PCA.[10] In the second stage we used the SAS FACTOR procedure to conduct PCA on the transformed data.

Two challenges when conducting PCA are to determine which variables (here, the survey questions) to retain, and how many factors to construct. In general, we retained questions that had factor loadings of at least 0.4.[11] We used the "Kaiser criterion" to determine the number of factors to consider for retention, basing our decision on a review of the factors at or near the Eigenvalue threshold.[12] If the factor "made sense" we retained it. To "make sense," the factor should have at least two questions with high factor loadings (above 0.6) that appear to relate to some underlying concept. We then used logistic regression to evaluate the factors' influence on taxpayer compliance behavior.

6 We used the varimax rotation, an orthogonal rotation, meaning that after rotation each of the factor axes is at right angles to the other axes in n-dimensional space. This is the most common rotation method. It has the effect of making it easier to see which factor subsumes each variable (because the variable is most highly correlated with that factor).

7 *See* Rensis Likert, *A Technique for the Measurement of Attitudes*, Archives of Psychology (1932).

8 The survey used the Likert scale to measure the respondents' level of agreement. The values ranged from one to five, where one denoted "strongly agree" and five denoted "strongly disagree." *See* National Taxpayer Advocate 2012 Annual Report to Congress vol. 2, § 1, Appdx. I. "The average of 'fair' and 'good' is not 'fair-and-a-half'; which is true even when one assigns integers to represent 'fair' and 'good'!" Susan Jamieson, *Likert Scales: How to (Ab)Use Them*, 38 Medical Educ'n 1217 (2004).

9 Data with a KMO score of 0.5 or greater are considered suitable for PCA. The KMO score for our data exceeded 0.8. We also tested the data in SAS subsequent to transforming it with PRINQUAL. The transformed data had a KMO of 0.9.

10 We used the maximum total variance (MTV) method and optimal scoring (OPSCORE) transform to transform the Likert scale data for PCA. *See* G. David Garson, *Factor Analysis*, Statistical Associates Blue Book Series (2013).

11 The factor loading for a variable shows the extent to which the variable is correlated with the factor that subsumes it.

12 PCA creates factors and orders them from highest to lowest based on Eigenvalue, which is a measure of the amount of data variance the factor explains. The Kaiser criterion states that factors with Eigenvalues lower than one should be discarded.

We used the taxpayer's compliance level (low or high) as our dependent variable in the regression models. Because each model had a binary dependent variable (where one represents low compliance and zero represents high compliance), we used logistic regression, which transforms the dependent variable to overcome difficulties that binary dependent variables introduce when performing regular regression (*i.e.,* ordinary least squares regression).[13] The factor scores computed in SAS were the independent variables in the regression model.[14] We ranked the relative influence of the factors on compliance behavior based on their statistical significance in the regression model.

## FACTOR ANALYSIS

Based on a review of tax morale and associated compliance literature, the 2012 report identified six influential factors in Table A below. Survey questions as set forth in that report elicited responses regarding the factors. The 2012 report distinguished between high- and low-compliance groups with respect to responses pertinent to certain factors, as presumed by the literature. This approach left open questions of whether each presumed factor actually existed, and if so, of the relative influence of each factor on compliance. The statistical technique that can help answer the first question is exploratory factor analysis, specifically PCA, as discussed above. To clarify, factor analysis derives from data latent factors that may or may not be the same as the factors originally drawn from the literature.[15] Discussed below is the statistical technique of logistic regression, with regard to whether the identified factors influenced taxpayer compliance behavior.

### TABLE A, Factors Potentially Driving Voluntary Compliance[16]

| Factor | Description |
|---|---|
| Deterrence | People comply when the potential sanction multiplied by the perceived likelihood of getting caught outweighs the economic gain from cheating. However, the deterrence model is incomplete because it seems economically irrational for so many taxpayers to comply given the low probability of getting caught cheating. |
| Norms | According to social norms and reciprocity theories, taxpayers who believe most other taxpayers comply are more likely to reciprocate by complying. |
| Tax morale | Taxpayers who cheat may feel guilty when they break the norm if it has been adopted as the taxpayer's own tax morale. In addition, those who trust the government and feel the tax laws and procedures are fair and fairly enforced may be more likely to feel a moral obligation to comply, even if the outcome of those procedures is unfavorable. |
| Trust | Taxpayers may use unfair rules or procedures, unreasonable penalties, bad experiences with the IRS, or a lack of faith in government or the IRS to justify either reducing efforts to comply or active noncompliance. |
| Complexity and convenience | Taxpayers who face complicated rules may be unable to comply, or may use complexity as a reason to justify noncompliance. |
| Preparers and other third parties | Tax preparers may have a significant effect on tax compliance. |

13 In logistic regression, the binary dependent variable, which has a value of either one or zero, is transformed into a logit, which is the natural log of the odds associated with an outcome of one.

14 For a given factor, SAS computes a factor score for each respondent representing that respondent's position relative to the other respondents in the distribution of factor scores for that factor.

15 *See generally* Alan O. Sykes, *An Introduction to Regression Analysis*, Coase Lect., Working Paper in L. & Econ., Univ. of Chicago (Dec. 1, 1992), *available at* http://www.law.uchicago.edu/node/1309 (last visited Aug. 19, 2013); J. Scott Armstrong, *Derivation of Theory by Means of Factor Analysis or Tom Swift and His Electric Factor Analysis Machine*, 21 Amer. Statistician 17 (1967).

16 National Taxpayer Advocate 2012 Annual Report to Congress, Vol. 2, § 1 at 8.

As discussed in the 2012 report, the National Survey contained a battery of 37 substantive questions inspired by factors from the literature review.[17] Applying factor analysis yields 26 questions in six groups of correlated responses. Because similar responses came from the questions in each of the six groups, each group represents an underlying factor. These empirically generated factors appear as groups of questions in Table B, Factor Analysis of All Low- and High-Compliant Taxpayers in the Appendix, for comparison with the factors from the literature review. Further iterations of factor analysis applied to three subcategories of respondents, characterized by use of a preparer, low income, and high income, respectively appear in the Appendix in Tables C, Factor Analysis of Taxpayers who used a Preparer, D, Factor Analysis of Low Income Taxpayers, and E, Factor Analysis of High-Income Taxpayers, each resulting in seven factors.

The overall analysis, Table B, resulted in six factors, in order of explanatory importance with respect to variance in survey responses:

1. ***Taxpayer Service.*** The seven questions in this group relate to IRS service, encompassing both pre-filing (e.g., forms) and post-filing (*e.g.* collection) treatment of taxpayers. All these questions came from a part of the questionnaire that had ten questions eliciting responses about trust in government, but the factor analysis reduced the most correlated questions to these seven. Thus, taxpayer service is the primary factor.
2. ***Norms.*** These four questions are about perceptions of reporting compliance of other small businesses as well as collection of taxes by the IRS. Focusing on social perceptions, the second factor is norms.
3. ***Fairness.*** These five questions are about fairness in the tax law and unfair advantages of large businesses and the wealthy. Thus, the third factor is fairness. Like the first factor, fairness may be encompassed within trust.
4. ***Tax Policy.*** This group combines three questions about government benefits with one about financial risk. In short, the fourth factor is tax policy. That is, compliance may reflect agreement or disagreement with legislative design, potentially resulting in noncompliance of the type classified by researchers as symbolic.[18] Because this factor relates to (lack of) faith in the government, which includes the IRS, tax policy also may be an aspect of trust.
5. ***Tax Morale.*** These three questions relate to moral obligation, discussed in the literature as tax morale.
6. ***Economics.*** The sixth group of three questions relates to financial status or cost-benefit motivations. The 2012 report did not find that deterrence (*e.g.* penalties) thwarted noncompliance, perhaps because small business owners may be motivated by short-term cash flow (making ends meet).[19] While confirming the importance of economics, this factor may subsume deterrence among outweighing motivations.

17 *See* National Taxpayer Advocate 2012 Annual Report to Congress, Vol. 2, § 1, App. 1, Q. 7-10 at 43-45.

18 *See* National Taxpayer Advocate 2012 Annual Report to Congress, Vol. 2, § 1, Table 1 (Typology of Noncompliance) at 7.

19 *See id.*, n. 43 at 28.

The analysis of respondents who used a preparer, Table C, resulted in seven factors, in order of importance:

1. ***Trust in Government.*** The nine questions in this group consist of the same seven questions about taxpayer service as in the primary factor in the overall analysis, Table B discussed above, plus two questions about fairness. Both service and fairness may be elements of trust.
2. ***Norms.*** This group of four questions is the same as in the second factor in the overall analysis, Table B above.
3. ***Tax Morale.*** This group of three questions is the same as in the fifth factor in the overall analysis, Table B above.
4. ***Preparers.*** This group of four questions relates to return preparation.
5. ***Fairness.*** This group of three questions about unfair advantages of large businesses and the wealthy is a subset of the five questions in the third factor in the overall analysis, Table B above. Two questions about tax fairness were included in the first factor, trust, above. Again, fairness may be a component of trust.
6. ***Complexity.*** This group of four questions touches on complexity, the role of government, and financial status. Complexity may seem to justify noncompliance, especially for taxpayers who disagree with the government or confront financial pressure. Nevertheless, this factor ranks low in importance or explanatory power over statistical variation in responses to the questions.
7. ***Tax Policy.*** This group of three questions about government benefits is a subset of the four questions in the fourth factor in the overall analysis, Table B above. Again, tax policy is encompassed by trust in government.

The analysis of low income respondents, Table D, resulted in seven factors, in order of importance:

1. ***Trust in Government.*** The eight questions in this group consist of the same seven questions about taxpayer service as in the primary factor in the overall analysis, Table B discussed above, plus one question about fairness. Both service and fairness may be elements of trust.
2. ***Norms.*** This group consists of the same four questions as in the second factor in the overall analysis, Table B above, plus one question about penalties.
3. ***Welfare.*** This group of seven questions touches on government benefits, complexity, fairness, and financial status. This broad range of topics goes to the well-being of society.
4. ***Tax Morale.*** This group consists of the same three questions as in the fifth factor in the overall analysis, Table B above (plus one about recordkeeping).
5. ***Fairness.*** This group contains the same three questions as in the fifth factor for the Table C preparer category discussed above, plus one about detection by the IRS.
6. ***Economics.*** This group contains two of the same questions about financial status as in the sixth factor in the overall analysis, Table B above, plus one question about deterrence. In other words, this factor encompasses the ineffectiveness or effectiveness of deterrence.
7. ***Tax Policy.*** These two questions, one of which appeared in the fourth and seventh factors in the two analyses of Tables B and C above, are about the role of government. Thus, the tax policy factor relates to trust in government.

The analysis of high-income respondents, Table E resulted in seven factors, in order of importance:

1. ***Taxpayer Service.*** These seven questions, six of which overlap with those in the first factor from the overall analysis, Table B discussed above, relate to IRS service, including pre- and post-filing treatment of taxpayers.
2. ***Welfare.*** These eight questions touch on government benefits, complexity, financial status, and fairness, half of which overlap with the third factor in the Table D low income analysis discussed above.
3. ***Tax Morale.*** This group consists of the same three questions as in the fifth factor in the overall analysis, Table B above, plus one about penalties.
4. ***Fairness.*** This group contains four of the same five questions, about fairness in the tax law and unfair advantages of large businesses and the wealthy, as in the third factor of the overall analysis, Table B above.
5. ***Economics.*** These three questions relate to financial status, deterrence, and recordkeeping. One of these three questions overlaps with a question in the "Economics" factor in Table B, while another of these three questions also appeared in D.
6. ***Norms.*** This group consists of two of the same questions as in the second factor of the overall analysis, Table B above, about reporting, plus one question about financial status.
7. ***Trust in Government.*** These four questions, the first of which also appeared in the first factors of both Tables C and D, above, relate to government services and tax reporting.

In sum, the factor that explains the most statistical variance in responses to the questionnaire on voluntary compliance by small proprietors is taxpayer service, which contributes to trust in government. At the same time, factor analysis disaggregated fairness as a separate factor, related to trust as described in the literature. Similarly, tax policy appeared as a distinct factor in this analysis, suggesting that agreement or disagreement with legislative design influences compliance. Likewise, the tax policy factor may be another aspect of trust in government. These findings are consistent with the 2012 report's emphasis on trust.

When applied to income subcategories, factor analysis isolated a concern about welfare, parallel but variant between low and high-income respondents. As anticipated by the literature review, perhaps the second most important factor, with respect to the variance in the data that it explains, consists of norms. Tax morale, preparers, and complexity are also influential. Although the 2012 report could not confirm the influence of deterrence, this analysis identifies economics, or motivations that may counter deterrence, as a distinct factor.

## LOGISTIC REGRESSION

While the literature review and factor analysis identify the most important factors in explaining variance in questionnaire responses, they do not predict high- or low-compliance behavior. To associate responses with high or low compliance, statistical techniques such as logistic regression are useful. We used logistic regression to measure whether the factors we identified in our exploratory factor analysis appear to influence tax compliance behavior.

As discussed in Factor Analysis above, analysis of the population of low- and high-compliant taxpayers yielded six factors. Table X1 below shows the results of our logistic regression that uses these factors to predict compliance behavior.[20]

**TABLE X1, Logistic Regression — All Low- and High-Compliant Taxpayers**

| Factor | Coefficient | Std. Error | Lower Bound | Upper Bound | t statistic | Degrees of Freedom | Statistical Significance |
|---|---|---|---|---|---|---|---|
| (Intercept) | -0.007 | 0.077 | -0.158 | 0.144 | -0.093 | 2905 | 0.926 |
| Taxpayer Service | 0.124 | 0.058 | 0.011 | 0.237 | 2.145 | 2905 | 0.032 |
| Norms | -0.222 | 0.058 | -0.336 | -0.108 | -3.82 | 2905 | 0 |
| Fairness | -0.071 | 0.047 | -0.162 | 0.021 | -1.512 | 2905 | 0.131 |
| Tax Policy | 0.022 | 0.075 | -0.125 | 0.168 | 0.289 | 2905 | 0.773 |
| Tax Morale | -0.056 | 0.056 | -0.167 | 0.054 | -0.995 | 2905 | 0.32 |
| Economics | -0.039 | 0.054 | -0.144 | 0.067 | -0.724 | 2905 | 0.469 |

The highlighted rows above are the factors that were significant at the five-percent level, meaning that there is at least a 95-percent chance that these factors are significant in predicting the compliance level of these taxpayers.[21] The two significant factors are taxpayer service and norms, with norms being the most significant.[22] The results suggest that these factors influence taxpayer compliance behavior.

Interestingly, our analysis of the subcategory of taxpayers who used preparers (shown below) had four factors that were significant at the five-percent level and one factor, trust in government, that was significant at the ten-percent level (highlighted rows below).[23] This suggests that most of the factors we identified (five out of seven) probably influence the compliance behavior of this group of taxpayers. Again, norms is the most significant, being the only factor significant at the one-percent level, meaning there is at least a 99-percent chance that norms help predict the level of compliance behavior.

20 The dependent variable for the regression is the logit of the binary variable representing low- and high-compliant taxpayers, where one is low-compliant and zero is high-compliant.

21 The decimal value in the Significance column shows the level of statistical significance of the factor coefficient. A factor is statistically significant if its coefficient is statistically significant. A decimal value of 0.05 or less indicates statistical significance at the five-percent level, meaning that there is at most a five-percent chance that coefficient is not significant, and therefore at least a 95-percent chance that it is significant. A value of 0.10 or less means the factor is significant at the ten-percent level, *i.e.*, there is at most a ten-percent chance the coefficient is not significant, and at least a 90-percent chance that it is significant.

22 Since the decimal value for norms is less than 0.01, norms are significant at the 1-percent level, meaning that there is at least a 99-percent chance that this factor is significant in predicting compliance behavior.

23 Significance at the ten-percent level means that there is at least a 90-percent chance that this factor was significant in predicting compliance behavior.

**TABLE X2, Logistic Regression — Low- and High-Compliant Taxpayers Who Used Preparers**

| Factor | Coefficient | Std. Error | Lower Bound | Upper Bound | t statistic | Degrees of Freedom | Statistical Significance |
|---|---|---|---|---|---|---|---|
| (Intercept) | 0.136 | 0.09 | -0.041 | 0.312 | 1.508 | 2233 | 0.132 |
| Trust in Gov. | 0.125 | 0.067 | -0.005 | 0.256 | 1.885 | 2233 | 0.06 |
| Norms | -0.171 | 0.061 | -0.289 | -0.052 | -2.817 | 2233 | 0.005 |
| Tax Morale | -0.136 | 0.065 | -0.265 | -0.008 | -2.084 | 2233 | 0.037 |
| Preparers | -0.103 | 0.048 | -0.197 | -0.01 | -2.165 | 2233 | 0.03 |
| Fairness | -0.118 | 0.057 | -0.229 | -0.006 | -2.073 | 2233 | 0.038 |
| Complexity | 0.099 | 0.066 | -0.031 | 0.229 | 1.494 | 2233 | 0.135 |
| Tax Policy | 0.025 | 0.078 | -0.128 | 0.177 | 0.32 | 2233 | 0.749 |

Below are the results of the logistic regression using the factors we identified for the group of taxpayers with the lowest incomes. Two factors are significant at the five-percent level: trust in government and fairness, suggesting that these factors influence the compliance behavior of the low income group of taxpayers.

**TABLE X3, Logistic Regression — Low- and High-Compliant Taxpayers in the Group of Taxpayers with the Lowest Incomes**

| Factor | Coefficient | Std. Error | Lower Bound | Upper Bound | t statistic | Degrees of Freedom | Statistical Significance |
|---|---|---|---|---|---|---|---|
| (Intercept) | 0.005 | 0.116 | -0.223 | 0.233 | 0.043 | 699 | 0.965 |
| Trust in Gov. | 0.234 | 0.113 | 0.011 | 0.456 | 2.058 | 699 | 0.04 |
| Norms | -0.21 | 0.128 | -0.462 | 0.043 | -1.631 | 699 | 0.103 |
| Welfare | -0.097 | 0.164 | -0.419 | 0.226 | -0.588 | 699 | 0.557 |
| Tax Morale | -0.087 | 0.138 | -0.357 | 0.183 | -0.633 | 699 | 0.527 |
| Fairness | -0.268 | 0.12 | -0.503 | -0.032 | -2.231 | 699 | 0.026 |
| Economics | -0.002 | 0.117 | -0.232 | 0.227 | -0.021 | 699 | 0.983 |
| Tax Policy | -0.132 | 0.136 | -0.4 | 0.136 | -0.965 | 699 | 0.335 |

Finally, Table X4 below presents the results of the logistic regression using the factors we identified for the group of taxpayers with the highest incomes. While none of the factors are significant at the five-percent level, the taxpayer service and welfare factors are significant at the ten-percent level, suggesting that they probably influence the compliance behavior of taxpayers in the high-income group.

**TABLE X4, Logistic Regression — Low- and High-Compliant Taxpayers in the Group of Taxpayers with the Highest Incomes**

| Factor | Coefficient | Std. Error | Lower Bound | Upper Bound | t statistic | Degrees of Freedom | Statistical Significance |
|---|---|---|---|---|---|---|---|
| (Intercept) | -0.002 | 0.114 | -0.226 | 0.222 | -0.021 | 761 | 0.984 |
| Taxpayer Service | -0.173 | 0.095 | -0.361 | 0.014 | -1.816 | 761 | 0.07 |
| Welfare | 0.208 | 0.113 | -0.012 | 0.429 | 1.852 | 761 | 0.064 |
| Tax Morale | -0.068 | 0.111 | -0.285 | 0.149 | -0.612 | 761 | 0.54 |
| Fairness | -0.087 | 0.098 | -0.28 | 0.105 | -0.893 | 761 | 0.372 |
| Economics | 0.1 | 0.116 | -0.128 | 0.328 | 0.861 | 761 | 0.389 |
| Norms | 0.001 | 0.109 | -0.213 | 0.215 | 0.007 | 761 | 0.995 |
| Trust in Gov. | -0.016 | 0.108 | -0.227 | 0.196 | -0.145 | 761 | 0.885 |

## METHODOLOGY FOR COMMUNITY STUDY

The community survey within the 2012 report on the compliance study mapped low-compliance sites as they occurred not randomly but heavily clustered in regions where geographers have classified cultures of the South and West.[24] At the same time, responses to a set of questions in the community survey tended to link low compliance levels with social affiliations or networks associated especially with volunteering, voting, and congregations (*i.e.* houses of worship of any denomination). Consequently, the question arises whether low-compliance sites are located in regions where those social networks are prevalent.

To answer that question, further analysis focuses on one state containing low-compliance sites among other sites not so classified. In particular, the state is composed of 23 counties, six of which contained low-compliance sites.[25] Physical geography divides the counties into areas labeled Valley, Hills, and Shore (East & West). According to geographers, the Valley and East Shore fall into cultures of the North and South, respectively.[26] The Hills and adjacent West Shore run between those two areas, hosting a regional Metropolitan corridor classified by geographers as Megalopolis.[27] The low-compliance sites were located in Megalopolis.

Given this geographic layout, this analysis employs a fairly transparent methodology as follows. Table Y in the Appendix juxtaposes statistics reported by the Census and other published sources on relevant

24 From all areas, cities, and towns, in the U.S., those with median DIF scores in the top or bottom 30 percent constituted the low- or high-compliance communities, respectively. *See* National Taxpayer Advocate 2012 Annual Report to Congress vol. 2, § 1, 1 at 30 (*Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results*).

25 While the data are publicly available as cited, the purpose of this study is to make observations of general applicability rather than focus on the names of the state and counties.

26 *See* Wilbur Zelinsky, *Cultural Geography of the U.S.* (Prentice Hall, 1973) 127.

27 *See* Raymond Gastil, *Cultural Regions of the U.S.* (Seattle: Univ. of Wash. Press, 1975) Map 14 at 61.

demographics, urban concentration,[28] congregational membership,[29] charities, and voter turn-out. County-level data are averaged into the four physical areas, with the two middle areas again averaged for Megalopolis, which has the highest urban concentration.

## ANALYSIS OF GEOGRAPHIC AREAS

The demographic and related statistics for the geographic areas identified above reveal the following. Megalopolis has the highest percentages of population involved in congregations, living in families,[30] and turning out to vote (depending on which election). Within Megalopolis, the six counties containing low-compliance sites had high rates of urban concentration and ethnic diversity. On the other hand, the Valley has the most charities per ten thousand population. The Valley has the lowest rates of voter turnout and population living in families. Overall, the Valley's population is the oldest, least ethnically diverse, and most masculine (*i.e.* has the highest male to female ratio) of the three average areas. Finally, the East Shore population was the youngest and least religious, but most rural.

In sum, Megalopolis had some expected characteristics related to social networks. However, another area turned out to be more charitable. Accordingly, Table Y may be inconclusive at this point while additional research could uncover further, more accurate data. If further research could confirm that the least compliant area is the densest in social networks, an implication might be that those networks could be a medium for messages about tax compliance.

Potentially, future research could extend to field studies at a granular level. More generally, future research alternatively could survey relevant social science literature for attributes statistically linked to the prevalence or density of social networks. If a collection of attributes is readily available at a regional level, larger-scale computer analysis of low-compliant communities could be possible.

To recapitulate, the analysis above shows that taxpayer service and trust in government account in significant part for high or low levels of voluntary compliance. Unlike generic economic tendencies, such as risk aversion or rational maximization, taxpayer service with associated trust are socially conditioned and thus geographically identifiable. These factors travel along social networks. By mapping these networks, tax administration can focus outreach more effectively.

28 "The Census Bureau's urban-rural classification is fundamentally a delineation of geographical areas, identifying both individual urban areas and the rural areas of the nation. The Census Bureau's urban areas represent densely developed territory, and encompass residential, commercial, and other non-residential urban land uses. The Census Bureau delineates urban areas after each decennial census by applying specified criteria to decennial census and other data. The Census Bureau identifies two types of urban areas: Urbanized Areas (UAs) of 50,000 or more people; Urban Clusters (UCs) of at least 2,500 and less than 50,000 people. 'Rural' encompasses all population, housing, and territory not included within an urban area." U.S. Census Bureau, *Urban & Rural Classification, available at* http://www.census.gov/geo/reference/urban-rural.html (last visited Aug. 27, 2013).

29 "Congregational adherents include all full members, their children, and others who regularly attend services. The 2010 reports contain incomplete counts of congregations and adherents belonging to the eight largest historically African-American denominations." Assoc'n of Relig. Data Archives, *County Membership Rep't, available at* http://www.thearda.com/rcms2010/r/c/24/rcms2010_24001_county_name_2010.asp (last visited Aug. 27, 2013).

30 The Census reports on population living in families, generally defined as "those related to each other by birth, marriage or adoption." U.S. Census Bureau, *Families & Living Arrangements, available at* http://www.census.gov/hhes/families/about/ (last visited Aug. 27, 2013).

## CONCLUSION

The theory of factor analysis is that variables that are highly correlated all relate to a more general, unobserved concept that subsumes them. Consequently, factor analysis is useful in identifying these underlying concepts, also commonly referred to as factors. Factor analysis orders the factors it identifies based on the extent to which empirical data supports their existence. Factor analysis identified taxpayer service, which contributes to trust in government, as the highest ranking factor. At the same time, factor analysis identified fairness and tax policy as separate factors, related to trust. These findings are consistent with the 2012 report's emphasis on trust.

Factor analysis ranked norms as the second most important factor in accounting for various survey responses. Tax morale, preparers, and complexity are also important factors. Although the 2012 report could not confirm the influence of deterrence, this analysis also identifies economics, or motivations that may counter deterrence, as a distinct factor.

It is important to note that while factor analysis provides statistical evidence for the existence of concepts, it does not evaluate whether these concepts influence compliance behavior. We used logistic regression for that purpose. The results of the logistic regressions show that norms and trust in government (specifically the taxpayer service and fairness components of trust in government) appear to have the most influence on taxpayer compliance behavior. The preparer and tax morale factors also appear to influence the compliance behavior of the subcategory of taxpayers who use preparers. In sum, further analysis lends support to the suggestion in the 2012 report that improvements in taxpayer service could increase voluntary compliance by small business proprietors.[31]

Additionally, the 2012 report contemplated future analysis of the community survey in the nature of market research, as discussed above. While this survey elicited direct responses from taxpayers, the "social" nature of norms should be observable even beyond these responses, potentially by observing characteristics of the high- and low-compliance communities or regions. Future research could build upon the survey results by investigating social noncompliance and compliance in sites where they occur. Further investigation would relate to tax administration vis-à-vis regional traditions.

31 *See* National Taxpayer Advocate 2012 Annual Report to Congress, Vol. 2, § 1 at 39.

## APPENDIX OF TABLES

### TABLE B, Factor Analysis of All Low- and High-Compliant Taxpayers[32]

| Questions | Factor 1 | Factor 2 | Factor 3 | Factor 4 | Factor 5 | Factor 6 |
|---|---|---|---|---|---|---|
| 9.10 I Am Satisfied With The Quality Of The Federal Tax Services The IRS Provides | 0.778 | -0.021 | -0.044 | -0.080 | 0.042 | 0.008 |
| 9.3 The IRS Treats Taxpayers With Respect | 0.757 | 0.010 | 0.015 | -0.011 | 0.023 | -0.016 |
| 9.1 The IRS Treats Taxpayers Fairly | 0.739 | -0.174 | -0.148 | -0.073 | 0.014 | -0.082 |
| 9.9 It Is Easy For Me To Access The Federal Tax Services That The IRS Provides | 0.720 | -0.053 | 0.029 | 0.068 | 0.079 | -0.012 |
| 9.8 The IRS Offers All Of The Federal Tax Services I Need | 0.689 | -0.038 | -0.056 | -0.057 | 0.125 | -0.047 |
| 9.5 Because The IRS Treats Taxpayers Fairly, I Accept Its Decisions Even If I Disagree With Them | 0.644 | 0.393 | 0.007 | -0.033 | -0.020 | 0.157 |
| 9.4 The IRS Will Work With You If You Have Difficulty Paying Your Taxes | 0.611 | 0.324 | 0.139 | -0.054 | 0.030 | 0.171 |
| 10.1 Many Small Businesses Do Not Report All Of Their Income | 0.044 | 0.737 | 0.064 | 0.076 | 0.133 | 0.042 |
| 10.3 Most Small Businesses Could Not Survive If They Reported All Of Their Income | 0.029 | 0.729 | 0.084 | 0.115 | 0.137 | 0.078 |
| 9.2 The IRS Is More Concerned With Collecting As Much As It Can, Than With Collecting The Correct Amount Of Tax | -0.248 | 0.555 | 0.209 | 0.201 | 0.010 | 0.137 |
| 10.2 Most Of My Competitors Report All Of Their Income | -0.079 | -0.669 | -0.086 | -0.040 | -0.246 | 0.026 |
| 8.9 The Wealthy Have Ways Of Minimizing Their Federal Taxes That Are Not Available To The Average Taxpayer | 0.033 | 0.130 | 0.738 | 0.006 | 0.188 | 0.082 |
| 8.8 Large Businesses Have Loopholes To Reduce Their Federal Taxes That Smaller Businesses Do Not Have | -0.020 | 0.141 | 0.678 | 0.199 | 0.039 | 0.085 |
| 9.6 Wealthy Taxpayers Have An Advantage When Dealing With The IRS | 0.046 | 0.260 | 0.604 | 0.019 | 0.119 | 0.183 |
| 8.5 The Federal Tax Laws Are Fair | 0.426 | -0.002 | -0.505 | -0.319 | -0.011 | 0.068 |
| 8.7 Under Our Federal Tax Laws, Everyone Pays Their Fair Share Of Taxes | 0.056 | 0.077 | -0.698 | -0.298 | -0.016 | -0.122 |
| 8.2 Taxes Fund Important Federal Government Benefits And Services | 0.046 | 0.219 | 0.201 | 0.676 | 0.088 | -0.064 |
| 7.3 Taking Risks Is Necessary To Achieve Financial Success | -0.026 | 0.234 | 0.049 | 0.591 | 0.051 | 0.287 |
| 8.4 The Federal Government Is Involved In Areas Best Left To The Private Sector | -0.106 | -0.018 | 0.254 | 0.501 | 0.149 | 0.258 |
| 8.3 Taxpayers Would Tolerate Higher Taxes If It Meant Improved Federal Government Services | 0.113 | 0.025 | -0.106 | -0.758 | -0.086 | 0.049 |
| 10.6 I Feel A Moral Obligation To Correctly Report All Of My Income | 0.087 | 0.128 | 0.150 | 0.125 | 0.815 | 0.127 |
| 10.5 Everyone Should Correctly Report All Of Their Income | 0.105 | 0.154 | 0.082 | 0.248 | 0.812 | -0.010 |
| 10.7 If Others Found Out I Did Not Report All Of My Income, I Would Be Embarrassed | 0.079 | 0.246 | 0.099 | -0.010 | 0.756 | 0.075 |
| 7.4 A Person's Status In My Community Depends On Their Financial Status | 0.123 | -0.008 | 0.054 | 0.094 | 0.064 | 0.708 |
| 7.1 These Days, It Is Difficult To Make Ends Meet | -0.067 | 0.123 | 0.253 | 0.004 | 0.044 | 0.694 |
| 7.2 Achieving Financial Success Is Important To Me | -0.038 | 0.159 | 0.097 | 0.441 | 0.087 | 0.475 |

32 The numbers in the second and succeeding columns are the factor loadings for the variables, which in our case are survey questions, in each of the factors. The factor loading for a variable shows the extent to which the variable is correlated with the factor. Ideally the loading will be high for the factor that contains the variable, and relatively low for the other factors.

### TABLE C, Factor Analysis of Taxpayers Who used a Preparer

| Questions | Factor 1 | Factor 2 | Factor 3 | Factor 4 | Factor 5 | Factor 6 | Factor 7 |
|---|---|---|---|---|---|---|---|
| 9.10 I Am Satisfied With The Quality Of The Federal Tax Services The IRS Provides | 0.804 | -0.002 | 0.064 | 0.013 | 0.061 | 0.043 | -0.045 |
| 9.1 The IRS Treats Taxpayers Fairly | 0.800 | -0.092 | 0.033 | 0.008 | 0.073 | 0.079 | 0.022 |
| 9.9 It Is Easy For Me To Access The Federal Tax Services That The IRS Provides | 0.788 | -0.024 | 0.061 | 0.099 | 0.088 | 0.028 | -0.082 |
| 9.3 The IRS Treats Taxpayers With Respect | 0.740 | 0.075 | 0.083 | 0.061 | 0.004 | -0.094 | -0.034 |
| 8.5 The Federal Tax Laws Are Fair | 0.732 | -0.018 | 0.085 | -0.070 | -0.109 | -0.067 | 0.189 |
| 8.7 Under Our Federal Tax Laws, Everyone Pays Their Fair Share Of Taxes | 0.702 | 0.078 | 0.068 | -0.039 | -0.091 | -0.047 | 0.110 |
| 9.8 The IRS Offers All Of The Federal Tax Services I Need | 0.626 | -0.001 | 0.215 | -0.005 | 0.154 | 0.137 | -0.039 |
| 9.5 Because The IRS Treats Taxpayers Fairly, I Accept Its Decisions Even If I Disagree With Them | 0.620 | 0.542 | 0.021 | 0.061 | 0.131 | -0.088 | 0.050 |
| 9.4 The IRS Will Work With You If You Have Difficulty Paying Your Taxes | 0.614 | 0.466 | -0.007 | 0.176 | 0.132 | 0.003 | -0.023 |
| 10.1 Many Small Businesses Do Not Report All Of Their Income | 0.019 | 0.786 | 0.148 | 0.082 | -0.021 | -0.102 | -0.064 |
| 10.3 Most Small Businesses Could Not Survive If They Reported All Of Their Income | 0.047 | 0.776 | 0.152 | 0.075 | 0.058 | -0.038 | -0.095 |
| 10.2 Most Of My Competitors Report All Of Their Income | 0.013 | 0.621 | 0.273 | 0.075 | 0.213 | 0.108 | -0.003 |
| 9.2 The IRS Is More Concerned With Collecting As Much As It Can, Than With Collecting The Correct Amount Of Tax | -0.040 | 0.533 | 0.001 | 0.083 | 0.286 | -0.195 | -0.212 |
| 10.5 Everyone Should Correctly Report All Of Their Income | 0.112 | 0.194 | 0.792 | 0.104 | 0.026 | -0.048 | -0.232 |
| 10.6 I Feel A Moral Obligation To Correctly Report All Of My Income | 0.270 | 0.073 | 0.747 | 0.109 | 0.174 | -0.143 | -0.009 |
| 10.7 If Others Found Out I Did Not Report All Of My Income, I Would Be Embarrassed | 0.125 | 0.246 | 0.742 | 0.117 | 0.119 | -0.021 | 0.030 |
| 7.11 I Always Follow The Instructions Or Advice From The Person Who Prepares My Return | -0.024 | 0.086 | 0.140 | 0.647 | 0.241 | -0.180 | -0.115 |
| 7.9 I Make Sure That I Understand Every Item That Is Included Or Omitted From My Return Before Signing It | 0.152 | 0.087 | 0.242 | 0.629 | 0.134 | -0.098 | -0.099 |
| 7.8 Even Though Someone Else Prepared My Return, I Know The Federal Tax Laws Well Enough To Prepare My Own Tax Return | 0.005 | 0.379 | -0.042 | 0.575 | 0.113 | -0.231 | 0.014 |
| 7.10 The Person Who Prepares My Return Finds Creative Ways To Minimize Taxes | 0.005 | 0.004 | -0.018 | -0.756 | 0.013 | 0.007 | 0.088 |
| 8.9 The Wealthy Have Ways Of Minimizing Their Federal Taxes That Are Not Available To The Average Taxpayer | 0.050 | 0.059 | 0.224 | 0.184 | 0.764 | 0.016 | -0.119 |
| 8.8 Large Businesses Have Loopholes To Reduce Their Federal Taxes That Smaller Businesses Do Not Have | 0.003 | 0.140 | -0.002 | 0.088 | 0.656 | -0.274 | -0.156 |
| 9.6 Wealthy Taxpayers Have An Advantage When Dealing With The IRS | 0.161 | 0.221 | 0.110 | 0.125 | 0.617 | -0.155 | -0.085 |

*continued on next page*

| Questions | Factor 1 | Factor 2 | Factor 3 | Factor 4 | Factor 5 | Factor 6 | Factor 7 |
|---|---|---|---|---|---|---|---|
| 7.5 The Rules About What To Report As Income Are Clear | 0.053 | 0.012 | -0.005 | -0.199 | 0.070 | 0.660 | 0.142 |
| 8.1 The Federal Government Spends Tax Dollars Wisely | 0.229 | 0.060 | -0.054 | 0.024 | -0.250 | 0.562 | 0.309 |
| 7.2 Achieving Financial Success Is Important To Me | 0.083 | 0.202 | 0.100 | 0.329 | 0.158 | -0.516 | -0.022 |
| 7.1 These Days, It Is Difficult To Make Ends Meet | 0.094 | 0.157 | 0.060 | 0.033 | 0.348 | -0.538 | 0.073 |
| 8.3 Taxpayers Would Tolerate Higher Taxes If It Meant Improved Federal Government Services | 0.113 | -0.012 | -0.054 | -0.092 | -0.038 | 0.135 | 0.784 |
| 8.2 Taxes Fund Important Federal Government Benefits And Services | 0.000 | -0.265 | -0.036 | -0.179 | -0.199 | -0.005 | 0.681 |
| 8.4 The Federal Government Is Involved In Areas Best Left To The Private Sector | 0.105 | 0.066 | 0.163 | 0.042 | 0.175 | -0.425 | -0.538 |

### TABLE D, Factor Analysis of Low Income Taxpayers

| Questions | Factor 1 | Factor 2 | Factor 3 | Factor 4 | Factor 5 | Factor 6 | Factor 7 |
|---|---|---|---|---|---|---|---|
| 9.10 I Am Satisfied With The Quality Of The Federal Tax Services The IRS Provides | 0.820 | 0.052 | 0.060 | 0.067 | 0.066 | 0.010 | 0.045 |
| 8.5 The Federal Tax Laws Are Fair | 0.789 | 0.009 | 0.059 | 0.043 | -0.008 | 0.212 | -0.023 |
| 9.9 It Is Easy For Me To Access The Federal Tax Services That The IRS Provides | 0.781 | 0.008 | -0.036 | 0.133 | 0.120 | -0.018 | 0.000 |
| 9.3 The IRS Treats Taxpayers With Respect | 0.763 | 0.093 | -0.044 | 0.067 | 0.019 | 0.038 | 0.090 |
| 9.1 The IRS Treats Taxpayers Fairly | 0.691 | -0.131 | -0.021 | 0.085 | -0.040 | 0.169 | -0.231 |
| 9.5 Because The IRS Treats Taxpayers Fairly, I Accept Its Decisions Even If I Disagree With Them | 0.634 | 0.572 | -0.028 | 0.021 | 0.106 | 0.167 | -0.015 |
| 9.8 The IRS Offers All Of The Federal Tax Services I Need | 0.611 | -0.016 | 0.115 | 0.279 | 0.148 | 0.012 | 0.023 |
| 9.4 The IRS Will Work With You If You Have Difficulty Paying Your Taxes | 0.572 | 0.484 | -0.010 | 0.011 | 0.130 | 0.194 | -0.087 |
| 10.3 Most Small Businesses Could Not Survive If They Reported All Of Their Income | 0.027 | 0.788 | -0.057 | 0.091 | 0.082 | 0.148 | 0.021 |
| 10.1 Many Small Businesses Do Not Report All Of Their Income | 0.036 | 0.778 | -0.042 | 0.176 | 0.031 | -0.042 | 0.063 |
| 10.2 Most Of My Competitors Report All Of Their Income | -0.039 | 0.592 | -0.042 | 0.352 | 0.231 | -0.003 | -0.165 |
| 9.2 The IRS Is More Concerned With Collecting As Much As It Can, Than With Collecting The Correct Amount Of Tax | -0.008 | 0.570 | -0.251 | -0.099 | 0.243 | 0.061 | 0.157 |
| 10.4 People Who Do Not Report All Of Their Income Are Likely To End Up Paying Even More In Penalties And Interest | -0.022 | -0.448 | 0.165 | -0.175 | -0.087 | 0.010 | -0.442 |
| 8.3 Taxpayers Would Tolerate Higher Taxes If It Meant Improved Federal Government Services | 0.089 | 0.012 | 0.768 | -0.115 | 0.044 | 0.117 | -0.144 |
| 7.5 The Rules About What To Report As Income Are Clear | 0.146 | 0.093 | 0.640 | 0.126 | -0.100 | -0.004 | -0.132 |
| 8.2 Taxes Fund Important Federal Government Benefits And Services | -0.032 | -0.333 | 0.579 | -0.236 | 0.005 | 0.095 | -0.113 |
| 8.7 Under Our Federal Tax Laws, Everyone Pays Their Fair Share Of Taxes | -0.388 | 0.055 | 0.536 | 0.001 | -0.342 | -0.135 | 0.027 |
| 8.6 The Tax Rules Are So Complicated That It Is Very Difficult To Get A Tax Return Exactly Right | 0.100 | 0.246 | -0.491 | -0.039 | 0.359 | 0.105 | 0.173 |
| 7.2 Achieving Financial Success Is Important To Me | 0.054 | 0.221 | -0.534 | 0.080 | 0.044 | 0.480 | 0.040 |
| 7.3 Taking Risks Is Necessary To Achieve Financial Success | -0.077 | 0.299 | -0.602 | 0.150 | 0.024 | 0.337 | -0.088 |
| 10.7 If Others Found Out I Did Not Report All Of My Income, I Would Be Embarrassed | 0.093 | 0.225 | 0.091 | 0.735 | 0.132 | 0.137 | 0.047 |
| 10.5 Everyone Should Correctly Report All Of Their Income | 0.229 | 0.147 | -0.231 | 0.727 | -0.034 | -0.097 | 0.127 |
| 10.6 I Feel A Moral Obligation To Correctly Report All Of My Income | 0.408 | 0.030 | -0.100 | 0.545 | 0.204 | 0.125 | 0.088 |
| 8.9 The Wealthy Have Ways Of Minimizing Their Federal Taxes That Are Not Available To The Average Taxpayer | 0.057 | 0.107 | -0.021 | 0.214 | 0.751 | 0.112 | 0.057 |

*continued on next page*

| Questions | Factor 1 | Factor 2 | Factor 3 | Factor 4 | Factor 5 | Factor 6 | Factor 7 |
|---|---|---|---|---|---|---|---|
| 9.6 Wealthy Taxpayers Have An Advantage When Dealing With The IRS | 0.215 | 0.261 | -0.099 | 0.043 | 0.605 | 0.088 | 0.112 |
| 8.8 Large Businesses Have Loopholes To Reduce Their Federal Taxes That Smaller Businesses Do Not Have | -0.042 | 0.185 | -0.407 | -0.027 | 0.585 | 0.002 | 0.168 |
| 9.7 The IRS Probably Knows When People Do Not Report All Of Their Income | 0.389 | 0.012 | 0.078 | 0.346 | 0.456 | -0.005 | -0.129 |
| 7.4 A Person's Status In My Community Depends On Their Financial Status | 0.288 | -0.043 | 0.005 | -0.001 | 0.026 | 0.641 | 0.089 |
| 7.1 These Days, It Is Difficult To Make Ends Meet | 0.098 | 0.240 | 0.016 | -0.034 | 0.282 | 0.545 | 0.326 |
| 7.7 Hearing About People Who Were Caught Not Reporting Their Taxes Makes Me Tend To Be Even More Careful With My Own Taxes | 0.094 | 0.059 | -0.087 | 0.418 | 0.062 | 0.510 | 0.065 |
| 8.4 The Federal Government Is Involved In Areas Best Left To The Private Sector | 0.106 | 0.139 | -0.227 | 0.185 | 0.089 | 0.236 | 0.639 |
| 8.1 The Federal Government Spends Tax Dollars Wisely | 0.234 | 0.104 | 0.259 | 0.008 | -0.187 | -0.179 | -0.526 |

### TABLE E, Factor Analysis of High-Income Taxpayers

| Questions | Factor 1 | Factor 2 | Factor 3 | Factor 4 | Factor 5 | Factor 6 | Factor 7 |
|---|---|---|---|---|---|---|---|
| 9.3 The IRS Treats Taxpayers With Respect | 0.773 | -0.145 | -0.007 | -0.020 | -0.136 | -0.113 | 0.057 |
| 9.1 The IRS Treats Taxpayers Fairly | 0.736 | -0.290 | -0.037 | 0.017 | -0.085 | 0.020 | 0.060 |
| 9.10 I Am Satisfied With The Quality Of The Federal Tax Services The IRS Provides | 0.723 | -0.290 | 0.109 | -0.060 | -0.068 | -0.026 | 0.179 |
| 9.9 It Is Easy For Me To Access The Federal Tax Services That The IRS Provides | 0.675 | 0.012 | 0.000 | -0.086 | -0.105 | -0.140 | 0.051 |
| 9.4 The IRS Will Work With You If You Have Difficulty Paying Your Taxes | 0.631 | -0.061 | -0.246 | -0.024 | 0.151 | -0.248 | 0.086 |
| 9.8 The IRS Offers All Of The Federal Tax Services I Need | 0.608 | -0.158 | 0.079 | -0.065 | -0.211 | -0.145 | 0.309 |
| 9.2 The IRS Is More Concerned With Collecting As Much As It Can, Than With Collecting The Correct Amount Of Tax | -0.610 | 0.306 | 0.117 | 0.086 | -0.250 | 0.112 | 0.098 |
| 8.4 The Federal Government Is Involved In Areas Best Left To The Private Sector | -0.144 | 0.730 | 0.134 | 0.059 | 0.119 | 0.034 | -0.167 |
| 8.6 The Tax Rules Are So Complicated That It Is Very Difficult To Get A Tax Return Exactly Right | -0.238 | 0.507 | -0.103 | 0.274 | 0.115 | 0.187 | -0.100 |
| 7.1 These Days, It Is Difficult To Make Ends Meet | -0.184 | 0.473 | 0.133 | 0.167 | 0.041 | 0.345 | 0.192 |
| 8.3 Taxpayers Would Tolerate Higher Taxes If It Meant Improved Federal Government Services | -0.191 | 0.471 | 0.217 | 0.223 | 0.016 | -0.108 | -0.228 |
| 7.3 Taking Risks Is Necessary To Achieve Financial Success | -0.017 | 0.459 | 0.134 | -0.087 | 0.359 | 0.122 | -0.316 |
| 7.5 The Rules About What To Report As Income Are Clear | 0.186 | -0.408 | 0.339 | 0.004 | 0.233 | -0.322 | 0.025 |
| 8.5 The Federal Tax Laws Are Fair | 0.265 | -0.548 | -0.069 | -0.315 | -0.239 | -0.065 | 0.209 |
| 8.1 The Federal Government Spends Tax Dollars Wisely | 0.228 | -0.694 | -0.069 | -0.030 | -0.099 | -0.097 | -0.050 |
| 10.6 I Feel A Moral Obligation To Correctly Report All Of My Income | 0.005 | 0.036 | 0.805 | 0.101 | 0.219 | 0.064 | 0.034 |
| 10.5 Everyone Should Correctly Report All Of Their Income | -0.058 | 0.079 | 0.765 | 0.107 | 0.208 | 0.109 | -0.001 |
| 10.7 If Others Found Out I Did Not Report All Of My Income, I Would Be Embarrassed | 0.029 | 0.061 | 0.699 | 0.137 | 0.134 | 0.071 | -0.171 |
| 10.4 People Who Do Not Report All Of Their Income Are Likely To End Up Paying Even More In Penalties And Interest | 0.138 | -0.137 | -0.531 | -0.119 | -0.067 | -0.020 | 0.275 |
| 8.9 The Wealthy Have Ways Of Minimizing Their Federal Taxes That Are Not Available To The Average Taxpayer | 0.032 | 0.091 | 0.094 | 0.794 | 0.173 | -0.037 | -0.018 |
| 8.8 Large Businesses Have Loopholes To Reduce Their Federal Taxes That Smaller Businesses Do Not Have | 0.036 | 0.139 | 0.119 | 0.722 | 0.027 | 0.065 | -0.197 |
| 9.6 Wealthy Taxpayers Have An Advantage When Dealing With The IRS | -0.341 | 0.106 | 0.237 | 0.603 | -0.040 | 0.168 | -0.030 |
| 8.7 Under Our Federal Tax Laws, Everyone Pays Their Fair Share Of Taxes | 0.132 | -0.407 | -0.089 | -0.453 | -0.289 | -0.092 | 0.157 |

*continued on next page*

| Questions | Factor 1 | Factor 2 | Factor 3 | Factor 4 | Factor 5 | Factor 6 | Factor 7 |
|---|---|---|---|---|---|---|---|
| 7.2 Achieving Financial Success Is Important To Me | -0.121 | 0.198 | 0.173 | 0.115 | 0.642 | 0.231 | 0.142 |
| 7.7 Hearing About People Who Were Caught Not Reporting Their Taxes Makes Me Tend To Be Even More Careful With My Own Taxes | -0.081 | 0.118 | 0.178 | 0.114 | 0.577 | 0.099 | -0.070 |
| 7.6 My Record Keeping System Makes It Easy For Me To Compute The Amount Of Income Tax I Need To Report On My Return | 0.001 | 0.075 | 0.227 | 0.086 | 0.570 | -0.160 | -0.121 |
| 10.1 Many Small Businesses Do Not Report All Of Their Income | -0.217 | 0.014 | 0.178 | 0.023 | 0.207 | 0.706 | -0.169 |
| 7.4 A Person's Status In My Community Depends On Their Financial Status | -0.134 | 0.186 | -0.066 | 0.117 | 0.324 | 0.552 | -0.193 |
| 10.2 Most Of My Competitors Report All Of Their Income | 0.181 | -0.167 | -0.160 | -0.056 | 0.170 | -0.687 | 0.124 |
| 9.5 Because The IRS Treats Taxpayers Fairly, I Accept Its Decisions Even If I Disagree With Them | 0.335 | -0.221 | -0.056 | -0.064 | 0.040 | -0.163 | 0.615 |
| 9.7 The IRS Probably Knows When People Do Not Report All Of Their Income | 0.123 | -0.035 | -0.102 | -0.171 | -0.152 | -0.145 | 0.514 |
| 8.2 Taxes Fund Important Federal Government Benefits And Services | -0.074 | 0.042 | 0.236 | 0.392 | 0.105 | 0.040 | -0.433 |
| 10.3 Most Small Businesses Could Not Survive If They Reported All Of Their Income | 0.003 | 0.132 | 0.490 | 0.089 | -0.138 | 0.114 | -0.519 |

## TABLE Y, County Data

| County | Demographics [33] | Urban % [34] | Congreg. % pop'n [35] | Charities [36] | | Voter T/o [37] | |
|---|---|---|---|---|---|---|---|
| | | | | #/10K | % | 2010Q | 2012% |
| **Valley** | | | | | | | |
| A | Family % 81.9<br>Non-Hisp. White % 97.3<br>Median Age 42.7<br>M:F .987 | 16.1 | 36.6 | 52 | 9.41 | 2 | 70.5 |
| B | Family % 68.4<br>Non-Hisp. White % 88.2<br>Median Age 40.9<br>M:F 1.07 | 72.8 | 47.0 | 39 | 13.1 | 2 | 71.1 |
| C | Family % 76.6<br>Non-Hisp. White % 88.3<br>Median Age 39.7<br>M:F 1.03 | 70.5 | 37.7 | 41 | 10.1 | 1 | 72.2 |
| **Hills** | | | | | | | |
| D | Family % 83.1<br>Non-Hisp. White % 77.8<br>Median Age 38.6<br>M:F .986 | 74.8 | 41.9 | 38 | 8.46 | 3 | 79.4 |
| E* | Family % 75.5<br>Non-Hisp. White % 90.8<br>Median Age 41.1<br>M:F .975 | 60.5 | 43.0 | 30 | 9.75 | 4 | 79.5 |
| F* | Family % 77.5<br>Non-Hisp. White % 62.7<br>Median Age 39.1<br>M:F .896 | 93.5 | 41.3 | 36 | 10.1 | 3 | 75.1 |
| G | Family % 84.8<br>Non-Hisp. White % 79.2<br>Median Age 39.4<br>M:F .957 | 82.2 | 39.1 | 27 | 6.39 | 4 | 78.9 |
| H* | Family % 81.3<br>Non-Hisp. White % 49.3<br>Median Age 38.5<br>M:F .923 | 97.6 | 39.6 | 51 | 9.68 | 2 | 74.1 |
| I | Family % 85.1<br>Non-Hisp. White % 59.2<br>Median Age 38.4<br>M:F .960 | 90.8 | 43.1 | 39 | 7.70 | 4 | 81.3 |

* Counties containing low-compliance sites.

*continued on next page*

33 U.S. Census data for population in families, by race, age & sex *available at* http://planning.maryland.gov/msdc/home.shtml.

34 U.S. Census data for urban & rural population at *ibid*.

35 Pop'n adhering to any religious congregation compiled by Assoc'n of Relig. Data Archives *available at* http://www.thearda.com/rcms2010/r/c/24/rcms2010_24001_county_name_2010.asp (last visited Aug. 27, 2013).

36 IRC § 501(c)(3) organizations per 10,000 pop'n and non-profit percent of workforce *available at* http://mdnonprofits.simplicitymetrics.com/.

37 Voter turn-out by quintile for 2010 General Election computed from State Bd. of Election data by State Univ. *available at* www.capc.umd.edu/rpts/2010/Turnout.pdf/. Voter turn-out by percent for 2012 General Election *available at* http://www.elections.state.md.us/press_room/.

| County | Demographics [33] | Urban % [34] | Congreg. % pop'n [35] | Charities [36] | | Voter T/o [37] | |
|---|---|---|---|---|---|---|---|
| | | | | #/10K | % | 2010Q | 2012% |
| **Shore (W)** | | | | | | | |
| J* | Family % 80.5<br>Non-Hisp. White % 72.4<br>Median Age 38.4<br>M:F .977 | 94.7 | 38.1 | 30 | 6.61 | 4 | 74.8 |
| K* | Family % 78.1<br>Non-Hisp. White % 14.9<br>Median Age 34.9<br>M:F .922 | 98.0 | 45.6 | 41 | 4.86 | 1 | 68.6 |
| L | Family % 86.4<br>Non-Hisp. White % 79.7<br>Median Age 40.1<br>M:F .971 | 61.3 | 62.1 | 30 | 8.88 | 4 | 77.7 |
| M* | Family % 85.5<br>Non-Hisp. White % 48.4<br>Median Age 37.4<br>M:F .935 | 70.5 | 37.0 | 29 | 5.01 | 3 | 77.2 |
| N | Family % 81.9<br>Non-Hisp. White % 75.5<br>Median Age 36.0<br>M:F .990 | 49.6 | 37.1 | 29 | 5.35 | 2 | 74.9 |
| **Shore (E)** | | | | | | | |
| O | Family % 82.6<br>Non-Hisp. White % 87.4<br>Median Age 38.9<br>M:F .990 | 57.9 | 31.1 | 24 | 7.33 | 2 | 68.2 |
| P | Family % 72.6<br>Non-Hisp. White % 78.1<br>Median Age 45.6<br>M:F .913 | 27.4 | 49.6 | 77 | 20.6 | 5 | 79.1 |
| Q | Family % 84.6<br>Non-Hisp. White % 87.3<br>Median Age 42.6<br>M:F .987 | 45.5 | 36.8 | 33 | 3.46 | 4 | 77.3 |
| R | Family % 79.3<br>Non-Hisp. White % 79.0<br>Median Age 47.4<br>M:F .912 | 45.3 | 42.8 | 64 | 15.0 | 5 | 81.1 |
| S | Family % 82.0<br>Non-Hisp. White % 78.2<br>Median Age 38.7<br>M:F .952 | 24.0 | 33.7 | 35 | 13.6 | 2 | 73.8 |
| T | Family % 78.5<br>Non-Hisp. White % 66.2<br>Median Age 43.3<br>M:F .913 | 43.8 | 36.5 | 40 | 10.4 | 3 | 77.2 |
| U | Family % 73.7<br>Non-Hisp. White % 66.6<br>Median Age 35.7<br>M:F .912 | 74.2 | 37.8 | 39 | 11.5 | 2 | 74.9 |

* Counties containing low-compliance sites.

*continued on next page*

| County | Demographics [33] | Urban % [34] | Congreg. % pop'n [35] | Charities [36] | | Voter T/o [37] | |
|---|---|---|---|---|---|---|---|
| | | | | #/10K | % | 2010Q | 2012% |
| V | Family % 78.3<br>Non-Hisp. White % 80.3<br>Median Age 48.1<br>M:F .948 | 64.5 | 48.4 | 40 | 5.10 | 5 | 76.3 |
| W | Family % 60.3<br>Non-Hisp. White % 52.1<br>Median Age 36.5<br>M:F 1.15 | 54.2 | 22.3 | 28 | 10.8 | 1 | 73.8 |
| **Averages** | | | | | | | |
| Valley | Family % 75.6<br>Non-Hisp. White % 84.8<br>Median Age 41.1<br>M:F 1.03 | 53.1 | 40.4 | 44 | 10.9 | 1.7 | 71.3 |
| Shore (E) | Family % 76.9<br>Non-Hisp. White % 79.4<br>Median Age 36.8<br>M:F .863 | 48.5 | 37.7 | 42.2 | 10.9 | 3.2 | 75.7 |
| Megalopolis Hills + Shore (W) | Family % 81.9<br>Non-Hisp. White % 62.0<br>Median Age 38.3<br>M:F .955 | 79.0 | 42.7 | 34.3 | 7.41 | 3.1 | 76.4 |
| Hills | Family % 81.2<br>Non-Hisp. White % 69.8<br>Median Age 39.2<br>M:F .950 | 83.2 | 41.3 | 36.8 | 8.68 | 3.3 | 78.1 |
| Shore (W) | Family % 82.5<br>Non-Hisp. White % 58.4<br>Median Age 37.4<br>M:F .959 | 74.8 | 44.0 | 31.8 | 6.14 | 2.8 | 74.6 |
| E, F, H, J, K & M | Family % 79.7<br>Non-Hisp. White % 56.4<br>Median Age 38.2<br>M:F .938 | 85.8 | 40.8 | 36.2 | 7.67 | 2.8 | 74.9 |

* Counties containing low-compliance sites.

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# The Service Priorities Project: Developing a Methodology for Optimizing the Delivery of Taxpayer Services

SECTION FOUR

# The Service Priorities Project: Developing a Methodology for Optimizing the Delivery of Taxpayer Services[1]


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1 The principal authors of this study are Carol Hatch, TAS Research Program Manager, and Tom Beers, Senior Research Advisor to the National Taxpayer Advocate.

## INTRODUCTION

The objective of this report is to present a set of recommendations that will guide the development and implementation of the Service Priorities Project ranking methodology. The goal of the methodology is to identify, from both the government perspective and the taxpayer perspective, the value of each taxpayer service offered by the IRS. The IRS will be able to use this ranking methodology to make resource allocation decisions that will optimize the delivery of taxpayer service activities given resource constraints.[2] Congress will be able to use the results of this methodology to determine whether it is adequately funding core taxpayer service activities. The implementation of this approach is particularly urgent in light of today's funding environment for taxpayer service.[3]

## BACKGROUND

The National Taxpayer Advocate is concerned that the ongoing cuts to the IRS's budget in fiscal years (FY) 2010–FY 2013 have significantly eroded the quality of taxpayer service. In the long run, this erosion increases taxpayer burden, undermines taxpayers' faith in the tax system, and will reduce voluntary compliance.[4] While she believes high quality taxpayer service can only be restored by adequate funding, the National Taxpayer Advocate has urged the IRS to develop a methodology that would enable it to optimize the use of its limited resources to deliver the best possible taxpayer service given resource constraints.[5] This methodology would also help identify the impact of not funding certain core taxpayer services.

In response to the National Taxpayer Advocate's concerns, the Wage & Investment (W&I) Division and TAS are collaborating on an initiative, the Service Priorities Project, that will enable the IRS to identify a proper balance between automated and personal services. The project team is developing a ranking methodology for IRS taxpayer services that takes taxpayer needs and preferences into account. The methodology will value each of the major taxpayer services offered by the IRS from both the government's and the taxpayer's perspective. The IRS will be able to use this ranking methodology to make resource allocation decisions based on highest valued services in the face of budget or staffing constraints.

The methodology measures "value" using separate sets of criteria for taxpayers and the IRS. This is necessary because taxpayers and the IRS have different priorities. The IRS is concerned with conserving scarce resources, especially in a tight budget environment. Taxpayers need services that will enable them to understand their tax obligations and resolve tax issues without imposing undue burden. Frequently, these needs are best met by personal services that are more costly to the IRS than automated services, such as internet based services.

We use the word "optimize" to mean that the ranking methodology will provide the IRS with a rigorous way to select the combination of competing taxpayer service initiatives that maximizes the "value" of service delivery given available resources. The methodology assigns a score to each initiative that reflects

2 The meaning of "optimize" for purposes of this study is discussed in the Background section below.

3 For a discussion of the current IRS funding environment, see Most Serious Problem: *IRS Budget: The IRS Desperately Needs More Funding to Serve Taxpayers and Increase Voluntary Compliance, supra* Vol. 1.

4 *See Progress on the Implementation of the Taxpayer Assistance Blueprint: Five-Year Progress Report: FY 2008–FY 2012* 45-47 (Apr. 23, 2012).

5 See National Taxpayer Advocate 2012 Annual Report to Congress 226 (Most Serious Problem: *The IRS Telephone and Correspondence Services Have Deteriorated Over the Last Decade and Must Improve to Meet Taxpayer Needs*). *See also Progress on the Implementation of The Taxpayer Assistance Blueprint: Five-Year Progress Report: FY 2008–FY 2012* 45-47 (Apr. 23, 2012).

its overall value based on an appropriate balance between criteria that weigh the value of the initiative to the IRS and to the taxpayer. The IRS can use these scores to choose between the competing initiatives.

Components of the methodology include:

- Lists of government value and taxpayer value criteria to evaluate service activities (*e.g.*, answering tax law questions, helping with notices, etc.) by delivery channel;
- Weights assigned to each criterion;
- Operational and survey data used to quantify criteria; and
- The score for each of the service activities, which will be the sum of the weighted criteria values.

In order to populate the ranking tool that will implement the ranking methodology, the IRS must develop values for each of the ranking criteria. The values are scores that will range from a low of one to a high of five. The scores will be based on data relevant to the criteria being evaluated. Some of this data is readily available for services offered by the IRS, such as taxpayer wait time when calling the IRS. Other information will be collected through surveys or increased tracking of IRS service contacts.

In the sections that follow, the report covers the major elements of the methodology. It documents work completed by the project team to date, and presents recommendations to guide completion of the service ranking methodology.

## IDENTIFYING THE SERVICE ACTIVITIES TO BE RANKED

The IRS delivers a broad variety of services to taxpayers over different service "channels." These channels include the telephone lines (some toll-free),[6] the IRS's Taxpayer Assistance Centers (TACs) that provide face-to-face assistance, electronic service via the Internet, and correspondence.

Given the broad scope of IRS services, the project team recognized the need to prioritize the coverage of the various service activities early on. The team decided to focus initially on the services delivered by the Wage & Investment Division (W&I), which address the needs of individual taxpayers, and to defer coverage of the correspondence channel.[7] Thus, the ranking tool currently focuses on toll-free telephone lines, TACs, and online service delivery.

The team developed an extensive inventory of W&I taxpayer services and initially targeted 21 activities for coverage. The team determined, however, that the IRS had limited data on many of the services, and research showed that a subset of them represents the vast majority of individual taxpayer service needs (see Figure 1 below).

6 The taxpayer service telephone lines available to international taxpayers are not toll-free.

7 The IRS will need to extend the methodology to encompass the service needs of business taxpayers and tax exempt organizations at a future date.

**FIGURE 1, Service Interactions by Issue, TY 2007-2011**[8]

| Issue | TY 2007 | TY 2008 | TY 2009 | TY 2011 |
|---|---|---|---|---|
| Refund Information | 14% | 24% | 21% | 30% |
| Get Form or Publication | 23% | 26% | 26% | 19% |
| Notice [9] | 11% | 14% | 13% | 12% |
| Tax Law Question while Preparing a Return [10] | 6% | 8% | 9% | 10% |
| Return Preparation Assistance | 10% | 10% | 8% | 9% |
| Payment Information | 5% | 6% | 5% | 5% |
| Obtain Prior Year Tax Return | 6% | 6% | 5% | 4% |
| Obtain Tax ID Number | 2% | 3% | 2% | 2% |
| Tax Law Information after Filing Return | n/a | n/a | 3% | 3% |
| Make a Payment | n/a | n/a | 4% | 6% |
| Other [11] | 23% | 3% | 4% | 0% |

TAS therefore recommends that service ranking be limited to the following services (see Figure 2 below).

**FIGURE 2, Services Recommended for Inclusion in Ranking Methodology**

| Pre-Filing |
|---|
| Help with tax law questions |
| Help obtaining tax ID number (EIN or ITIN) |
| Help obtaining forms & publications |
| **Filing** |
| Return preparation assistance |
| Providing date-stamped proof of filing of prior year tax return [12] |
| **Post-Filing** |
| Providing copy of prior year tax return |
| Help understanding a notice or letter |
| Providing refund information |
| Providing payment information (includes setting up a payment agreement) |
| Making a payment |

Some of the omitted services are actually covered by the higher-level service categories recommended above. The IRS will need to develop separate procedures to prioritize the other omitted services. See Figure 3 below for a list of the services that would not be covered under the new ranking methodology:

8 *Progress on the Implementation of the Taxpayer Assistance Blueprint: Five-Year Progress Report: FY 2008–FY 2012* 6 (Apr. 23, 2012). Information for tax year 2010 is omitted because the information source, the Taxpayer Experience Survey, was not administered for tax year 2010.

9 This service covers IRS assistance to taxpayers who are responding to IRS notices.

10 TY 2007 & 2008, includes before and after filing the return.

11 In TY 2007, includes questions about the Economic Stimulus Package.

12 Although this was not identified as a high-volume service, it is an essential service to both taxpayers and practitioners who require proof of filing to demonstrate that tax obligations have been met. Information needed to support this service can be collected in periodic TAC surveys, as discussed later in this report.

**FIGURE 3, Services Recommended for Exclusion from the Ranking Methodology**

| Pre-Filing |
|---|
| Providing general procedural assistance and information (covered under other categories) |
| **Filing** |
| Return preparation assistance for prior year tax return (covered under broader category) |
| Resolving issue on rejected e-file return |
| Facilitating the filing of Form 2290, Heavy Highway Vehicle Use Tax Return |
| **Post-Filing** |
| Providing tax account assistance (covered under broader category) |
| Providing transcript of prior year tax return (covered under broader category) |
| Providing assistance with responses to notices, audits, Injured Spouse and Innocent Spouse claims (covered under broader category) |
| Providing manual tax refund |
| Locating (trace), replacing lost or stolen refunds |
| Reissuing undeliverable checks |
| Providing Sailing Clearance |

## DEFINING THE GOVERNMENT VALUE AND TAXPAYER VALUE CRITERIA

As discussed above, the methodology will score both the government value and taxpayer value of each service activity on each of the channels (as noted above. the channels are the taxpayer assistance centers, the IRS toll-free telephone lines, and the IRS web site).

The project team initially proposed six government value and four taxpayer value criteria. After further analysis, TAS is recommending changes to both sets of criteria.

### Government Value Criteria

The following are the government value criteria the team proposed for ranking each service activity by channel:

- Total taxpayer contacts – The number of times taxpayers received the particular service. This criterion enables the IRS to identify how heavily a service is used compared to other services.
- Assistor Service time – Average time (in seconds) the assistor spent providing service to a taxpayer. This criterion enables the IRS to estimate how costly each service contact is.
- Taxpayer contacts per Assistor – Number of taxpayer contacts for each taxpayer-facing full-time equivalent position (FTE). This criterion enables the IRS to estimate the total cost of delivering the service.
- Accuracy – Percent of times the information given and actions taken were correct. Incorrect information causes "downstream" costs, such as errors in tax returns that can lead to additional return processing costs associated with correcting errors, and the costs associated with audits that address errors not corrected during return processing.
- IRS issue resolution – Percent of taxpayers who had their issue resolved as a result of the service they received. This criterion is of high importance to the government, because taxpayers may

continue to contact the IRS until their issues are resolved, and each contact will require additional IRS resources (this is another kind of downstream cost).

- Customer satisfaction – Percent of taxpayers who were satisfied or very satisfied with the service they received. Dissatisfied taxpayers may not have had their issues resolved completely or during the first contact. As discussed above, this can lead to downstream costs.

TAS recommends, however, that the taxpayer contacts per assistor measure be dropped, because it is redundant with the first two criteria (*i.e.,* the taxpayer contacts per assistor can be derived from the number of contacts and the assistor time spent on those contacts). Instead, we recommend that a new cost measure be included. None of the current criteria capture the costs associated with developing and maintaining the automated Internet and telephone-based activities. A cost measure that captures the overhead associated with the various service activities will provide a more accurate estimate of the cost to the IRS of delivering these services.

TAS also recommends that the accuracy criterion not be applied when scoring the web and telephone-based automated services. These activities are not analogous to the interactive services provided in IRS taxpayer assistance centers (TACs) and over the phone. Since there is no opportunity for interaction, it is unclear whether the taxpayer understood the information provided, or was even able to find the correct information.

In cases where a criterion is not applicable to a particular service activity or data is not available for scoring, TAS recommends that the remaining criteria be given additional weight to compensate for the missing criterion score, as long as scores for issue resolution and customer satisfaction are available. As discussed above, these criteria effectively summarize the likelihood that the IRS will experience resource intensive "downstream" costs. For example, if while completing a tax return a taxpayer is unable to find or understand the answer to a tax law question on the IRS web site, he or she will call the IRS, visit a TAC, or make an error that the IRS will subsequently have to correct. Taxpayers who have had inadequate service will give low ratings to the issue resolution and customer satisfaction criteria.

### Taxpayer Value Criteria

As stated above, the project team initially proposed four taxpayer value criteria:

- Taxpayer Issue Resolution – Percent of taxpayers who reported their issue was resolved after receiving service. This criterion measures taxpayers' perception that they received the correct answer to a tax law question or the assistance they needed to resolve a tax problem arising from a notice, audit, or other IRS contact. In prior research, taxpayers identified issue resolution as the most important attribute for service contacts. As discussed above, the project team also identified it as the most important attribute for the IRS, since resolution obviates the need for costly additional contacts.
- Wait time – Average time the taxpayer spent waiting before receiving service. This criterion and the following two criteria, taxpayer service time and hours of operation, measure the amount of taxpayer burden (*e.g.*, time and inconvenience) associated with the service experience.
- Taxpayer Service time – Average time the taxpayer spent getting service.
- Hours of operation – The hours per week the channel is available to taxpayers.

TAS subsequently proposed four additional criteria:

- Willingness – Percent of taxpayers who would use this service channel in the future for the task under consideration. This measure captures taxpayers' preferences when choosing between competing service channels.
- Vulnerable population – Percent of vulnerable taxpayers who use the service channel for the task under consideration. The vulnerable population is: seniors, taxpayers with limited English proficiency (LEP), low income, or disabled taxpayers. Generally, these taxpayers are more dependent on the IRS for services than other segments of the taxpayer population. This criterion weights service activities based on how heavily they are used by vulnerable taxpayers.
- Taxpayer Impact – Impact on taxpayers if they do not receive the service (through a particular channel) from the IRS. In effect, this criterion measures how important the service activity is to taxpayers relative to other activities.
- Customer satisfaction – Percent of taxpayers who were satisfied or very satisfied with the service they received. The customer satisfaction criterion effectively summarizes the taxpayers' overall service experience and is therefore the single best criterion representing the taxpayer's perspective.

The IRS has agreed to incorporate the first three of the above four additional taxpayer value criteria as data becomes available.[13] TAS recommends the inclusion of the customer satisfaction criterion because it effectively summarizes the taxpayers' overall service experience, and can serve as a proxy for other criteria that cannot be scored if data is unavailable. TAS will collaborate with the IRS to ensure that customer satisfaction is accurately captured in future surveys.

TAS is also recommending some refinements to the scoring of the above criteria. Concerning the vulnerable population, TAS suggests that low income serve as a proxy for the other groups, since income data is generally available and is a good indicator of the extent to which an individual is dependent on IRS services.[14] Low income could be defined as taxpayers at or below 250 percent of the federal poverty level. The IRS uses this definition for related purposes, such as eligibility for access to the Low Income Taxpayer Clinics (LITCs).[15]

Use by the low income population could be calculated based on the percent of users of the service activity who are members of that population. For example, if low income taxpayers represented 40 percent of the taxpaying population, but comprised more than 40 percent of the users of a particular service, that service would be scored higher than the median (*i.e.*, higher than three, where scores range from one to five).

TAS is recommending that the taxpayer impact criterion be scored initially based on the combined judgment of W&I and TAS executives. In the future, ranking data could be captured from taxpayers in surveys.

13 *See* National Taxpayer Advocate 2012 Annual Report to Congress 228 (Most Serious Problem: *The IRS Telephone and Correspondence Services Have Deteriorated Over the Last Decade and Must Improve to Meet Taxpayer Needs*).

14 For a discussion of the service needs and demographics of the low income population, see National Taxpayer Advocate 2009 Annual Report to Congress 110-133 (Most Serious Problem: *Beyond EITC: The Needs of Low Income Taxpayers Are Not Being Adequately Met*).

15 In 1998, the Congress enacted the Internal Revenue Restructuring and Reform Act of 1998 (RRA), in which it authorized matching grants for Low Income Taxpayer Clinics (LITCs). *See* Pub. L. No. 105-206, § 3601, 112 Stat. 685, 774 (July 22, 1998). For nominal or no cost, clinics represent taxpayers in controversies with the IRS, provide tax outreach and education to taxpayers who speak English as a second language (ESL), or both. Representation is generally limited to taxpayers whose income is at or below 250% of the federal poverty level. See Internal Revenue Code (IRC) §§ 7526(b)(1) for the definition of a qualified low income taxpayer clinic.

## DATA SOURCES

In order to populate the ranking tool, the IRS must develop values for each of the ranking criteria. Operational data can be used, where available, to determine the values for the government and taxpayer value criteria (*e.g.,* how long taxpayers have to wait on hold to talk with an assistor). Survey data can be used for service activities when operational data is not available (*e.g.,* the percent of taxpayers reporting that their issue was resolved comes from survey data).

While some of this information is available, other information must be collected through surveys or increased tracking of IRS service contacts. In particular, TAS recommends the following:

- The Taxpayer Experience Survey (TES) collects valuable data on issue resolution and customer satisfaction by channel for most of the major service activities discussed above.[16] This data is not available elsewhere. In recent years, the IRS has decreased the survey sample size, and it is not sufficient to accurately score some of the service activities. TAS recommends that the sample be increased to at least 5,000 respondents. In the interim, TAS will develop scores based on the 2009 TES for illustrative purposes, since it had a significantly larger sample size than subsequent versions of the TES.
- To meet project data needs, TAS recommends changes to the TES survey. Questions ranking the importance of service activities should be added to facilitate scoring for the taxpayer impact criterion. Also, some of the service activity definitions should be refined to align more closely with the project methodology definitions:
  - Getting information about making a payment should explicitly include the establishment of installment agreements.
  - Making payments should be a separate category.
  - Getting prior year return information should explicitly be defined as obtaining a prior year return or transcript.
  - Getting help to prepare a tax return should be included as a separate category.
- Because taxpayers use the TACs less than the other service channels, surveys administered to the general population of taxpayers usually have insufficient sample sizes to capture adequate volumes of TAC service usage. TAS recommends that IRS periodically conduct surveys in the TACs to capture this data. Data should be collected at several times during the year to capture seasonal changes in usage patterns and should include both taxpayers who were served in the TACs and taxpayers who were turned away from the TACs because of staffing levels or service unavailability.

## CAPTURING INCREMENTAL CHANGES IN LEVELS OF SERVICE

The ranking methodology captures the government value and taxpayer value of the scored services at a particular time. These values can be viewed as the base case. Typically the IRS needs to make budget decisions that change the level at which service activities are delivered. For example, the IRS might want to

16 The TES is administered annually to a representative sample of US individual taxpayers (*i.e.*, those filing Form 1040, U.S. Individual Income Tax Return, or other returns in the 1040 series) by the IRS Wage & Investment (W&I) Division. The purpose of the survey is to capture information about the taxpayer service experiences and service needs of this diverse population. Information is collected on a variety of subjects, including service usage, issue resolution, and customer satisfaction by channel, among others.

compare the impact of reducing the number of assistors answering taxpayer calls to reducing the number of assistors helping taxpayers prepare tax returns. The IRS needs a methodology to evaluate these kinds of incremental service changes.

The IRS currently has mathematical models that it could adapt to estimate the impact of changes in service delivery on taxpayer value.[17] These models calculate the change in the "utility" of a service activity to taxpayers given one or more changes to service level parameters, such as hours of operation, issue resolution rate, or wait time. The percentage increase or decrease in utility could be used to scale the baseline taxpayer value score up or down. To implement this approach, the IRS would estimate how funding increases or decreases would impact service delivery parameters (*i.e.*, attributes the IRS will use to measure taxpayer value and government value, such as number of taxpayer contacts, time spent getting service and issue resolution rate).

The IRS could also use the estimated change in service delivery parameters to compute updated scores for all of the government value criteria, except customer satisfaction, which could be scaled up or down based on the percentage change in utility. The updated government value score could be compared to the baseline score to determine the change in government value.

## CONCLUSION

Research by the project team has already benefited the IRS, since it highlights the areas where we need to do additional research and analysis to determine how taxpayer services are being used and how taxpayers would like to use these services. Continuing research to populate the ranking tool will help the IRS understand the best ways to deliver each type of service to the taxpayer and optimize its overall taxpayer service strategy.

The National Taxpayer Advocate is pleased that the IRS has agreed to collaborate with TAS to develop this tool and to use it to inform future taxpayer service decisions. The project requires additional data, however, and much work remains to fully populate the ranking tool. The National Taxpayer Advocate urges the IRS to complete the research and data collection necessary to make the ranking tool effective. While populating the tool will require an investment upfront, it will enable the IRS to make better decisions and to allocate resources more appropriately in the future.

The Service Priority Ranking Tool will also provide congressional appropriators with a valuable tool for identifying whether core taxpayer services are being adequately funded. But time is of the essence here: already the IRS has made potentially harmful service delivery decisions without having the benefit of this methodology.[18]

17 In 2008, a vendor developed the Taxpayer Value Model (TVM) for the IRS. It measures how changes in service level parameters, such as hours of operation, impact the utility of the service to taxpayers. In 2012, the IRS developed a similar model, the Taxpayer Choice Model (TCM), using more current information.

18 *See* IRS, e-News for Tax Professionals – Issue Number 2013-49, Item 4, *Some IRS Assistance and Taxpayer Services Shift to Automated Resources, available at* http://www.irs.gov/uac/Some-IRS-Assistance-and-Taxpayer-Services-Shift-to-Automated-Resources (last visited Dec. 23, 2013).

# Fundamental Changes to Return Filing and Processing Will Assist Taxpayers in Return Preparation and Decrease Improper Payments

SECTION FIVE

# Fundamental Changes to Return Filing and Processing Will Assist Taxpayers in Return Preparation and Decrease Improper Payments[1]


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## EXECUTIVE SUMMARY

The National Taxpayer Advocate has repeatedly written about the need to develop an accelerated information reporting system to enable the IRS to match third-party reports to return data before issuing refunds. The proposed system would benefit tax administration by protecting revenue. The government would avoid issuing erroneous funds and then chasing down the dollars through future enforcement actions. Taxpayers would benefit by avoiding enforcement and collection actions months or even years after filing the returns. Both tax administration and taxpayers would further benefit if the IRS provides taxpayers and their representatives with electronic access to their third-party data before the return filing deadline to assist in tax preparation.

The IRS acknowledged the need to develop an accelerated information reporting system in 2011 through the creation of the IRS Real Time Tax System Initiative. As part of the initiative, the IRS held two public meetings and solicited comments from a variety of impacted stakeholders, all of whom indicated general support for the proposed system. Further, the IRS promised to include the Taxpayer Advocate Service in any further development of the initiative. However, the National Taxpayer Advocate has not seen any progress since.

In this study, we evaluate various options to achieve upfront matching and enable taxpayers to access and download their third-party information into commercial tax preparation software. The evaluations consider the benefits and risks of each option and try to strike a balance to benefit all impacted stakeholders: taxpayers, the IRS, preparers, third-party report issuers, and software companies.

Ultimately, we recognize that changes to return filing and processing of this magnitude require a great deal of forethought, analysis, and stakeholder engagement. To date, the IRS has not made meaningful progress, which only delays the significant benefits we outlined above and throughout this report. Thus, we reiterate our 2009 legislative recommendation that Congress require the IRS and the Department of Treasury to prepare a report, in consultation with the National Taxpayer Advocate, which provides a plan and timeline to achieve an accelerated third-party information reporting system. In furtherance of this issue, the National Taxpayer Advocate offers the following preliminary recommendations to develop an accelerated third-party reporting system:

**Recommendation 1.1:** Provide taxpayers with access to real-time transcripts of third-party data to aid in return preparation.

**Recommendation 1.2:** Provide a platform from which taxpayers and preparers could download third-party data directly into commercial tax return preparation software.

**Recommendation 2.1:** Develop and implement a one-year pilot to determine if the IRS can screen Form W-2 data as effectively as the Social Security Administration.

**Recommendation 2.2:** Eliminate the March 31 deadline for e-filed information reports. All information reports, whether e-filed or filed on paper, would be due at the end of February.

**Recommendation 2.3:** Minimize corrections by creating a $50 *de minimis* threshold for corrections.

**Recommendation 2.4:** Further increase electronic filing by reducing the 250 report threshold in IRC § 6011(e) to 50 reports and offer 2D bar code technology for those who cannot e-file.

**Recommendation 3.1:** Issue direct deposit and other electronic refunds by April 30 and paper checks by May 31.

## INTRODUCTION

In the 2009, 2011, and 2012 Annual Reports, the National Taxpayer Advocate wrote about the benefits of accelerated third-party information reporting to both tax administration and taxpayers.[2] The IRS also acknowledged the benefits of such a system through the development of the Real Time Tax System Initiative in 2011, which received widespread support in the associated public hearings.

In this report, we will first discuss the benefits of an accelerated information reporting system to both tax administration and taxpayers. A system that enables the IRS to perform upfront matching has the main benefit of protecting government revenue. Taxpayers also benefit through improved service, modernization, and reduced downstream consequences associated with inadvertent return errors.

As discussed later in this report, taxpayers will not realize the full benefits of this system unless the IRS provides taxpayers and their representatives with the ability to access and download their third-party data from an online account to assist in return preparation. This aspect of the proposal requires development of an online account system, of which the IRS is in the preliminary planning stages.[3]

The goal of this report is to provide a strategic framework and preliminary recommendations to develop an accelerated third-party reporting system. The National Taxpayer Advocate offers a proposal on how to better structure the filing season to reduce fraud and protect the interests of taxpayers and the government. The proposal is based on research conducted by the Taxpayer Advocate Service, including discussions with impacted stakeholder groups, and is meant to serve as the first step toward implementation. We have attempted to address all identified concerns and risks; however, we acknowledge that there will be unexpected challenges and risks before a proposal along these lines is implemented.

There are competing and mutually exclusive goals in tax administration of protecting revenue and delivering refunds. This report tries to balance the competing concerns by maximizing the benefits and minimizing the burdens imposed on impacted stakeholders, namely taxpayers, preparers, third parties, tax software companies, and tax administration. To achieve upfront matching, it is necessary to evaluate the feasibility of adjusting critical dates:

- The date the IRS receives the information reports,
- The dates of the filing season, and
- The date a refund is issued.

The adjustment of any of these dates impacts several stakeholders in varying ways. We attempt to identify how each stakeholder is affected and develop a system that strikes a balance.

Accordingly, we encourage stakeholders from wide-ranging backgrounds to read our analysis and preliminary recommendations and submit comments and suggestions to the Office of the Taxpayer Advocate. We look forward to further discussing the proposal and making any necessary adjustments to move this initiative to the next level — *i.e.*, planning and implementation.

2 National Taxpayer Advocate 2009 Annual Report to Congress 338-345; National Taxpayer Advocate 2011 Annual Report to Congress 284-295; National Taxpayer Advocate 2012 Annual Report to Congress 180-191.

3 It is our understanding that the IRS Office of Online Services is in the preliminary stages of developing a draft roadmap to develop such an online account. IRS Online Services, *Get Transcript and Account Update: W&I Executive Briefing* 12-17 (Nov. 13, 2013).

### *Upfront Matching Benefits Tax Administration by Protecting Revenue*

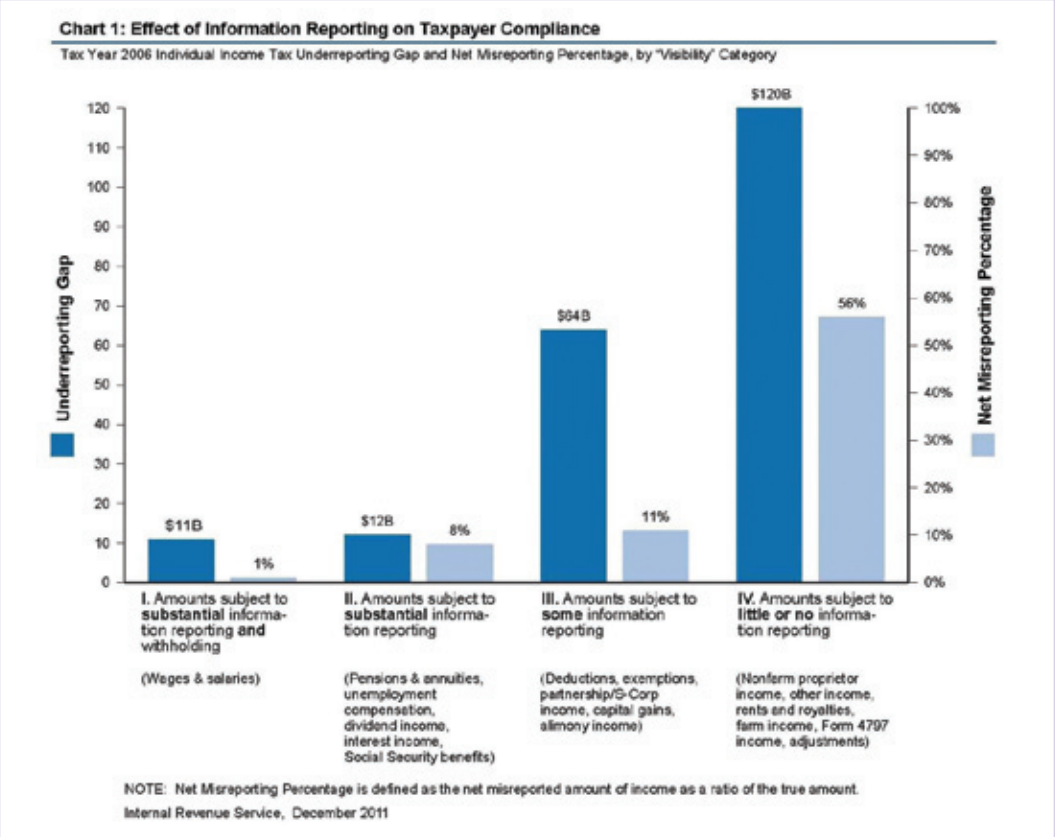
Third-party information reporting is a crucial element in maximizing tax compliance. Tax gap data show the importance of information reporting compliance, and how third-party reporting is essential to encourage voluntary compliance. Specifically, the data show that when taxpayers have a choice about reporting their income, tax compliance rates are remarkably low. For example, workers who are classified as employees have little opportunity to underreport their earned income because it is subject to both information reporting on Forms W-2 and tax withholding. In fact, IRS data show that taxpayers report about 99 percent of their wages and salaries.[4]

Among workers whose income is not subject to both information reporting and tax withholding, compliance rates plummet. For income subject to substantial information reporting but no tax withholding (such as pensions, annuities, unemployment compensation, dividends, interest and Social Security benefits), taxpayers reported about 92 percent of their income. In contrast, for income subject to little or no information reporting (such as nonfarm proprietor income, rents, royalties, and farm income), taxpayers reported only about 44 percent of their income.[5] Below is the infographic developed by the IRS to illustrate the impact of information reporting and withholding on tax compliance rates.[6]

4 IRS, Tax Gap for Tax Year 2006 Overview, Chart 1 (Jan. 6, 2012).

5 *Id*.

6 *Id*.




The government benefits from the revenue protection aspect of upfront matching. As noted below, the IRS does not match third-party data with items reported on taxpayers' returns until long after the filing season. Accelerated third-party reporting would enable the IRS to protect revenue by identifying and resolving inaccurate income reporting at the time of return filing and preventing the release of erroneous refunds.[7] This system would deter tax fraud, identity theft, and inadvertent errors by stopping the refund associated with a mismatch. In particular, enabling the IRS to receive and process Forms W-2, *Wage and Tax Statement*, before releasing refunds would be an important step toward these goals.[8] Further, the IRS would devote fewer resources to compliance and collection activities on basic omission and understatement cases, and could use the savings to resolve more complex issues.[9]

7 IRS, PowerPoint, *Real Time Tax System Initiative, Public Meeting* 2 (Dec. 8, 2011), *available at* http://www.irs.gov/pub/irs-utl/rtts_deck.pdf.

8 Recently, the Treasury Inspector General for Tax Administration found in an analysis of tax year (TY) 2010 returns that almost 1.5 million returns claiming in excess of $5.2 billion in refunds were not detected by the IRS as potentially fraudulent. The common characteristic of these tax returns was that the income and withholding they reported were false. Generally, the perpetrators reported fabricated income to maximize credits and increase the amount of the fraudulent tax refunds. TIGTA, Ref. No. 2013-40-083, *Income and Withholding Verification Processes Are Resulting in the Issuance of Potentially Fraudulent Tax Refunds* 4 (Aug. 7, 2013).

9 IRS, PowerPoint, *Real Time Tax System Initiative, Public Meeting* 1 (Dec. 8, 2011), *available at* http://www.irs.gov/file_source/pub/irs-utl/rtts_deck.pdf. When the Automated Underreporter system identifies a mismatch between items reported on the taxpayer's return and information reports, it generates a CP 2000 notice to be mailed to the taxpayer. In TY 2010, the IRS mailed 3,823,766 of these notices with an estimated 45 percent response rate. These numbers have declined from 4,546,817 notices in TY 2009 (with an estimated response rate of 60 percent) and 4,788,360 notices in TY 2008 (with an estimated response rate of 57 percent). IRS response to TAS information request (Oct. 17, 2012) (data through Oct. 16, 2012).

Approximately 97 percent of taxpayers receive at least one information return.[10] In 2010, the IRS closed 4.3 million cases in which it identified a discrepancy between the taxpayer's return and third-party information, leading to $7.2 billion in additional assessments.[11] The real volume of mismatches is significantly larger, because this data only reflects mismatches large enough for the IRS to actually work and does not include others that did not reach the threshold. For example, the IRS identified almost 23.8 million mismatches on TY 2010 returns, but only worked about 5.3 million cases (22 percent).[12] If the IRS identified mismatches before releasing the refunds claimed on returns, taxpayers would avoid the consequences of paying back refunds months or years after they receive them from the IRS.

### *Upfront Matching Reduces Taxpayer Burden*

Accelerated information reporting would substantially reduce taxpayer burden in several ways:

- First, taxpayers can better answer questions about an underlying economic transaction if the IRS identifies the mismatch within months rather than a year or more after the fact.
- Second, matching data before the IRS releases refunds will prevent taxpayers from facing IRS collection actions long after they have spent the refunds.[13]
- Third, taxpayers will save money by avoiding the long-term accrual of penalties and interest on unintentionally omitted or under-reported items.
- Fourth, upfront matching can potentially reduce taxpayers' vulnerability to identity-theft related refund fraud.[14]
- Fifth, as discussed below, providing taxpayers and their representatives with direct electronic access to third-party data before the filing deadline will help them prepare returns and avoid inadvertent omissions and understatements. The government benefits from the increased compliance and reduced enforcement actions.

### *The Anticipated Benefits Come with Challenges*

As discussed, there are real benefits to the development of an accelerated third-party reporting system. However, each component of the proposed system presents challenges to its development. For example, any changes in filing deadlines or return processing procedures would require IRS computer system updates. The IRS would likely need to reprogram existing systems and install new ones. We assume the IRS could reprogram its systems to change filing deadlines, due to its history of delaying the filing experience. However, any changes to the order of the processing pipeline, such as moving the matching procedures up before refund release, will require extensive system alterations. Finally, e-authentication is also a major

10 IRS, PowerPoint, *Real Time Tax System Initiative, Public Meeting* 2 (Dec. 8, 2011), *available at* http://www.irs.gov/pub/irs-utl/rtts_deck.pdf.

11 *Id*.

12 IRS response to TAS information request (Oct. 17, 2012).

13 The Organisation for Economic Co-Operation and Development (OECD) has found that post-assessment matching of third-party information to tax return data results in administrative costs for the revenue body and further administrative burden on taxpayers and/or their representatives. In addition, the OECD has stated that post-assessment matching creates resentment by taxpayers who were under the impression that their tax obligations had already been finalized and believe that they should have been advised of the unreported income when the return was initially filed. Forum on Tax Administration: Taxpayer Services Subgroup, OECD, *Information Note: Third Party Reporting Arrangements and Pre-Filled Tax Returns: The Danish and Swedish Approaches* 6 (Jan. 22, 2008).

14 William Hoffman, *IRS Oversight Board Brainstorms Real-Time Tax System, ID Theft Initiatives*, Tax Notes Today (May 2, 2013); IRS, PowerPoint, *Real Time Tax System Initiative, Public Meeting* 1 (Dec. 8, 2011), available at http://www.irs.gov/file_source/pub/irs-utl/rtts_deck.pdf. For more information on identity-theft refund fraud, see National Taxpayer Advocate 2013 Annual Report to Congress, Most Serious Problem: *The IRS Should Adopt a New Approach to Identity Theft Victim Assistance that Minimizes Burden to Such Taxpayers*, *supra*; National Taxpayer Advocate 2012 Annual Report to Congress 42-67 (Most Serious Problem: *The IRS Has Failed to Provide Effective and Timely Assistance to Victims of Identity Theft*).

concern if the IRS provides taxpayers or their representatives access to the third-party data, as discussed in detail below.

It is the goal of this report to acknowledge the burdens imposed on the IRS and other stakeholders and attempt to achieve an acceptable balance between the benefits and burdens.

### IRS Has Acknowledged the Benefits of Upfront Matching

During 2011, the IRS launched the "Real Time Tax System Initiative" which acknowledged the benefits of matching information reports before issuing tax refunds. As part of the initiative, the IRS solicited suggestions and concerns from a variety of stakeholders at two public meetings regarding a potential "real-time" tax system (RTTS).[15] During the meeting held on December 8, 2011, the IRS heard statements from the members of three panels: (1) tax practitioners, (2) federal and state government representatives, and (3) taxpayer and consumer advocates. The second meeting held on January 25, 2012 solicited comments from four panels comprised of (1) payroll/W-2 filers, (2) Form 1099 issuers, (3) software providers, and (4) state revenue agencies.[16] While the participants expressed concerns about how the IRS would achieve a real-time tax system, there was consensus that the goal of the initiative would serve both taxpayers and tax administration.[17]

In its response to the National Taxpayer Advocate's 2012 Most Serious Problem, the IRS acknowledged that it had taken early steps toward development of a real-time tax system with the ultimate goal of reducing taxpayer burden and increasing compliance upfront.[18] The IRS had also committed to include the Taxpayer Advocate Service in further developing the initiative or planning any new initiatives. However, the National Taxpayer Advocate has not seen any real progress on this issue.[19]

## TAXPAYER ACCESS AND ABILITY TO DOWNLOAD THIRD-PARTY DATA

### Proposal to Provide Taxpayers Electronic Access to Third-Party Data

The National Taxpayer Advocate has proposed several times that the IRS provide taxpayers with the ability to access third-party data electronically.[20] Providing taxpayers and their representatives with direct electronic access to this data would prevent many mismatches from occurring in the first place. Consider taxpayers who have worked several different jobs during the tax year and moved after completing one job early in the year. If the Form W-2 or 1099 associated with the first job is not properly forwarded to the taxpayer's current address, he or she could inadvertently omit the item from the return and not realize it until the IRS sends a (CP 2000) notice.

15 IRS, IR-2011-114, *IRS to Host Public Meeting Dec. 8 on Real-Time Tax System* (Nov. 30, 2012), *available at* http://www.irs.gov/uac/IRS-to-Host-Public-Meeting-Dec.-8-on-Real-Time-Tax-System.

16 For written and oral statements of panelists at the two RTTS public meetings, see http://www.irs.gov/Tax-Professionals/Real-Time-Tax-Initiative (last visited Dec. 17, 2013).

17 *Id*.

18 National Taxpayer Advocate 2012 Annual Report to Congress 190.

19 *Id*. at 180-191.

20 National Taxpayer Advocate 2009 Annual Report to Congress 338-345; National Taxpayer Advocate 2011 Annual Report to Congress 284-295; National Taxpayer Advocate 2012 Annual Report to Congress 180-191.

To address inadvertent omissions, the IRS should provide access to real-time transcripts of third-party data to aid in return preparation.[21] Taxpayers and preparers could refer to the transcript to make sure they do not accidentally leave out income. In fact, this issue was raised on the practitioner panel during the December 8, 2011, public meeting.[22] Ideally, taxpayers could access their data through an online account. Recent IRS research has provided a strong rationale for developing an online account product. IRS research found a significant number of taxpayers contact the IRS with account-related issues but indicated low satisfaction for how the IRS met their needs through the phones and the web. Accordingly, the IRS Office of Online Services has taken initial steps to develop a draft roadmap for an online account program.[23]

One step above the transcript would be to provide a platform from which taxpayers and preparers could download third-party data submitted to the IRS or the Social Security Administration directly into tax preparation software. This second option would eliminate transcription errors and provide a one-stop-service to taxpayers who would not need to download the data separately from each third party. The taxpayers (or preparers with permission) could download the data directly into a commercial tax software package or even an improved version of the IRS's Free File Fillable Forms (FFFF).[24] Providing the ability to download into software, including FFFF, would allow both taxpayers and the government to enjoy the benefits experienced by other tax administrations through pre-filled returns, but would still encourage competition in the tax software industry.[25]

IRS data show that less than 20 million "plain vanilla" individual income tax returns were filed in TY 2011. "Plain vanilla" returns are filed by individual taxpayers who report only Form W-2 income, take the standard deduction, use the single filing status, and list no dependents.[26] This amounts to about 13.5 percent of individual returns filed for TY 2011.[27] Because the U.S. tax laws recognize family composition in the calculation of tax liability, because there is no reliable way for the IRS to project the family status of taxpayers prior to filing, and because many taxpayers claim the benefits of tax provisions that have specific eligibility criteria, few taxpayers would be able to rely on third-party data alone to prepare their returns. Nevertheless, all taxpayers would benefit from downloading their data into FFFF or commercial software. The download feature could prevent taxpayers from being victimized by preparer fraud.

### OECD Studies on Benefits and Challenges of Pre-Filled Returns

Many international tax administrations provide taxpayers with pre-filled or pre-populated returns, which are tax returns on which the revenue body populates the fields of the taxpayer's return with information included on third-party information reports. The National Taxpayer Advocate is not recommending that

21 See National Taxpayer Advocate 2012 Annual Report to Congress 189.

22 IRS, *Transcript of the Public Meeting on Real Time Tax System Initiative* 42 (Dec. 8, 2011), *available at* http://www.irs.gov/Tax-Professionals/December-8,-2011-Meeting.

23 IRS Online Services, *Get Transcript and Account Update: W&I Executive Briefing* 12-17 (Nov. 13, 2013).

24 The IRS provides Free File Fillable Forms (FFFF) through its public partnership with the Free File Alliance. FFFF is an online version of IRS paper tax forms designed for people comfortable preparing their own tax returns. The program does not offer state tax returns and performs only basic calculations.

25 For a detailed discussion of the pre-filled return options available in other countries in 2009 and expected in 2012, see Organisation for Economic Co-Operation and Development, Centre for Tax Policy and Administration, Forum on Tax Administration: Taxpayer Services Sub-Group, *Survey of Trends and Developments in the Use of Electronic Services for Taxpayer Service Delivery* 34-38 (Mar. 2010).

26 Individual Master File, Tax Year 2011.

27 IRS, Statistics of Income, Table 1. Individual Income Tax Returns, Tax Year 2011 Preliminary Data: Selected Income and Tax Items, by Size of Adjusted Gross Income (Showing 145,579,530 individual income tax returns filed in TY 2011 based on preliminary data).

the IRS develop pre-filled or pre-populated returns. Rather, her proposal maintains market competition by downloading the third-party data into commercial software as well as an enhanced version of the existing FFFF product. However, to evaluate the benefits and challenges of such a system, it is useful to review the experience of other countries in administering pre-filled returns.

The OECD found in a recent study that revenue bodies have realized significant benefits associated with the provision of pre-filled returns for personal income taxes. These benefits include:

- Substantially reduced compliance burden for taxpayers;
- Greater certainty for taxpayers that they have fully and properly reported their income and deduction entitlements;
- An improved image of the revenue body, resulting from the personalized service and decreased burden imposed on taxpayers;
- Faster processing of tax return information;
- Faster refund payouts; and
- Elimination of much of the work associated with amended assessments that result from unintended taxpayer errors and traditional post-assessment verification programs.[28]

At the same time, the provision of pre-filled returns raises the following concerns:[29]

- The development of pre-filled returns by the tax administrator could be seen as the government competing with private industry.[30]
- Taxpayers, particularly those who have low incomes or speak English as a second language, may feel apprehensive about challenging an error or making an adjustment.
- Maintaining taxpayer privacy is a paramount concern as the tax administrator issues or distributes the returns.[31]

Almost half of the revenue bodies surveyed for a 2013 OECD study reported some use of pre-filling in 2011. Seven countries (Chile, Denmark, Finland, Malta, New Zealand, Norway, and Sweden) provide a service that at year-end can generate a complete electronic or paper personal income tax return (or its equivalent) for most taxpayers who need to file. In addition, four revenue bodies (Singapore, South Africa, Spain, and Turkey) report they offer such services to 30 to 50 percent of their individual taxpayers.

28 OECD, *Information Note: Using Third Party Information Reports to Assist Taxpayers Meet Their Return Filing Obligations — Country Experiences With the Use of Pre-Populated Personal Tax Returns* 13-14 (Mar. 2006). While there is always the risk that a pre-filled return could encourage taxpayers to not disclose additional income not included on the return generated by the revenue body. However, none of the countries surveyed reported this as a significant issue; See also Thomas Dohrmann and Gary Pinshaw, McKinsey & Company, *The Road to Improved Compliance: A McKinsey Benchmarking Study of Tax Administrations – 2008–2009*, 19, 30 (Sept. 2009) (Identifying pre-population as a best practice after evaluating the tax administrations of the following 13 countries: Australia, Belgium, Brazil, Canada, Chile, Denmark, France, Ireland, Norway, South Africa, Spain, Sweden, and the United States); OECD, *Tax Administration 2013: Comparative Information on OECD and Other Advanced and Emerging Economies* 241 (2013).

29 Joseph Cordes and Arlene Holen, *Should the Government Prepare Individual Income Tax Returns?*, Technology Policy Institute (Sept. 2010).

30 The Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98), Pub. L. No. 105-206 title II, § 2004, 112 Stat. 726 (July 22, 1998), conference report states that the conferees want the IRS and Treasury "to press for robust private sector competition." H.R. Conf. Rep. No. 105-599, at 235 (1998).

31 Joseph Cordes and Arlene Holen, *Should the Government Preparer Individual Income Tax Returns?*, Technology Policy Institute (Sept. 2010).

Finally, eight additional revenue bodies (Australia, Estonia, France, Hong Kong, Iceland, Italy, Lithuania, and Portugal) report providing at least partially completed pre-filled returns to individual taxpayers.[32]

In general, revenue bodies that offer pre-filled returns have comprehensive systems requiring third parties to report information related to income, assets, and deductions.

- *Income information* generally includes wages, bonuses, severance payments, employee fringe benefits, interest, dividends, pensions, and insurance payments.
- *Asset-related information* includes the sales and purchases of capital assets.
- *Deduction-related information* includes gifts, union fees, home mortgage interest, contributions to unemployment insurance and retirement plans, and child care expenses.

Typically, the third parties face strict and timely end-of-year reporting obligations, with final information reports typically required within three to four weeks after the end of the relevant fiscal year.[33]

Most countries started offering pre-filled returns by requiring taxpayers to respond, either by confirming that the return gave a complete and accurate picture of tax affairs during the tax period, or by advising the revenue body of additional information to adjust the form. A number of countries moved to systems of "deemed acceptance" where no response is required and the return is deemed accepted and complete after a prescribed period. Taxpayers were generally given short response times — between two and six weeks.[34]

The rate of adjustment by taxpayers varies by country. The Nordic countries experienced a 50 to 75 percent rate of returns not requiring adjustment by taxpayers. Iceland had an abnormally high rate of adjustment due to an inability to receive interest income third-party information reports. Denmark was the originator of the pre-filled return concept and has reported a 78 percent rate of non-adjustment.[35]

Based on information received by surveyed revenue bodies, the OECD offered the following list of critical success factors for an effective pre-filled return programs:[36]

- *Accurate Withholding at the Source*. Accurate withholding at the source is necessary to avoid large refunds and the resulting desire by taxpayers to file returns shortly at the end of the fiscal year. To achieve this goal, most revenue bodies surveyed issued a tax card or notification of rate to be applied to taxpayers and their employers just before the new fiscal year. The card or notification provides personal information that can be used to establish individual amounts of withholdings, based on historical tax assessment data. If the IRS were to pursue such an avenue, it would require a major restructuring of our withholding system.[37]

32 OECD, *Tax Administration 2013: Comparative Information on OECD and Other Advanced and Emerging Economies* 241 (2013). For other types of taxes, pre-filling was very limited and generally confined to taxpayer identification and demographic information. In addition, Belgium and the Netherlands have developed limited pre-filled return systems. Forum on Tax Administration: Taxpayer Services Subgroup, OECD, *Information Note: Third Party Reporting Arrangements and Pre-Filled Tax Returns: The Danish and Swedish Approaches* 24 (Jan. 22, 2008).

33 OECD, *Information Note: Using Third Party Information Reports to Assist Taxpayers Meet Their Return Filing Obligations — Country Experiences With the Use of Pre-Populated Personal Tax Returns* 10 (Mar. 2006).

34 *Id*. at 11.

35 OECD, *Information Note: Using Third Party Information Reports to Assist Taxpayers Meet Their Return Filing Obligations — Country Experiences With the Use of Pre-Populated Personal Tax Returns* 12 (Mar. 2006).

36 *Id*. at 15; Forum on Tax Administration: Taxpayer Services Subgroup, OECD, *Information Note: Third Party Reporting Arrangements and Pre-Filled Tax Returns: The Danish and Swedish Approaches* 4 (Jan. 22, 2008).

37 National Taxpayer Advocate 2011 Annual Report to Congress vol. 2, 145-150 (Study: *Analyzing Pay-As-You-Earn Systems as a Path for Simplification of the U.S. Tax System*).

- *High Integrity Taxpayer Identification*. To match large numbers of third-party information reports with tax records, all reports received must have a high-integrity taxpayer identifier, such as the Social Security number used in the United States.
- *Invest Adequate Resources in Supporting Third-Party Reporting Bodies.* The revenue body must allocate adequate resources to educate and support third-party reporting bodies, software developers, and other stakeholders in all aspects of the reporting system's requirements.
- *Comprehensive Third-Party Reporting Systems*. All of the countries surveyed have substantial systems of third-party reporting covering major types of income, important deduction items, capital asset transactions, and other information relevant to determining tax liabilities.
- *Compatible Legislative Framework.* The tax laws must provide a limited scope for tax deductions, rebates, credits, and discretions that cannot be predicted by the revenue body using third-party reports or some other approach. Thus, deductions, tax credits, other items of income must be verifiable by the revenue body for an effective pre-filled return system.[38]
- *High Degree of Automation Among Information Suppliers*. Processing the third-party reports by the revenue body is greatly facilitated if reporting bodies can transmit reports electronically.
- *Large-Scale Information Processing*. Revenue bodies typically have six to ten weeks to process the third-party reports that generate the pre-filled returns. To meet these deadlines, substantial information processing systems are required to capture, validate, and prepare relevant data.
- *Automated and Minimal Interaction with Taxpayers*. To reduce resources associated with processing the pre-filled returns, the surveyed revenue bodies have devised the following mechanisms to ascertain acceptance or adjustment by taxpayers: (1) deemed acceptance if no response is received within a given time, (2) automated acceptance using SMS, phone, or Internet communications, and (3) communication of adjustments through the Internet.

The National Taxpayer Advocate believes a fully populated return for most taxpayers is not possible in the United States given the current state of the Internal Revenue Code. There are too many unverifiable provisions in the Code that have eligibility requirements outside the scope of information reporting documents received by the IRS. For example, approximately 28.3 million taxpayers received the EITC in TY 2011[39] while approximately 51.5 million returns claimed at least one dependent.[40] As noted earlier, the IRS cannot pre-populate the return with family structure because it varies from year to year. However, to reduce the compliance burden on taxpayers, the IRS can make the data available in a way that provides them with a choice of filing method and minimizes inadvertent errors.

**Recommendation 1.1:** Provide taxpayers with access to real-time transcripts of third-party data to aid in return preparation.

38 Verifiable information from third-party information reports is particularly important for the administration of refundable credits. *See* National Taxpayer Advocate 2009 Annual Report to Congress, vol. 2, 75-104 (Research and Related Studies: *Running Social Programs Through the Tax System*).

39 Statistics of Income, Table 1. Individual Income Tax Returns, Tax Year 2011 Preliminary Data: Selected Income and Tax Items, by Size of Adjusted Gross Income

40 Individual Master File, Tax Year 2011 (51,519,527 returns claimed at least one exemption excluding primary taxpayer and spouse, if relevant).

**Recommendation 1.2:** Provide a platform from which taxpayers and preparers could download third-party data directly into an enhanced Free Fillable Forms product and commercial tax return preparation software.

## BACKGROUND ON RETURN FILING AND PROCESSING

### The Current State of the Filing Season From the Individual Taxpayer's Perspective

The filing season typically begins for taxpayers with the receipt of their information reporting documents from their employers, financial institutions, local governments, and other payors of income These information reporting documents include, but are not limited to the documents in the following table.

### FIGURE 1, Information Reporting Documents

| Number | Title |
|---|---|
| Form W-2 | *Wage and Tax Statement* |
| Form W-2G | *Certain Gambling Winnings* |
| Schedule K1- Form 1041 | *Beneficiary's Share of Income, Credits, Deductions, etc.* |
| Schedule K1- Form 1065 | *Partner's Share of Income, Credits, Deductions, etc.* |
| Schedule K1- Form 1120-S | *Shareholder's Share of Income, Deductions, Credits, etc.* |
| **Foreign Information Returns filed by foreign corporations that pay interest or dividend income to U.S. citizens (no standard form)** | |
| Form SSA-1099 | *Social Security Benefit Statement*, and Form RRB-1099, *Payments by the Railroad Retirement Board* |
| Form 1042-S | *Foreign Person's U.S. Source Income Subject to Withholding* |
| Form 1098 | *Mortgage Interest Statement* |
| Form 1098-C | *Contributions of Motor Vehicles, Boats and Airplanes* |
| Form 1098-E | *Student Loan Interest Statement* |
| Form 1098-T | *Tuition Statement* |
| Form 1099-A | *Acquisition or Abandonment of Secured Property* |
| Form 1099-B | *Proceeds from Broker and Barter Exchange Transactions* |
| Form 1099-C | *Cancellation of Debt* |
| Form 1099-DIV | *Dividends and Distributions* |
| Form 1099-G | *Certain Government Payments* |
| Form 1099-H | *Health Coverage Tax Credit (HCTC) Advance Payments* |
| Form 1099-INT | *Interest Income* |
| Form 1099-K | *Merchant Card and Third Party Payments* |
| Form 1099-LTC | *Long-Term Care and Accelerated Death Benefits* |
| Form 1099-MISC | *Miscellaneous Income* |
| Form 1099-OID | *Original Issue Discount* |
| Form 1099-PATR | *Taxable Distributions Received from Cooperatives* |
| Form 1099-Q | *Payments from Qualified Education Programs (Under Sections 529 and 530)* |
| Form 1099-R | *Distributions from Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.* |
| Form 1099-S | *Proceeds from Real Estate Transactions* |
| Form 1099-SA | *Distributions from an HSA, Archer MSA or Medicare Advantage MSA* |

| Number | Title |
|---|---|
| Form 3921 | *Exercise of an Incentive Stock Option Under Section 422(b)* |
| Form 3922 | *Transfer of Stock Acquired through an Employee Stock Purchase Plan* |
| Form 5498 | Form 5498 |
| Form 5498-ESA | *Coverdell ESA Contribution Information* rm 5498-ESA |
| Form 5498-SA | *HSA, Archer MSA or Medicare Advantage MSA Information* |
| FinCEN 103 | *Currency Transaction Report by Casinos* |
| FinCEN 104 | *Currency Transaction Report (CTR)* (formerly Form 4789) |
| Form 8300 | *Report of Cash Payments Over $10,000 Received in a Trade or Business* |

Taxpayers generally receive their information reports in January or early February.[41] However, taxpayers may receive amended or corrected information reports from the payors later on. Once a taxpayer is confident that he or she has all information reports, the taxpayer files a federal income tax return by April 15 or requests an extension until October 15. If the return claims a refund, the government will typically issue it within three weeks.[42] Once the IRS issues the refund, the remaining time depends on the method of refund requested — electronic or paper. As discussed below, if the taxpayer's return requires further review, the refund turnaround time can take longer.

## IRS Information Report Processing

### *The IRS Receives Form W-2 Data From the SSA*

Forms W-2 require several more initial processing steps than other information reports. The SSA receives all Forms W-2 before the IRS and compares the name and Social Security number (SSN) combinations against its SSN database to determine whether the names and numbers match. Name/SSN mismatches may arise for a variety of reasons. In some cases, the earnings should be attributed to the worker listed on Form W-2 (*e.g.*, when "Robert Jones" uses "Bob Jones" on his employment paperwork or when a woman marries and takes her husband's surname but fails to inform SSA). In other cases, the earnings should not be attributed to the worker listed on Form W-2 (*e.g.*, when an undocumented worker uses another person's SSN to obtain employment).

When the SSA receives Forms W-2 with names and SSNs that do not match, it uses a variety of automated processes in an attempt to correct mismatches that likely are inadvertent. The SSA sends relevant information extracted from Forms W-2 to the IRS in electronic form in mid-March, and it is available for document matching by late March.[43]

41 IRS, *General Instructions for Certain Information Returns — Main Contents, available at* http://www.irs.gov/instructions/i1099gi/ar02.html#d0e400 (last visited Dec. 17, 2013).

42 *See* IRS, *What to Expect for Refunds in 2013, available at* http://www.irs.gov/Refunds/What-to-Expect-for-Refunds-in-2013 (last visited Dec. 17, 2013).

43 TAS, *ARAP Briefing Paper, Information Returns Acceleration Sub-Team* (Oct. 31, 2011). For a detailed discussion of the SSA's processes, see Government Accountability Office, GAO-06-458T, *Social Security Numbers: Coordinated Approach to SSN Data Could Help Reduce Unauthorized Work* (Feb. 16, 2006) (testimony before the House Ways and Means Subcommittees on Social Security and on Oversight).

### *IRS Receipt and Processing of Information Reports*

The IRS receives approximately 2.29 billion information reports each calendar year, covering a wide array of taxpayer incomes.[44] IRS projections show the number of information reports steadily increasing through 2021.[45] In addition, the IRS will increase the volume of third-party data it receives under new initiatives, including several new third-party information reporting requirements. Most notably, merchant card issuers generally must report the aggregate amount of reportable payments they process for businesses,[46] and brokerage firms generally must report the cost bases (as well as gross proceeds) of stock, bond, and mutual fund sales.[47] The new information reporting requirements of the Affordable Care Act for insurers and employers will further increase the volume and complexity of information reports transmitted to the IRS.[48]

Once the IRS receives the information reports from the payors, or the Social Security Administration (SSA) in the case of Forms W-2, it loads the information onto its Information Returns Master File (IRMF) database. The IRS builds the IRMF database in February for the preceding year and the database is ready to match information reporting documents in mid-March.[49] The IRS runs the tax return through its Automated Underreporter (AUR) system, which compares amounts reported on the return with amounts on third-party information reports, such as the W-2, 1099, 1098, K-1, and 5498 series.[50] AUR case inventory includes payee mismatches over a certain threshold. AUR reviewers manually screen cases to determine if the IRS can resolve the discrepancy without contacting the taxpayer. In the remaining cases, the IRS will typically send a notice, known as the CP 2000, to the payee (taxpayer) to request an explanation of the discrepancies or payment of additional taxes.[51]

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44 IRS Publication 6961, *2013 Update: Calendar Year Projections of Information and Withholding Documents for the United States and IRS Campuses*, Table 2; GAO, GAO-09-238, *Tax Gap: IRS Could Do More to Promote Compliance by Third Parties with Miscellaneous Income Reporting Requirements* (Jan. 2009).

45 IRS Publication 6961, *2013 Update: Calendar Year Projections of Information and Withholding Documents for the United States and IRS Campuses*, Tables 2, 3, 4.

46 IRC § 6050W. The projected filings of Form 1099-K, Merchant Card and Third Party Payments, will increase from approximately nine million projected filings in calendar year 2012 to almost 22 million projected filings in CY 2020. IRS Publication 6961, *2012 Update: Calendar Year Projections of Information and Withholding Documents for the United States and IRS Campuses, 2012-2020, Table 2*.

47 IRC § 6045(g).

48 Sections 6055 and 6056 were added to the Code by §§ 1502 and 1514, respectively, of the Patient Protection and Affordable Care Act (ACA), enacted March 23, 2010, Pub. L. No. 111-148. Section 6055 requires annual information reporting by health insurance issuers, self-insuring employers, government agencies, and other providers of health coverage. Section 6056 requires annual information reporting by applicable large employers relating to the health insurance that the employer offers (or does not offer) to its full-time employees. Both are optional in 2014, but will fully apply in 2015. Employers will need to report the cost of coverage under an employer-sponsored group health plan on an employee's Form W-2, *Wage and Tax Statement*, in Box 12, using Code DD. The amount reported does not affect tax liability, as the value of the employer excludible contribution to health coverage continues to be excludible from an employee's income, and it is not taxable. This reporting is for informational purposes only, to show employees the value of their health care benefits. *See* Notice 2013-45; REG–136630–12, 78 Fed. Reg. 54996 (Sept. 9, 2013).

49 IRS, Overview of the Accelerated Refund Assurance Program, Slide 11 (Oct. 6, 2011); National Taxpayer Advocate 2009 Annual Report to Congress 338-345 (Legislative Recommendation: *Direct the Treasury Department to Develop a Plan to Reverse the "Pay Refunds First, Verify Eligibility Later" Approach to Tax Return Processing*).

50 IRM 4.19.3.1. The IRS nonfiler program handles cases where no income tax return was filed by a payee. The Automated Substitute for Return (ASFR) program is the key program for enforcing filing compliance by taxpayers who have not filed individual tax returns, but have incurred a "significant" tax liability. IRM 5.18.1.2; IRC § 6020(b).

51 IRM 1.4.19.1; IRM 4.19.3.1; Government Accountability Office (GAO), GAO-09-238, *Tax Gap: IRS Could Do More to Promote Compliance by Third Parties with Miscellaneous Income Reporting Requirements* 14 (Jan. 2009).

The IRS business operating divisions pursue entities that are required to file information documents and fail to do so by conducting examinations. Once it finds noncompliance, the IRS has the authority to penalize payors for failing to submit or submitting inaccurate information reports.[52]

## DEVELOPMENT OF AN ACCELERATED THIRD-PARTY REPORTING SYSTEM

### What is Necessary to Accomplish a Real Time Tax System?

To develop an effective modern tax system, the IRS needs to achieve the following milestones:

- Improve the accuracy of third-party information reports from payees and the SSA;
- Receive information reports early enough to perform matching before releasing refunds;
- Evaluate the benefits and burdens of delaying the filing season to accommodate document matching; and
- Evaluate the benefits and burdens of delaying refunds to accommodate document matching.

Each of these steps presents challenges to the various stakeholders in the tax preparation and filing process. None of the challenges are insurmountable, but they require careful planning, implementation, and evaluation.

### Improve the Accuracy of Third-Party Information Reporting Data

For any future initiative to benefit both taxpayers and the IRS, the third-party data used to match to the taxpayers' returns must have a high degree of accuracy. In reality, data on information returns is not perfect. Although the IRS does not track corrected information documents, it estimates that less than one percent of information reports are subject to subsequent amendments or corrections.[53] Even if we accept the IRS's estimate, the number is still significant considering that the IRS takes in approximately 2.29 billion information reports per year, with only about 48 million (2.1 percent) received on paper.[54] Further, IRS projections show the number of information reports steadily increasing through 2021.[55]

Taxpayers who already filed their returns before receiving the corrected report might find themselves entangled in the IRS enforcement procedures triggered by a real-time identification of a mismatch during the filing season through no fault of their own. In addition, approximately 4.3 percent of AUR assessments, involving 139,652 taxpayers, were abated in FY 2010.[56] Therefore, the IRS already pulls

52 IRC §§ 6721, 6722. The penalty is generally $100 per information return with a maximum aggregate penalty of $1.5 million per calendar year. However, the penalty and maximum penalty are reduced to $30 per report and $250,000 per year if the noncompliance is corrected within 30 days of the due date for filing. The rate is slightly higher at $60 per return with a $500,000 maximum penalty if the correction is made before August 1. The maximum penalty amounts are lower for small businesses with average annual gross receipts of $5 million or less for the three most recent tax years.

53 IRS, *PowerPoint, Real Time Tax System Initiative* 2, Public Meeting (Dec. 8, 2011), *available at* http://www.irs.gov/pub/irs-utl/rtts_deck.pdf.

54 IRS Publication 6961, 2013 Update: Calendar Year Projections of Information and Withholding Documents for the United States and IRS Campuses, Tables 2, 3; IRS, PowerPoint, *Real Time Tax System Initiative, Public Meeting* 2 (Dec. 8, 2011), *available at* http://www.irs.gov/pub/irs-utl/rtts_deck.pdf.

55 IRS Publication 6961, 2013 Update: Calendar Year Projections of Information and Withholding Documents for the United States and IRS Campuses, Table 2.

56 In FY 2010, approximately $1.05 billion of the approximately $6.9 billion tax assessed through AUR was abated (15.2 percent). In FY 2011, 68,984 taxpayers (or 2.1 percent) received approximately $307 million in abatements (5.2 percent of the tax assessed through AUR was abated). IRS Enforcement Revenue Information System's FY 2011 database.

compliant taxpayers into enforcement initiatives based on third-party data. This unnecessary burden is imposed in the following situations:

1. The third-party data is inaccurate;
2. The taxpayer reported the income elsewhere on the return but the IRS did not review it closely enough; or
3. The IRS did not use its own internal information to verify the information on the return.

Further, in cases before the Tax Court, the burden of proof for a deficiency of tax shifts to the IRS if the deficiency is based solely on information included on a third-party information report.[57] Therefore, the IRS has an additional incentive to adopt procedures to attempt to verify third-party data through other means, especially through information available internally, to screen out false positives or mismatches before taking enforcement actions.

The following chart provides six of the most common information reports received for TY 2011, the percentage received by April 15, and the percentage corrected or amended:

**FIGURE 2, Common Information Reports Received for TY 2011, by Count, Percent Received by April 15, 2012, and Percent Amended or Corrected[58]**

| Form | Count | # Received by 4/15 | % Received by 4/15 | # Corrected or Amended | % Corrected or Amended |
|---|---|---|---|---|---|
| W-2 | 219,970,807 | 181,926,210 | 82.70% | 1,904,508 | 0.87% |
| 1099-B | 1,115,720,789 | 149,412,621 | 13.39% | 83,427,833 | 7.48% |
| 1099-DIV | 83,586,516 | 5,670,208 | 6.78% | 3,088,862 | 3.70% |
| 1099-INT | 170,520,884 | 58,916,047 | 34.55% | 500,935 | 0.29% |
| 1099-MISC | 86,756,169 | 21,684,558 | 24.99% | 929,655 | 1.07% |
| 1099-R | 84,627,773 | 37,918,483 | 44.81% | 326,331 | 0.39% |

### Earlier Receipt of Information Reporting Documents

To conduct matching before releasing refunds, the IRS must receive information reports from the payors earlier, which would require revising the statutory information reporting deadlines for payors.[59] Currently, payors must generally submit information reports to payees by January 31 and to the IRS by

57 Because third-party information returns can be unreliable and difficult for a taxpayer to disprove, the IRS is not always entitled to rely on its general presumption of correctness in court when its determination is based on them. *See Portillo v. Comm'r*, 932 F.2d 1128, 1134 (5th Cir. 1991) (holding that the IRS "had some duty to investigate" the accuracy of an information return), rev'g in part T.C. Memo. 1990-68. IRC § 6201(d) was enacted following the government's loss in Portillo and requires the IRS to prove that its determination is based on "reasonable and probative information" in any court proceeding regarding a deficiency based on an information return.

58 IRS Compliance Data Warehouse, Information Returns Master File, TY 2011.

59 For example, IRC § 6051 requires employers to provide a written statement to employees each year showing, among other things, wages paid and the amount of tax deducted and withheld. The statement must be furnished to the employee no later than January 31st of the following year. Treas. Reg. § 31.6051-2(a) requires the employer to file the Forms W-2 with the Social Security Administration. Employers have until the end of February to file with the SSA if they file by paper or the end of March if they file electronically. Treas. Reg. § 31.6071(a)-1(a)(3). Similarly, IRC § 6049 provides requirements for interest payments and IRC § 6042 provides requirements for dividend payments.

February 28 or March 31, depending on whether they file by paper or electronically, respectively.[60] Payors submitting 250 or more information reports must submit the forms magnetically or electronically.[61]

**FIGURE 3, CURRENT DEADLINES FOR FILING VARIOUS INFORMATION REPORTS[62]**

| Type of Information Report | Deadline to Submit to Payee | Deadline for Paper Filing | Deadline for Electronic Filing |
|---|---|---|---|
| 1098-T | January 31st | February 28th | April 1st |
| 1099-DIV | January 31st | February 28th | April 1st |
| 1099-INT | January 31st | February 28th | April 1st |
| 1099-MISC | January 31st (extended to Feb. 15th in certain circumstances) | February 28th | April 1st |
| 1099-R | January 31st | February 28th | April 1st |
| W-2 (to SSA) | January 31st | February 29th | March 31st |

The following discussion provides potential options to enable the IRS to receive third-party data early enough to perform upfront matching.

### *Filing Forms W-2 with the IRS Directly.*

As discussed above, Forms W-2 are now sent first to the SSA to allow the SSA to "scrub" the data before transmitting it to the IRS.[63] The SSA checks the Form W-2 data against its database to determine if the name and SSN match, then electronically sends data extracted from the forms to the IRS, which conducts its own "scrubbing."

In order to receive Form W-2 data earlier, the IRS has the following two options:[64]

- Evaluate SSA procedures to determine if processing improvements within the SSA would enable the IRS to receive the data earlier.
- Evaluate whether the IRS could receive Form W-2 data directly from employers and perform the screens itself, as it did prior to 1978. The IRS should conduct a test to determine whether it can screen Form W-2 data as effectively as SSA. If the IRS develops the capacity to screen for name/SSN mismatches and can complete the task more quickly than SSA, it should consider creating a joint processing center. Employers could be directed to submit Forms W-2 to center, and the IRS

60 IRS, General Instructions for Certain Information Returns — Main Contents, *available at* http://www.irs.gov/instructions/i1099gi/ar02.html#d0e400 (last visited Sept. 28, 2013); Instructions to IRS Form 1098-T, Tuition Statement; Instructions to 1099-DIV, Instructions to IRS Form 1099-INT, Interest Income; Instructions to IRS Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc, Social Security Administration, Deadline Dates to Submit W-2s, *available at* http://www.ssa.gov/employer/filingDeadlines.htm (last visited Sept. 28, 2013).

61 IRC § 6011(e)(2)(A).

62 IRS, *General Instructions for Certain Information Returns - Main Contents, available at* http://www.irs.gov/instructions/i1099gi/ar02.html#d0e400 (last visited Oct. 12, 2012); Instructions to IRS Form 1098-T, Tuition Statement; Instructions to 1099-DIV, Instructions to IRS Form 1099-INT, Interest Income; Instructions to IRS Form 1099-R, *Distributions from Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc*, Social Security Administration, Deadline Dates to Submit W-2s, *available at* http://www.ssa.gov/employer/filingDeadlines.htm (last visited Oct. 12, 2012).

63 National Taxpayer Advocate 2009 Annual Report to Congress 338-345; Comments from the National Payroll Reporting Consortium, Internal Revenue Service Public Hearing, Proposed Real-Time Tax System (Jan. 25, 2012) (Noting that the large employers are already voluntarily providing specialized units with the IRS with electronic W-2 data before it is due to be filed with the Social Security Administration).

64 National Taxpayer Advocate 2009 Annual Report to Congress 338-345 (Legislative Recommendation: *Direct the Treasury Department to Develop a Plan to Reverse the "Pay Refunds First, Verify Eligibility Later" Approach to Tax Return Processing*).

and SSA would both have immediate access to the data. Alternatively, the agencies could create a portal to give the IRS direct access to the SSA database, and both agencies could make use of the data.

### *Eliminate E-File Incentive as Unnecessary.*

The National Payroll Reporting Consortium has noted that the March 31 electronic filing reporting deadline was initially established as an e-file incentive, which may no longer be necessary.[65] The group also points out that the later deadline is likely responsible for the low level of amendments to Forms W-2s, as an earlier deadline would probably translate into a higher rate of amendments. The Consortium estimated the amendment rate would rise from approximately one percent to a range of six to eight percent, due to the complex compensation and benefits offerings from large employers, but added that six states and the District of Columbia already require employers to report Form W-2s by January 31.[66] Thus, the IRS should evaluate the amendment rates experienced by these jurisdictions in determining the most effective way to accelerate third-party reporting.

### *Tighten Information Reporting Deadlines.*

The most straightforward way to enable the IRS to receive third-party information report data earlier is to tighten the current deadlines. To address the increase in erroneous refunds released due to fraudulent Forms W-2 and 1099, the Information Reporting Program Advisory Committee (IRPAC) recommended in 2011 that the IRS work with stakeholder groups to determine if shortening the timeframe for reporting employer/payer information would be feasible.[67] IRPAC's Employee Benefits and Payroll Subgroup specifically mentioned the possibility of filing Forms W-2 by an earlier date, such as February 15. The subgroup also noted that it would be impractical to file Forms 1099 earlier due to information gathering and processing issues.[68]

Any acceleration of deadlines will potentially burden third-party payors and other preparers of information reports. Therefore, the IRS should consult with the stakeholders on an ongoing basis to determine how any change in filing deadlines to accomplish upfront matching would impact payor burden and compliance.[69] The size of the employer or service recipient may make a difference in the burden imposed by earlier deadlines. Large businesses are more likely to have the resources and capability to file forms with the IRS at the same time they send them to payees, but smaller businesses may struggle more to meet tighter deadlines. Moreover, smaller firms may be more likely to use preparers, who may find it difficult to complete the work within compressed deadlines. In fact, the small business community has already expressed concerns about any changes in filing deadlines. For example, for TY 2011, approximately 24 percent of Forms W-2 filed with the IRS were for employers with 50 or fewer employees.[70] These businesses are already trying to comply with the new information reporting requirements under the Affordable Care Act and any changes to basic filing deadlines may be too much too handle at one time.[71]

65 IRS Public Hearing, *Proposed Real-Time Tax System, Comments from the National Payroll Reporting Consortium* (Jan. 25, 2012).

66 *Id*.

67 IRPAC, IRPAC Report Executive Summary (2011).

68 IRPAC, Employee Benefits and Payroll Subgroup Report, General Report 37-39 (2011).

69 *See* IRS Public Hearing, *Proposed Real-Time Tax System, Comments from the National Payroll Reporting Consortium* (Jan. 25, 2012).

70 IRS Compliance Data Warehouse, Business Returns Transaction File and Information Returns Master File, Tax Year 2011.

71 Taxpayer Advocate Service Presentation at the National Small Business Forum (July 16, 2013) (comments received from attendees).

In setting earlier information reporting deadlines, it is necessary to address the burden imposed on third-party reporters due to the complexity of Form W-2. The form has ten fields for "indicative data" such as names, addresses, EINs, SSNs, and state and local information. The form also has three checkboxes and 15 monetary fields, as well as two monetary fields which are variably used, such as Box 12, which has 26 defined monetary amounts along with an alpha code to identify the amount reported. The other variably used field is Box 14, with more than a dozen tax, insurance, and various other state and locally-defined deductions, in addition to optional use by the employer. Each data element represents a distinct determination and recordkeeping responsibility of the employer and is subject to extensive regulations.[72]

Due to the complexity of the W-2, the National Payroll Reporting Consortium has opined that employers need at least one month to prepare the forms. In addition to cash wages, employers are responsible for gathering as many as 50 types of compensation, of which some are administered by third parties. Cash wages may be identifiable by the last day of the year, but the value of benefits and certain other types of compensation often cannot be determined for at least two weeks after the end of the year. In fact, some third-party administrators are not required to provide information to employers until January 15. It is the opinion of the consortium that employers should not be expected to receive and process third-party information earlier than January 20. Thus, it would be problematic to have a filing deadline before January 31 when the quality control and tax professional services are added into the equation.[73] As discussed below, a *de minimis* exception could offset any anticipated errors resulting from earlier deadlines.

In order to minimize burden on payors and taxpayers, the IRS must work closely with state and local tax administrations. Generally, payors submit information reports to local tax administrations as well. These administrations may already have earlier filing deadlines, which may reduce the burden of establishing an earlier federal deadline.[74] However, if the local deadlines are currently later than the federal deadlines, any change may increase the burden substantially.

When determining whether to move the information reporting deadline, it is also helpful to evaluate the experience of foreign tax administrations. In Sweden, all reporting bodies must supply information reports by January 31, one month after the end of the fiscal year. In 2006, all 80 million third-party reports had been received and registered by February 10, the date for sending reminders to overdue reporting bodies. Reporting bodies are advised to make corrections before March 5, when the computer systems begin preparing their pre-filled returns.[75] In Denmark, all reporting bodies must supply information reports by January 20, about three weeks after the end of the fiscal year. The revenue body receives corrections of data once a week until April and once every two weeks until October. The Danish revenue body estimates it receives 98 to 99 percent of corrections by February 15 each year.[76]

72 Comments from the National Payroll Reporting Consortium, Internal Revenue Service Public Hearing, Proposed Real-Time Tax System (Jan. 25, 2012).

73 *Id.*

74 Six states and the District of Columbia already require employers to report W-2s by January 31. In addition, California and New York require reporting of earnings subject to income tax and withholding in another format by January 31. Comments from the National Payroll Reporting Consortium, Internal Revenue Service Public Hearing, Proposed Real Time Tax System 2 (Jan. 25, 2012).

75 Forum on Tax Administration: Taxpayer Services Subgroup, OECD, *Information Note: Third Party Reporting Arrangements and Pre-Filled Tax Returns: The Danish and Swedish Approaches* 11 (Jan. 22, 2008).

76 Forum on Tax Administration: Taxpayer Services Subgroup, OECD, *Information Note: Third Party Reporting Arrangements and Pre-Filled Tax Returns: The Danish and Swedish Approaches* 11 (Jan. 22, 2008).

Both Sweden and Denmark provide significant ongoing support to reporting bodies, with special attention provided to the largest reporting entities. Both countries have emphasized the critical importance of building good relations and personal contacts within the group of larger suppliers to contribute to the smooth functioning of the overall system. Denmark interacts with approximately 100 large reporting entities as well as trade organizations and provides detailed technical guidance. Sweden holds annual meetings with the largest companies every June to explain changes in legislation and reporting schemes and ensure that the third parties have time to prepare their systems. Finally, both countries recognize the key role of software developers and Denmark even consults with the developers before enacting legislation that would impact third-party reporting.[77]

Similar to Sweden and Denmark, the IRS has built partnerships with third-party reporters and their representatives. Among other contacts, the IRS has the Information Reporting Program Advisory Committee and it meets regularly with the National Payroll Reporting Consortium. The IRS has the avenues to solicit and receive comments and suggestions. As it works through implementing the recommended future reporting system, it should utilize these partnerships. During these conversations, the IRS should address the concerns of small businesses and their representatives. In a 2009 report, GAO noted that complex reporting requirements contribute to the significant level of 1099-MISC noncompliance. At the time, the IRS, advisory group members, and others interviewed by GAO indicated confusion and lack of awareness over reporting responsibilities, whether payments were reportable due to different dollar reporting thresholds, and whether reporting was required for payments to corporations. GAO recommended the IRS make it easier to comply with the requirements as well as perform more outreach and education to explain them.[78] Accordingly, the IRS must commit to building partnerships with third-party reporters.

### *Minimize Amendments.*

If the IRS experiences a high amendment rate for certain information reports, such as the 7.48 percent rate for TY 2011 Forms 1099-B, it should evaluate different ways to reduce amendments, with a customized approach for each type of report.[79] For example:

- *Bifurcate Information Report Filing Deadlines*. If certain data on an information report lends itself to delays in reporting due to complexity or record-keeping issues, the IRS could split the information report deadlines. For example, if employers need more time to report pension benefit calculations, the IRS could require earlier reporting of the basic Form W-2 data such as wages and withholding, and give employers time to file a supplemental earnings statement with the more complicated items later. Taxpayers and the IRS would receive the information they need for calculating most tax liabilities early in the season and the IRS would receive the other, more complex information soon enough for compliance purposes.[80] We acknowledge that this option may present significant challenges to administer for both the IRS and payors. In our discussions

77 Forum on Tax Administration: Taxpayer Services Subgroup, OECD, *Information Note: Third Party Reporting Arrangements and Pre-Filled Tax Returns: The Danish and Swedish Approaches* 11, 12 (Jan. 22, 2008).

78 Government Accountability Office, GAO-09-238, *Tax Gap: IRS Could Do More to Promote Compliance by Third Parties with Miscellaneous Income Reporting Requirements* 4 (Jan. 2009).

79 IRS Compliance Data Warehouse, Information Returns Master File, TY 2011.

80 Comments from the National Payroll Reporting Consortium, Internal Revenue Service Public Hearing, Proposed Real-Time Tax System (Jan. 25, 2012) (In favor of earlier deadlines for more simple types of income if it would reduce the incidence of fraud as long as the IRS revisits the Form W-2C amendment process).

with the IRPAC, members strongly noted that bifurcating W-2 reporting would be fraught with problems and create additional work for reporting entities.[81]

- *Build flexibility into the reporting period*. The IRS should evaluate the feasibility of providing an option for payors to report certain complex transactions occurring during the last two months of the year on the return for the subsequent tax year.[82]
- *Create a de minimis dollar threshold for corrections*. As noted above, earlier information report filing deadlines may increase the number of corrections. In 2012, the IRPAC Burden Reduction Subgroup recommended that the IRS adopt a $50 *de minimis* dollar threshold for corrections to information returns.[83] Specifically, the advisory group recommended that failure to correct an information return for net changes of $50 or less of previously reported income would be deemed an "inconsequential error" that is not subject to the penalty provisions of IRC §§ 6721 and 6722.[84] The subgroup stated that the IRS and withholding agents expend substantial resources to correct and process corrected statements that, in many cases have no impact on tax liability. Treasury Regulation § 301.6721-1(d) provides for a *de minimis* number of failures to include correct information on certain information returns, but the exception is based on the number of corrections (the greater of ten or one-half of one percent of all information reports required to be filed), as opposed to the amount of income to be corrected.[85]

### *Increase Electronic Filing Rate of Reports.*

Electronic filing of third-party reports is essential to enable the IRS to process the reports efficiently. Currently the IRS receives approximately 97.9 percent of information reports electronically.[86] The IRS already requires larger reporters to file electronically, but smaller entities are not subject to the e-file requirement.[87]

According to the National Payroll Reporting Consortium, the current 250 return threshold affects about half of one percent (.005) of employers, which employ over 25 percent of the private sector workforce. In the opinion of the Consortium, lowering the threshold is feasible for small employers due to the wide availability of supporting software and services.[88]

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81 *See* National Taxpayer Advocate 2009 Annual Report to Congress 338-345; United States Government Accountability Office, GAO-11-747T, *Hearing before the Committee on Finance, U.S. Senate on Tax Gap: Complexity and Taxpayer Compliance* 14-17 (Statement of Michael Brostek, Director, Tax Issues, Strategic Issues, June 28, 2011).

82 IRS Public Hearing, Proposed Real-Time Tax System, Comments from the National Payroll Reporting Consortium (Jan. 25, 2012). The IRS already allows this for certain in-kind fringe benefits, such as the taxable value of an employer-provided vehicle. See Announcement 85-113, 1985-31 I.R.B. 31 (Aug. 5, 1985).

83 Burden Reduction Subgroup, Information Reporting Program Advisory Committee, *Burden Reduction Subgroup Report, Information Reporting Program Advisory Committee Public Meeting* 41 (Oct. 24, 2012).

84 IRC § 6721 imposes a penalty for the failure to file a correct information return in the amount of $100 per return. There is a $1.5 million maximum penalty per year. There is a *de minimis* exception and lower penalties for corrections within certain timeframes. Section 6722 imposes similar penalties for failure to file correct payee statements.

85 Burden Reduction Subgroup, Information Reporting Program Advisory Committee, *Burden Reduction Subgroup Report, Information Reporting Program Advisory Committee Public Meeting* 41 (Oct. 24, 2012).

86 IRS Pub. 6961, 2013 *Update: Calendar Year Projections of Information and Withholding Documents for the United States and Campuses, Tables 2-4* (of the 2,288,516,144 information reports received in Calendar Year 2012, 2,240,335,726 were received electronically).

87 IRC § 6011(e)(2)(A).

88 Comments from the National Payroll Reporting Consortium, Internal Revenue Service Public Hearing, Proposed Real-Time Tax System (Jan. 25, 2012).

The Employee Benefits and Payroll Subgroup of IRPAC has recommended that the IRS work with the payor and information reporting industries to assess whether reducing the threshold of returns required for e-filing is feasible, and whether the reduction would decrease fraudulent refund claims associated with paper Forms W-2. IRPAC suggested the IRS evaluate reducing the threshold from 250 returns to as few as 50.[89]

Alternatively, the IRS could provide an incentive other than a filing extension for payors to e-file their reports, perhaps a designation to payors who meet certain qualifications. The payors could advertise the designation as a way to minimize refund delays. In addition, for payors that will not convert to e-file, the IRS should offer a 2D barcoding technology option.[90]

### *Receipt of Data Earlier Through Quarterly Reporting.*

Another possible option would be to require more frequent reporting, such as quarterly, rather than moving up filing deadlines. Through quarterly reports received before the taxpayer files the return, the IRS might receive enough data to indicate a problems with the return.[91] However, the increase in reporting frequency also increases reporting compliance burden on the payors.[92]

### *Recommendations Based on Analysis of Current Filings*

The Taxpayer Advocate Service evaluated IRS data on receipt dates of the information reports with the highest volumes for TY 2011 and any associated amendments and corrections. The following chart provides the percentage of the total volume received by certain dates for the six TY 2011 information reports with the highest volumes. It also provides the percentage of the returns including these forms that filed extensions.

89 IRPAC, Employee Benefits and Payroll Subgroup Report, 2011 General Report 37-39 (2011).

90 The IRS currently offers the 2D barcode option for filers of Schedule K-1s. *See* http://www.irs.gov/uac/Two-Dimensional-Bar-Coding-for-Schedules-K-1 (last visited Dec. 16, 2013). In addition, the National Taxpayer Advocate previously proposed 2D bar-coding as a possible bridge for taxpayers who are reluctant to file electronically. National Taxpayer Advocate 2004 Annual Report to Congress 101-102 (Most Serious Problem: *Electronic Return Preparation and Filing*).

91 IRS Public Hearing, *Proposed Real-Time Tax System, Comments from the National Payroll Reporting Consortium* (Jan. 25, 2012) (California and Maine have quarterly reporting requirements for Forms W-2s); William Hoffman, *IRS Oversight Board Brainstorms Real-Time Tax System, ID Theft Initiatives* (May 2, 2013).

92 Before 1976, the IRS received quarterly reports of each employee's earnings with Forms 941. Congress shifted the quarterly reporting to an annual system and allowed the Social Security Administration to receive and process Forms W-2 for the IRS. Pub. L. No. 94-202, 89 Stat. 1137-1141 (Jan. 2, 1976).

**FIGURE 4, Percent of Top Forms Received by Certain Dates in Filing Season and Percent Associated with an Extension, Tax Year 2011**[93]

| Form | 2/16/2012 | 3/01/2012 | 3/15/2012 | 3/29/2012 | 4/13/2012 | % Filing Extension |
|---|---|---|---|---|---|---|
| W-2 | N/A | N/A | 54.38% | 64.91% | 82.70% | 3.90% |
| 1099-B | 0.003% | 0.08% | 0.13% | 0.21% | 13.4% | 22.49% |
| 1099-DIV | 0.12% | 1.46% | 2.00% | 4.83% | 6.78% | 11.2% |
| 1099-INT | 4.87% | 9.08% | 16.50% | 27.06% | 34.55% | 8.36% |
| 1099-MISC | 1.41% | 4.90% | 10.65% | 17.74% | 24.99% | 8.31% |
| 1099-R | 2.53% | 6.52% | 12.15% | 23.86% | 44.81% | 6.59% |

The above data for TY 2011 information report filings show that a significant percentage of reports are not filed on a timely basis with existing deadlines. Therefore, to reduce the burden on filers, we suggest any earlier filing deadlines are implemented with a transition period. In addition, to make the transition to earlier deadlines the least burdensome on filers, any date adjustment would need to be coupled with at least one other discussed option, such as providing a *de minimis* threshold for corrected filings, as provided below.

## RECOMMENDATIONS

To enable the IRS to receive information reports earlier, the National Taxpayer Advocate recommends the following:

**Recommendation 2.1:** Develop and implement a one year pilot to determine if the IRS can screen Form W-2 data as effectively as SSA**.**

**Recommendation 2.2:** Eliminate the March 31 deadline for e-filed information reports**.** All information reports, whether e-filed or filed on paper, would be due at the end of February.

**Recommendation 2.3:** Minimize corrections by creating a $50 *de minimis* threshold for corrections**.**

**Recommendation 2.4:** Further increase electronic filing by reducing the 250-report threshold in IRC § 6011(e) to 50 reports and offer 2D bar code technology for those who cannot e-file.

### *Concerns About Which Compliance Actions the IRS Will Take Upon Detecting a Mismatch in an Accelerated Information Reporting System.*

While receiving the information reports earlier is a main component of an accelerated information reporting system, the type of compliance action the IRS takes upon early identification of a mismatch is also crucial. The compliance action must impose minimum burden on both taxpayers and the IRS. Accordingly, the National Taxpayer Advocate has the following concerns as the IRS develops compliance procedures to achieve a program involving upfront matching:

- *Rejecting Returns With Mismatches Will Create Significant Burden on Taxpayers and the IRS.* The National Taxpayer Advocate cautions against rejecting returns containing mismatches, which

93 IRS CDW, Information Returns Master File, TY 2011.

would impose significant burden on both taxpayers and the IRS, with potentially serious consequences for the taxpayers. For example, such a rejection would cause a significant number of taxpayers or their preparers to call the IRS toll-free line. It could also lead more taxpayers to file by paper if they cannot resolve inaccuracies before the filing deadline. While it is ideal to inform taxpayers about mismatches as early as possible, the IRS does not necessarily need to reject a return to accomplish this goal.[94]

- *Expanding Math Error Authority Will Harm Taxpayers*. The National Taxpayer Advocate also cautions against the expansion of math error authority under IRC § 6213(g) to cover mismatched third-party data.[95] The National Taxpayer Advocate has written extensively about her various concerns with this issue,[96] which were also raised by the taxpayer and consumer advocate panel at the first IRS Real Time Tax System Initiative public meeting.[97] An expansion of math error authority would significantly harm taxpayers, especially low income taxpayers who may not understand math error notices or realize they need to respond timely. Accordingly, these taxpayers may lose their right to contest the adjustment in Tax Court.[98]
- *Provide Taxpayers With Certain Timeframes to Respond to Mismatch*. We encourage the IRS to pursue an option that would entail notifying the taxpayer of the mismatch and providing him or her with a certain timeframe to respond. If the taxpayer does not resolve the issue before the deadline, the IRS could assess the amount and issue a Notice of Deficiency.

### Evaluate the Necessity of Delaying the Filing Season

Another potential avenue for accomplishing upfront matching is to delay the filing season. Once the IRS receives the information reports as early as possible, the tax return filing due date could also be pushed back to enable the IRS to perform matching before releasing refunds. Delaying the filing season would also provide tax preparers the time they need to provide quality service to their clients.

Filing season dates, especially return filing deadlines, are ingrained in taxpayers' lives and psyche. Any changes to these dates would require significant outreach and education by the IRS. However, the IRS has modified filing season dates in the past. Most recently, the IRS announced that it will delay the 2014 filing season by one or two weeks due to the federal government shutdown in October 2013.[99] In addition, the 2013 filing season was delayed due to late tax law changes impacting the 2012 tax year. The IRS did not start processing TY 2012 individual income tax returns until January 30, 2013, eight calendar

94 *See, e.g.*, American Institute of Certified Public Accountants Statement Presented to the Internal Revenue Service on Real Time Tax System 3 (Dec. 8, 2011); Comments of Bonnie Speedy, Vice President and National Director, AARP Foundation Tax-Aide, IRS Public Meeting – Real Time Tax System (Dec. 8, 2011).

95 IRC § 6213(b) or (g) gives the IRS the authority to make an assessment without filing a statutory notice of deficiency (SNOD). Once the IRS notifies taxpayers of math errors, they have 60 days to request abatement of the additional tax. If the taxpayer makes a timely request, the IRS will abate the assessment and follow formal deficiency procedures to reassess the tax (*i.e.*, send the taxpayer a SNOD). However, if the taxpayer fails to request abatement timely, the IRS may collect the additional tax. At this point, the assessment cannot be appealed in the U.S. Tax Court.

96 *See* National Taxpayer Advocate 2011 Annual Report to Congress 74-92; National Taxpayer Advocate 2012 Annual Report to Congress 180-191.

97 IRS, Transcript of the Public Meeting on Real Time Tax System Initiative 92-94 (Dec. 8, 2011), *available at* http://www.irs.gov/Tax-Professionals/December-8,-2011-Meeting.

98 *See, e.g.*, Comments of T. Keith Fogg, Director, Villanova Law School Federal Tax Clinic, IRS Real Time Tax System Initiative 4-5 (Dec. 8, 2011). The IRS sent out over 2.04 million math error notices for TY 2011 returns in CY 2012. IRS Data Book, Table 15. Math Errors on Individual Income Tax Returns, by Type of Error, Calendar Year 2012.

99 IRS News Release, *2014 Tax Season to Start Later Following Government Closure; IRS Sees Heavy Demand As Operations Resume*, IR-2013-82 (Oct. 22, 2013)

days after it had initially planned.[100] Similarly, the 2011 filing season started on February 15 for individuals who claimed itemized deductions on Schedule A, the higher education tuition and fees deduction on Form 8917, or the educator expenses deduction for tax year 2010.[101]

Moving back the filing season would have a broad range of potential consequences. For example, taxpayers need to provide a copy of their most recent tax return for the Free Application for Federal Student Aid (FAFSA) and state financial aid applications.[102] Any change in return filing deadlines could impact the financial aid process.

### Evaluate the Necessity of Delaying Refund Issuance

Another element of this proposal includes delaying the release of refunds. Due to the substantial amount of the average tax refund — $2,803 in calendar year 2012[103] — many taxpayers rely on their income tax refunds to pay down debt or pay bills.[104] We acknowledge that the later issuance of refunds could have a detrimental impact on low income taxpayers. For example, many low income taxpayers use their tax refunds, including their refundable credits, to pay their winter utility bills.[105] In addition, it is our understanding that certain utility companies refrain from conducting the more aggressive bill collection techniques, including turning off utilities, until the point in the filing season when taxpayers can receive their sizable tax refunds, including refundable credits. Thus, if we delay the issuance of refunds, such arrangements may no longer be available, and taxpayers may not be able to pay their heating bills.

As illustrated in the chart below, IRS data show that over 91 percent of TY 2011 refunds were issued by the end of April 2012

100 IRS News Release, *IRS Plans Jan. 30 Tax Season Opening For 1040 Filers*, IR-2013-2 (Jan. 8, 2013).

101 IRS News Release, *IRS to Start Processing Delayed Returns on Feb. 14; Most People Unaffected and Can File Now*, IR-2011-7 (Jan. 20, 2011).

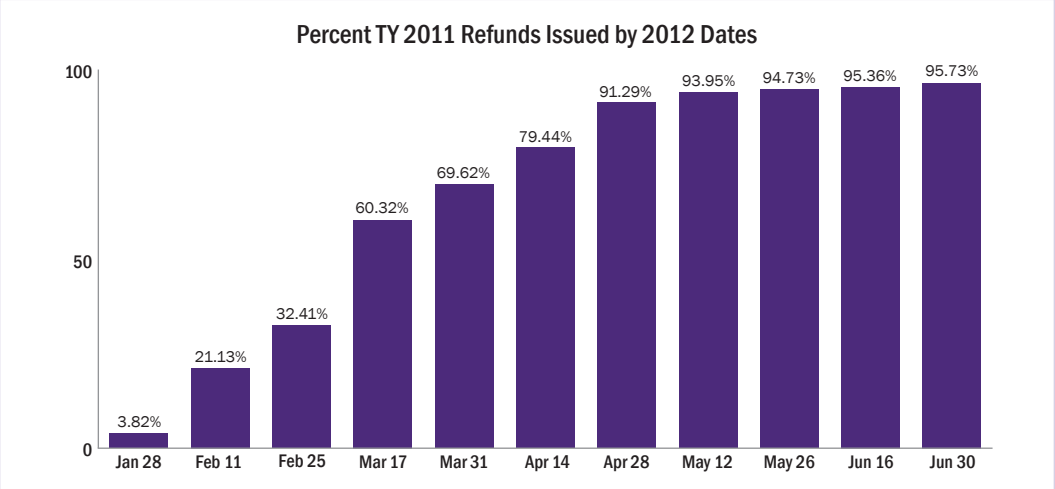
102 http://www.fafsa.ed.gov/deadlines.htm# (last visited Nov. 4, 2013). While the federal application deadline is June 30th, many state student aid applications are as early as March 1.

103 IRS, 2012 End-of-Year Filing Season Statistics, Cumulative through the weeks ending 12/30/11 and 12/28/12.

104 A recent survey of 1,500 adults conducted by American Express showed that 37 percent of those expecting a refund planned to use it to pay bills and pay down debts. Of those expecting a refund, 37 percent plan to use it to pay down debt or bills, while 26 percent plan to save the money. Only 28 percent said they expect to spend their refund checks on themselves or family, travel, home improvements or a big-ticket item. Melanie Hicken, *Fewer People Expect Tax Refunds This Year*, CNNMoney (Mar. 25, 2013).

105 In fact, utility companies engage in EITC outreach campaigns to raise awareness of the EITC to their low income customers. See Pennsylvania Utility Law Project, The Earned Income Tax Credit (EITC) as "Energy Assistance" in Pennsylvania (June 2009); Consumer Energy, *Payment Assistance Programs, available at* http://www.consumersenergy.com/content.aspx?id=1244#EarnedIncome.

**FIGURE 5, Percent TY 2011 Refunds Issued by Various 2012 Dates[106]**




In addition, IRS data show that of all TY 2011 refunds delayed or frozen by the IRS due to compliance issues, such as child support, matching, math error, identity theft, over 77 percent were identified and frozen (and some potentially released in part or full) by the IRS by the end of April.

**FIGURE 6, Percentage of TY 2011 Refunds Identified and Frozen by Certain 2012 Dates[107]**

| Date | % Identified and Frozen |
|---|---|
| January 28, 2012 | 5.88% |
| February 11, 2012 | 21.60% |
| February 25, 2012 | 35.53% |
| March 17, 2012 | 51.15% |
| March 31, 2012 | 59.31% |
| April 14, 2012 | 67.37% |
| April 28, 2012 | 77.21% |
| May 12, 2012 | 82.84% |
| May 26, 2012 | 85.47% |
| June 16, 2012 | 87.66% |
| June 30, 2012 | 88.88% |

106 IRS CDW, Individual Master File TY 2011.

107 *Id.*.

Based on the above data, the National Taxpayer Advocate recommends that the IRS:

**Recommendation 3.1:** Issue direct deposit and other electronic refunds by April 30th and paper checks by May 31

By issuing all refunds on the same date, rather than a rolling date depending on date of filing, the IRS would have less pressure to get the refund out before performing the necessary compliance screens and matching. Another alternative would be to release refunds in stages. Thus, for example, if the taxpayer filed by March 31, the IRS would issue the refund by April 30, in bi-monthly increments.

Pushing back the refund release date until the end of April may have a significant impact on small businesses. IRS data show that 59 percent of Schedules C, E, and F filers claimed refunds in TY 2011.[108] From an economic perspective, small businesses would only feel the financial strain of this proposal in the first year, when the refunds would be released potentially 15 months after the refunds for the previous year. Theoretically, with enough notice, taxpayers could plan to minimize their refund amounts in the first year of implementation. However, we recognize that the reality of such a delay may be very different from theory. Further analysis of IRS data into the date of filing patterns for this population will help quantify the actual impact.

Delaying refunds would also have a significant impact on the commercial refund industry. With the demise of the refund anticipation loan (RAL) industry in 2012, the refund anticipation check (RAC) has become a dominant commercial refund delivery product. In addition, a number of payday lenders and other non-bank businesses are making tax-time loans. [109]

For products with loan components, the length of the loan term increases when refund issuance is delayed. Research has shown that one in six payday loan borrowers repays his or her loans with a tax refund. Until taxpayer-borrowers receive their refund or some other cash infusion (such as financial help from family, selling possessions, etc.), approximately 41 percent of borrowers renew or reborrow the loan, incurring additional fees.[110] In addition, RACs include a loan for the tax preparation fee.[111] If the term of this loan component of the product increases, the product will involve more risk to the financial institution offering the RAC and this risk will likely translate to higher fees charged to the taxpayers. Therefore, delaying refund issuance will likely increase the cost of tax-related loans to the borrowers.

Later refund issuance also results in the lenders assuming an even greater risk if the IRS performs matching before issuing the refund. The more matching performed upfront, the greater the risk that the IRS will not pay out the entire anticipated refund. This greater risk imposed on the providers will make them less profitable and may drive some out of the market. The impact on the consumers of the products with loan components is an important consideration in determining whether delaying the refund is a viable option.

108 IRS Compliance Data Warehouse, Individual Master File, TY 2011 (of the 44,754,395 returns with Schedule C, E, or F, 32,721,894 claimed refunds).

109 Chi Chi Wu, National Consumer Law Center, *Something Old, Something New in Tax-Time Financial Products and the New Wave of Quickie Tax Loans* 2-10 (Feb. 2013).

110 Pew Charitable Trusts, *Payday Lending in America: Report 2: How Borrowers Choose and Repay Payday Loans* 6-7 (Feb. 2013).

111 Chi Chi Wu, National Consumer Law Center, *Something Old, Something New in Tax-Time Financial Products and the New Wave of Quickie Tax Loans* 6 (Feb. 2013).

Finally, we recognize that there will be many wide-ranging objections to pushing back the refund release date. One potential complaint would be that the government would profit off the "float" – *i.e.*, by holding onto the taxpayer's money even longer, it will earn more interest. A later tax payment date would not only counter this objection but might encourage taxpayers to minimize the size of their refunds by reducing their withholding.

## RECOMMENDATIONS

The National Taxpayer Advocate recognizes that the changes necessary to accomplish an accelerated third-party reporting system require a great deal of forethought, analysis, and stakeholder engagement. While the IRS has acknowledged the benefits of a real time tax system, it has not made any recent progress in developing a long-term plan for such a system. The IRS's lack of progress only delays the significant benefits we outlined throughout this report. Thus, we reiterate our 2009 Legislative Recommendation that Congress require the IRS and the Department of Treasury to prepare a report, in consultation with the National Taxpayer Advocate, which provides a plan and timeline to achieve an accelerated third-party reporting system. In furtherance of this issue, the National Taxpayer Advocate recommends that the following administrative and legislative actions be taken to achieve a system that allows the IRS to perform upfront matching to protect government revenue and improve taxpayer service:

**Recommendation 1.1:** Provide taxpayers with access to real-time transcripts of third-party data to aid in return preparation.

**Recommendation 1.2:** Provide a platform from which taxpayers and preparers could download third-party data directly into commercial tax return preparation software.

**Recommendation 2.1:** Develop and implement a one year pilot to determine if the IRS can screen Form W-2 data as effectively as SSA.

**Recommendation 2.2:** Eliminate the March 31st deadline for e-filed information reports. All information reports, whether e-filed or filed on paper, would be due at the end of February.

**Recommendation 2.3:** Minimize corrections by creating a $50 *de minimis* threshold for corrections.

**Recommendation 2.4:** Further increase electronic filing by reducing the 250 report threshold in IRC § 6011(e) to 50 reports and offer 2D bar code technology for those who cannot e-file.

**Recommendation 3.1:** Issue direct deposit and other electronic refunds by April 30th and paper checks by May 31st.

# The IRS Private Debt Collection Program — A Comparison of Private Sector and IRS Collections While Working Private Collection Agency Inventory

SECTION SIX

# The IRS Private Debt Collection Program — A Comparison of Private Sector and IRS Collections While Working the Private Collection Agency Inventory[1]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1 The principal authors of this study are Josh Beck, Attorney Advisor, Fran Cappelletti, Research Analyst, Joseph Saldana, Research Analyst, Jeff Wilson, Research Director, and Tom Beers, Senior Research Advisor, of the Office of the Taxpayer Advocate.

## EXECUTIVE SUMMARY

### Introduction

In 2004, Congress passed the American Jobs Creation Act, which granted the IRS the authority to contract out collection of past due taxes to private collection agencies (PCAs).[2] The original intent of the program was to address the buildup of potentially collectible inventory that was not being worked by the IRS.[3] The PCAs would help collect the aging receivables in exchange for commissions based on the amounts collected.[4]

In September 2006, the IRS began assigning taxpayer accounts to PCAs,[5] but the PCAs' authority to work these cases was limited, given that certain actions are considered inherently governmental and therefore could not be delegated to private entities. For instance, PCAs could not determine or negotiate the amount of a taxpayer's liabilities, and the only cases PCAs could resolve were those in which the amount was not in dispute. The IRS assigned PCAs the following types of cases:

- Cases that involved an individual taxpayer with a balance due for only one tax period and $25,000 or less due from September to December 2006; and
- Cases that involved an individual taxpayer with a balance due for one or more tax periods and $100,000 or less due from January 2007 to February 2009.

These cases, called Potential New Inventory (PNI) accounts, fell into three categories:

1. Queue – Accounts awaiting assignment to the collection field function (CFf) but suspended (*i.e.*, not being worked);
2. Shelved – Accounts not being worked due to IRS resource limitations; and
3. Unable to contact or unable to locate (UTC/UTL) – Accounts where the IRS is not able to contact or locate the taxpayer.

The Private Debt Collection (PDC) program continued for nearly three years before the IRS ended it. In total, the IRS placed about $1.8 billion (357,449 tax modules[6]) of outstanding tax liabilities with the PCAs for collection.[7] Upon ending the program, the IRS committed to working the tax modules recalled from the PCAs. This report examines the results the IRS obtained while working the inventory recalled from the PCAs and analyzes whether the IRS or the PCAs performed better when working the PCA inventory.

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2 The American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 881(e), 118 Stat. 1418 (2004), providing in pertinent part:

(e) BIENNIAL REPORT. — The Secretary of the Treasury shall biennially submit (beginning in 2005) to the Committee on Finance of the Senate and the Committee on Ways and Means of the House of Representatives a report with respect to qualified tax collection contracts under section 6306 of the Internal Revenue Code of 1986 (as added by this section) which includes —
(1) a complete cost benefit analysis.

3 In 2003, the IRS had a backlog of receivables of approximately $120 billion which was growing at approximately four percent per year. *See* General Accounting Office (GAO), GAO-04-492, *Tax Debt Collection, IRS Is Addressing Critical Factors for Contracting Out but Will Need to Study the Best Use of Resources* 1 (May 2004).

4 *Id*.

5 Three private collectors were used in the first phase of the initiative: CBE Group Inc. of Waterloo, Iowa; Linebarger, Goggan Blair & Sampson of Austin, Texas; and Pioneer Credit Recovery, Inc. of Arcade, N.Y. Internal Revenue Service News Release, IR-2006-42 (March 9, 2006). Linebarger was let out of its contract in March of 2007.

6 The IRS computer system creates a separate module in its master file for each return a taxpayer files. Activities affecting a particular tax return are recorded in the module corresponding to that return.

7 IRS, Filing and Payment Compliance Advisory Council (Oct. 19, 2009).

### Methodology

TAS compared the results for the IRS and PCAs while these entities worked the PCA Inventory. For this analysis, the IRS provided a list of all taxpayers whose accounts were assigned to a PCA, including the dates the cases were assigned to the agency and returned to the IRS. TAS used this list to determine when cases were under PCA control and when they were under IRS control.

TAS used the IRS Accounts Receivable Dollar Inventory (ARDI) to pull data on the balance owed at the time of case assignment, at six-month intervals after assignment, and at resolution for both the PCAs and the IRS.[8] We used the IRS collection status code history file to determine when cases were resolved and what their status was when they returned to the IRS.[9] Finally, we used the IRS Master File transaction history to determine the type and timing of payments received on the account, both while under PCA and IRS control. We broke out offset payments separately, rather than crediting them to the PCAs or IRS, since they happen automatically, rather than as a direct result of PCA or IRS collection efforts.[10]

### Limitations

Because IRS worked the PCA inventory after recall, our analysis comparing IRS and PCA results while working the PCA inventory places the IRS at a significant disadvantage to the PCAs. The liabilities were older on return to the IRS[11] and the PCAs had already had an opportunity to close the easy cases. Thus, outcomes showing superior IRS performance are conservative.

TAS used data supplied by the IRS to identify the tax modules worked by the PCAs and subsequently recalled by the IRS. The analysis does not include the tax modules for several hundred invalid taxpayer identification numbers (TINs) we found in the IRS files. In total, TAS identified 349,586 valid tax modules with tax liabilities totaling about $1.6 billion; these are the modules included in the analysis. As discussed above, this contrasts with the $1.8 billion (357,449 tax modules) of outstanding tax liabilities the IRS reported it placed with the PCAs for collection.[12]

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8 For unresolved PCA cases, TAS used the ARDI to determine the balance due on the date the case was recalled by the IRS. We continued to give the PCAs credit for payments received up to two weeks after recall, since the payments likely resulted from PCA collection efforts.

9 Status codes show the status of a taxpayer account at a particular point in time, such as whether the taxpayer has an outstanding liability that is:
- Being paid by installment agreement;
- Being worked in ACS; or
- Has been identified as currently not collectible (CNC).

10 Offsets are transfers of credit balances from one taxpayer module to another module on which there is an outstanding liability. For example, if a taxpayer files a refund return and has an unpaid liability for a prior year, the refund will be applied to the prior year liability rather than being refunded to the taxpayer.

11 The collection industry estimates that the probability of collecting unpaid accounts falls to 70 percent after three months, 52 percent after six months, and 23 percent after a year. See, *e.g.*, Treasury Inspector General for Tax Administration (TIGTA), Ref. No. 2011-30-112, *Reducing the Processing Time Between Balance Due Notices Could Increase Collections* 8 (Sept. 26, 2011) (citing collectability statistics based on a survey conducted by the Commercial Collection Agency Association).

12 IRS, Filing and Payment Compliance Advisory Council (Oct. 19, 2009).

## Findings

We compared PCA and IRS collections during four consecutive six-month intervals following case receipt. As the table below shows, the IRS collected about 62 percent more than the PCAs during these two years ($139.4 million compared to $86.2 million collected by the PCAs).[13]

### TABLE 1, Total Payments Collected by the PCAs and IRS during the Full Study Period

| | PCA Dollars Collected | Percent of Available Dollars | IRS Dollars Collected | Percent of Available Dollars |
|---|---|---|---|---|
| First Period | $63,646,131 | 4.0% | $45,051,770 | 3.0% |
| Second Period | $14,653,173 | 1.4% | $36,117,475 | 2.5% |
| Third Period | $6,013,101 | 1.0% | $30,498,716 | 2.1% |
| Fourth Period | $1,863,314 | 0.6% | $27,741,639 | 2.2% |
| **Total** | **$86,175,719** | **5.4%** | **$139,409,600** | **9.2%** |

The amount the PCAs collected falls precipitously after the first period, especially in comparison to IRS collections. This is consistent with our observation that the PCAs worked all the cases before the IRS, and had an opportunity to close the "easy" cases, *i.e.,* liabilities owed by taxpayers who responded quickly to telephone contact. The above analysis suggests that the PCAs had little success after working the easy cases. In contrast, the IRS continued to collect significant amounts throughout the two-year study period.

It is also noteworthy that the IRS collects significant amounts of money from refund offsets. We calculated that during the two-year periods under study, the IRS collected $237,694,764 through offsets. This is more than the combined total the PCAs and IRS collected through their collection activities.

## Conclusion

TAS study results show that the IRS was significantly more effective than the PCAs in collecting tax liabilities in all but the first six months after case receipt, collecting about twice as much as a percent of the dollars available for collection. These results likely understate the difference in IRS and PCA effectiveness, since our analysis placed the IRS at a significant disadvantage:

- All of the cases were older when the IRS got them, and some were more than two years older;[14] and
- The PCAs worked the cases first and collected the easy dollars, while the IRS only got cases the PCAs had already handled.

13 It is noteworthy that the IRS collects significant amounts of money from offsets. We calculated that during the two-year periods under study, the IRS collected $237,694,764 through offsets. This is more than the combined total the PCAs and IRS collected through their collection activities.

14 TAS analysis of IRS data showed that the IRS recalled nearly 300,000 tax modules, of which almost 11,000 were in PCA custody for more than two years.

## INTRODUCTION

In 2004, Congress passed the American Jobs Creation Act, which granted the IRS the authority to contract out collection of past due taxes to private collection agencies.[15] The original intent of the program was to address the buildup of potentially collectible inventory that was not being worked by the IRS.[16] The PCAs would help collect the aging receivables in exchange for commissions based on the amount collected.[17]

The Private Debt Collection Program has been the subject of several studies, including the IRS Cost Effectiveness Study (CES) and another study by the Government Accountability Office (GAO).[18] TAS decided to take an independent look at the IRS data. This report examines the results the IRS obtained while working the inventory recalled from the PCAs and analyzes whether the IRS or the PCAs performed better when working the PCA inventory.

## BACKGROUND

In September 2006, the IRS began assigning taxpayer accounts to PCAs.[19] The PCAs' authority to work these cases was limited. For instance, the agencies could not determine or negotiate the amount of a taxpayer's liabilities, and the only cases PCAs could resolve were those in which the amount was not in dispute. Moreover, the PCAs did not have the seizure, lien, or levy authority delegated to IRS collection employees, nor did they have the authority to enter into offers in compromise or lengthy installment agreements.[20] The IRS assigned PCAs the following types of cases:

1. Cases that involved an individual taxpayer with a balance due for one tax period and $25,000 or less due from September to December 2006;
2. Cases that involved an individual taxpayer with a balance due for one or more tax periods and $100,000 or less due from January 2007 to February 2009.

These cases were Potential New Inventory cases, which fall into three categories:

1. Queue – Accounts awaiting assignment to the collection field function but suspended (*i.e.,* not being worked);

15 The American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 881(e), 118 Stat. 1418 (2004), providing in pertinent part:

(e) BIENNIAL REPORT. — The Secretary of the Treasury shall biennially submit (beginning in 2005) to the Committee on Finance of the Senate and the Committee on Ways and Means of the House of Representatives a report with respect to qualified tax collection contracts under section 6306 of the Internal Revenue Code of 1986 (as added by this section) which includes —

(1) a complete cost benefit analysis,

16 In 2003, the IRS had a backlog of receivables of approximately $120 billion which was growing at approximately four percent per year. *See* General Accounting Office, GAO-04-492, *Tax Debt Collection, IRS is Addressing Critical Factors for Contracting Out but Will Need to Study the Best Use of Resources* 1 (May 2004).

17 GAO, GAO-04-492, Tax Debt Collection, *IRS Is Addressing Critical Factors for Contracting Out but Will Need to Study the Best Use of Resources* 1 (May 2004).

18 GAO, GAO 10-963, Tax Debt Collection, *IRS Could Improve Future Studies by Establishing Appropriate Guidance* (Sept. 2010).

19 Three private collectors were used in the first phase of the initiative: CBE Group Inc. of Waterloo, Iowa; Linebarger, Goggan Blair & Sampson of Austin, Texas; and Pioneer Credit Recovery, Inc. of Arcade, N.Y. Internal Revenue Service News Release, IR-2006-42 (March 9, 2006). Linebarger was let out of its contract in March of 2007.

20 For more background on the case selection and the limitations on PCA activity *see* National Taxpayer Advocate 2008 Annual Report to Congress 328-336 (Status Update: *The IRS's Private Debt Collection Initiative is Failing in Most Respects*); National Taxpayer Advocate 2007 Annual Report to Congress 411-43 (Status Update: *Private Debt Collection*); National Taxpayer Advocate 2006 Annual Report to Congress 34-61 (Most Serious Problem: *True Costs and Benefits of Private Debt Collection*); National Taxpayer Advocate 2005 Annual Report to Congress 76-93 (Most Serious Problem: *Training of Private Debt Collection Employees*); *See* also *IRS Private Debt Collection Program: Hearing Before the U.S. House of Representatives, Committee on Ways and Means* (May 23, 2007) (statement of Nina E. Olson, National Taxpayer Advocate).

2. Accounts that are not being worked due to IRS resource limitations; and
3. Unable to contact or unable to locate (UTC/UTL) – Accounts where the IRS is not able to contact or locate the taxpayer after researching available resources.

Initially, the IRS contracted with three PCAs to help collect tax debts. In March 2007, the IRS decided to extend the contract option for only two PCAs and recalled all accounts from the other contractor.[21] The PDC Program continued for nearly three years before the IRS ended it. In total, the IRS placed $1.8 billion (357,449 tax modules) of outstanding tax liabilities with the PCAs for collection.[22] In March of 2009, the IRS announced it would not renew the PCAs' contracts,[23] and began planning to recall the cases.[24] At the end of the program, the PCAs returned nearly 300,000 modules to the IRS. The IRS reviewed each case, determined its current status, and placed it back into the status it deemed appropriate.[25]

This report examines the results the IRS obtained while working the inventory recalled from the PCAs and analyzes whether the IRS or the PCAs performed better when working the PCA inventory. A limitation of the analysis is that it places the IRS at a significant disadvantage to the PCAs, since the liabilities were older when they returned to the IRS[26] than when they were placed with the PCAs, and the PCAs had already had an opportunity to close the easy cases. Thus, outcomes showing superior IRS performance are conservative.

## METHODOLOGY

As discussed above in the Background section, TAS performed a comparison of the IRS and PCA results while working the PCA Inventory. For this analysis, the IRS provided a list of all taxpayers whose accounts were assigned to a PCA, including the dates the cases were assigned to the agency and returned to the IRS. TAS used this list to determine when cases were under PCA control and when they were under IRS control.

TAS used the IRS Accounts Receivable Dollar Inventory (ARDI) to pull data on the balance owed at the time of case assignment, at six-month intervals after assignment, and at resolution for both the PCAs and the IRS.[27] We used the IRS collection status code history file to determine when cases were resolved and

21 IRS Filing and Payment Compliance Advisory Council Briefing, March 7, 2007. Initially, IRS contracted with CBE Group, Pioneer Collection and Linebarger (LGBS). In March 207, the contract with Linebarger was not extended.

22 IRS, Filing and Payment Compliance Advisory Council (Oct. 19, 2009).

23 IR-2009-19, IRS Employees More Flexible, More Cost Efficient (Mar. 5, 2009).

24 IRS, Filing and Payment Compliance Advisory Council (July 20, 2009).

25 Status codes show the status of a taxpayer account at a particular point in time, such as whether the taxpayer has an outstanding liability that is:
- Being paid by installment agreement;
- Being worked in the Automated Collection System (ACS); or
- Has been identified as currently not collectible (CNC).

26 The collection industry estimates that the probability of collecting unpaid accounts falls to 70 percent after three months, 52 percent after six months, and 23 percent after a year. See, *e.g.*, TIGTA, Ref. No. 2011-30-112, *Reducing the Processing Time between Balance Due Notices Could Increase Collections* 8 (Sept. 26, 2011) (citing collectability statistics based on a survey conducted by the Commercial Collection Agency Association).

27 For unresolved PCA cases, TAS used the ARDI to determine the balance due on the date the case was recalled by the IRS. We continued to give the PCAs credit for payments received up to two weeks after recall, since the payments likely resulted from PCA collection efforts.

what their status was when they were returned to the IRS.[28] Finally, we used the IRS Master File transaction history to determine the type and timing of payments received on the account, both while under PCA and IRS control. We broke out offset payments separately, rather than crediting them to the PCAs or IRS, since they happen automatically, rather than as a result of PCA or IRS collection efforts.[29]

### Limitations

Because the IRS worked the PCA inventory after recall, our analysis comparing IRS and PCA results while working the PCA inventory places the IRS at a significant disadvantage to the PCAs. The liabilities were older on return to the IRS[30] and the PCAs had already had an opportunity to close the easy cases. Thus, outcomes showing superior IRS performance are conservative.

On the other hand, PCAs did not have the authority to conduct certain actions on the cases that IRS collection employees are generally able to undertake. Specifically, because these actions require the exercise of judgment and discretion and therefore are inherently governmental, PCA employees were unable to issue liens and levies or seize property; they were also not able to enter in offers in compromise or lengthy installment agreements.[31]

TAS used data supplied by the IRS to identify the tax modules worked by the PCAs and subsequently recalled by the IRS. The analysis does not include the tax modules for several hundred invalid taxpayer identification numbers (TINs) we found in the IRS files. In total, TAS identified 349,586 valid tax modules with tax liabilities totaling about $1.6 billion; these are the modules included in the analysis. This contrasts with the $1.8 billion (357,449 tax modules) of outstanding tax liabilities the IRS reported it placed with the PCAs for collection.[32]

## FINDINGS

TAS calculated the dollars collected by the PCAs while working the population of PNI cases assigned to them during the PDC Program tenure. We also calculated the dollars the IRS collected while working the subset of these cases that it recalled. We only count payments made while the module was in PCA or IRS control. This period begins on the date that the PCA or IRS received the module[33] and ends at case

28 Status codes show the status of a taxpayer account at a particular point in time, such as whether the taxpayer has an outstanding liability that is:
- Being paid by installment agreement;
- Being worked in ACS; or
- Has been identified as currently not collectible (CNC).

29 Offsets are transfers of credit balances from one taxpayer module to another module on which there is an outstanding liability. For example, if a taxpayer files a refund return and has an unpaid liability for a prior year, the refund will be applied to the prior year liability rather than being returned to the taxpayer.

30 The collection industry estimates that the probability of collecting unpaid accounts falls to 70 percent after three months, 52 percent after six months, and 23 percent after a year. See, *e.g.*, TIGTA, Ref. No. 2011-30-112, *Reducing the Processing Time between Balance Due Notices Could Increase Collections* 8 (Sept. 26, 2011) (citing collectability statistics based on a survey conducted by the Commercial Collection Agency Association).

31 For an in-depth discussion of the concept of inherently governmental activities and how that concept applies to the Private Debt Collection initiative, *see IRS Private Debt Collection Program: Hearing Before the U.S. House of Representatives, Committee on Ways and Means* (May 23, 2007) (statement of Nina E. Olson, National Taxpayer Advocate).

32 IRS, Filing and Payment Compliance Advisory Council (Oct. 19, 2009).

33 The IRS computer system creates a separate module in its master file for each return a taxpayer files. Activities affecting a particular tax return are recorded in the module corresponding to that return.

resolution as described below. We break out offset payments separately, rather than crediting them to the PCAs or IRS, since they happen automatically, not because of PCA or IRS collection efforts.[34]

To adjust for the different lengths of time that the PCAs and IRS had to work the cases, we tracked dollars collected in six-month intervals, *i.e.*, dollars collected in the first six months after receipt, dollars collected in the second six months after receipt, etc. In total, we analyzed four such periods for both the PCAs and the IRS.

For both the PCAs and the IRS, we identified four kinds of case resolution and included dollars collected for each type of resolution in our calculations:

- Full pay – includes all payments in the reported periods until all the taxpayer's modules have been paid in full.
- Installment agreement (IA) – includes all payments in the reported time periods until full payment or default.[35]
- Currently not collectible (CNC)[36] – includes all payments in the reported time periods until full payment or recall of all of the taxpayer's modules.
- Unresolved – For the PCAs, includes all payments received in the reported periods or until recall, if recall occurred before two years (*i.e.,* four six-month intervals) elapsed. For the IRS, this includes all payments received in the reported periods.

In the tables that follow, we compare PCA and IRS collection results during the periods under study, *i.e.,* two years following receipt of the case. Since the PCAs had fewer dollars available for collection in several periods, to ensure a fair comparison, we compared the percent the PCAs and IRS collected of the total dollars available for collection. Table 2 below shows the total dollars available for collection at the beginning of each of the four six-month intervals after the PCAs or IRS received the case.

**TABLE 2, Dollars Available for Collection during the Four Intervals Following Case Receipt**

| | PCAs | IRS |
|---|---|---|
| Receipt Date | $1,581,918,726 | $1,514,951,108 |
| + 6 months | $1,049,362,723 | $1,468,992,774 |
| + 1 year | $574,351,356 | $1,422,894,453 |
| + 1.5 years | $287,589,003 | $1,380,819,526 |

34 Offsets are transfers of credit balances from one taxpayer module to another module on which there is an outstanding liability. For example, if a taxpayer files a refund return and has an unpaid liability for a prior year, the refund will be applied to the prior year liability rather than being returned to the taxpayer.

35 It should be noted that under this methodology, PCAs receive credit for all payments made on IAs in the reported periods. This includes payments that occurred after the recall date if the taxpayer made the payment within two years after the PCA received the case.

36 The IRS reports accounts as currently not collectible for a variety of reasons, including (among others):

- Inability to locate the taxpayer or assets;
- Collection of the liability would create a hardship for taxpayers by leaving them unable to meet necessary living expenses; and
- Death of an individual with no collection potential from the decedent/decedent estate.

*See* Internal Revenue Manual (IRM) 5.16.1 for a complete discussion of the reasons the IRS places an account in CNC status.

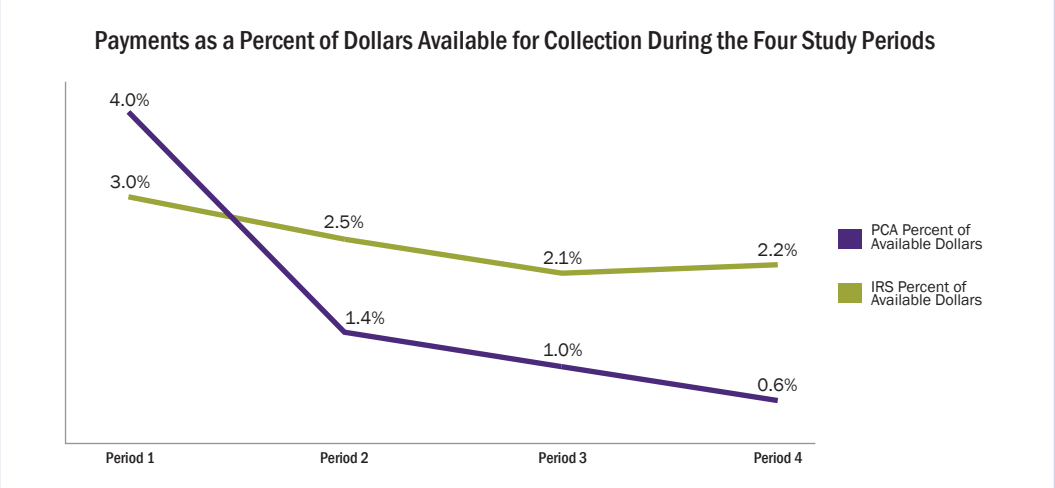
Table 3 below shows the dollars the PCAs and IRS collected during the four six-month intervals, and the percentage these amounts comprised of the dollars available for collection.

**TABLE 3, Total Payments Collected by the PCAs and IRS during the Full Study Period**

| | PCA Dollars Collected | Percent of Available Dollars | IRS Dollars Collected | Percent of Available Dollars |
|---|---|---|---|---|
| First Period | $63,646,131 | 4.0% | $45,051,770 | 3.0% |
| Second Period | $14,653,173 | 1.4% | $36,117,475 | 2.5% |
| Third Period | $6,013,101 | 1.0% | $30,498,716 | 2.1% |
| Fourth Period | $1,863,314 | 0.6% | $27,741,639 | 2.2% |
| **Total** | **$86,175,719** | **5.4%** | **$139,409,600** | **9.2%** |

As illustrated above, the IRS collected about 62 percent more than the PCAs during the two years following case receipt ($139.4 million compared to $86.2 million). It is noteworthy that the PCAs collected more during the first six-month period than the IRS, but significantly less in the remaining three periods. The amount the PCAs collected falls precipitously during these periods, especially in comparison to IRS collections, as shown in Figure 4 below.

**FIGURE 4, Payments as a Percent of Dollars Available for Collection During the Four Study Periods**




The abrupt decline in PCA collections after the first six-month period is consistent with our earlier observation that the PCAs worked all the cases before the IRS, and had an opportunity to close the "easy" ones, *i.e.,* liabilities owed by taxpayers who responded quickly to telephone contact. The above analysis suggests the PCAs had little success after working the easy cases. In contrast, the IRS continued to collect significant amounts throughout the study period.

The IRS also collected significant amounts from offsets, which are not included in the table above because they occur without any direct intervention by IRS or PCA personnel. During the two-year periods

under study, we calculated that the IRS collected $237,694,764 through offsets, which is more than the combined total the PCAs and IRS brought in through their collection activities.

## CONCLUSION

TAS study results show that the IRS was significantly more effective than the PCAs in collecting tax liabilities in all but the first six months after case receipt, collecting about twice as much as a percent of the dollars available for collection. These results likely understate the difference in IRS and PCA effectiveness, since our analysis placed the IRS at a significant disadvantage:

- All of the cases were older when the IRS got them, and some were more than two years older;[37] and
- The PCAs worked the cases first and collected the easy dollars, while the IRS only got cases the PCAs had already worked.

37 TAS analysis of IRS data showed that the IRS recalled nearly 300,000 tax modules, of which almost 11,000 were in PCA custody for more than two years.

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