

## MSP #17 **AUTOMATED SUBSTITUTE FOR RETURN (ASFR) PROGRAM: Current Selection Criteria for Cases in the ASFR Program Create Rework and Impose Undue Taxpayer Burden**

### RESPONSIBLE OFFICIAL

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### TAXPAYER RIGHTS IMPACTED<sup>1</sup>

- *The Right to Be Informed*
- *The Right to Pay No More Than the Correct Amount of Tax*
- *The Right to Challenge the IRS's Position and Be Heard*
- *The Right to a Fair and Just Tax System*

### DEFINITION OF PROBLEM

When a taxpayer who has a filing requirement fails to file a tax return, the IRS is authorized under Internal Revenue Code (IRC) § 6020(b) to use third-party information to determine and assess a tax liability.<sup>2</sup> This is principally worked through the Automated Substitute for Return (ASFR) program, the IRS's key program for enforcing filing compliance on taxpayers who have not filed individual income tax returns but appear to owe a tax liability.<sup>3</sup>

If a taxpayer has not filed a return and the IRS determines that a taxpayer has a filing requirement, it will typically select certain cases to prepare a Substitute for Return (SFR) and assess the liability based on information such as Forms W-2 and 1099 filed by employers, banks, and other third parties.<sup>4</sup> In preparing an SFR, the ASFR program generally treats the taxpayers as single (or married filing separately where there is evidence the taxpayer is married) with no dependents, allows one exemption and only a standard deduction (even where there is third-party documentation supporting deductions on file with the IRS).<sup>5</sup>

1 See Taxpayer Bill of Rights, available at [www.TaxpayerAdvocate.irs.gov/taxpayer-rights](http://www.TaxpayerAdvocate.irs.gov/taxpayer-rights).

2 IRC § 6020(b).

3 Internal Revenue Manual (IRM) 5.18.1.2, *What Is ASFR?* (Oct. 1, 2005). See also Treasury Inspector General for Tax Administration, Ref. 2014-30-023, *Expansion of the Delinquent Return Refund Hold Program Could Improve Filing Compliance and Help Reduce the Tax Gap* (Mar. 14, 2014).

4 IRM 5.18.1.2, *What Is ASFR?* (Oct. 1, 2005).

5 IRM 5.18.1.3.5, *Tax Delinquency Investigation (TDI) Supplement Information* (Oct. 1, 2005); IRM 5.18.1.7.2, *Computing Taxable Income* (Oct. 1, 2005); IRM 5.18.1.7.3, *Computing Tax Due, Penalties and Interest* (Oct. 1, 2005). ASFR programming determines the filing status, taxable income, tax, interest, and penalties "systemically," i.e., without an employee review.

The ASFR program has poor collection results and a high abatement rate:

- In fiscal year (FY) 2011 through FY 2014, the IRS assessed nearly \$34 billion through its ASFR authority. The IRS collected less than one-third of this amount, nearly \$11 billion.<sup>6</sup>
- For ASFR assessments made in FY 2011 through FY 2014, the IRS abated about \$10 billion of the ASFR assessments — for a total of 29 percent of all ASFR assessments.<sup>7</sup>
- The ASFR program's return on investment (ROI) is small. In FY 2014, the ASFR program had revenue of \$89.5 million, but spent \$39.8 million operating the ASFR program, which does not include the costs of later abating liabilities or the expense of sending out notices or making collection attempts. This means the IRS generated net revenue of about \$50 million when accounting for the cost of the program.<sup>8</sup>

The selection of these unproductive cases, which often result in abatement, cause rework for the IRS and potential harm to the taxpayer (*i.e.*, IRS attempts to collect the inflated liability by using its enforcement powers). The IRS could mitigate these outcomes by considering third-party documentation that supports deductions or credits when determining which cases to select for the program. Considering certain deductions and credits would result in a more accurate assessment, conserve IRS resources, and mitigate harm to taxpayers while protecting their rights.

## ANALYSIS OF PROBLEM

### Background

ASFR is the key IRS program for enforcing filing compliance by taxpayers who have not filed individual tax returns, but have incurred a “significant” tax liability.<sup>9</sup> The program estimates the liability by computing tax, penalties, and interest based upon information reported to the IRS by third parties.<sup>10</sup> When a taxpayer with reported income is delinquent in filing a return, the IRS attempts to secure the return

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- 6 Individual Master File (IMF), Enforcement Revenue Information System (ERIS) on IRS Compliance Data Warehouse (CDW). The \$34 billion assessed includes tax, penalties and interest. TAS Research worked closely with the ASFR Program Office to ensure that it was properly identifying ASFR cases. TAS and the IRS came very close in their data for ASFR cases and dollars collected through the ASFR program. However, there was a small difference in the number of cases and dollars collected. The numbers compiled by TAS Research showed about two percent fewer ASFR cases when compared to the ASFR Program Office's data, and showed about ten percent fewer dollars assessed compared to the ASFR Program Office's data.
- 7 IMF, ERIS on IRS CDW. Some ASFR abatements occur after the taxpayer files as the secondary taxpayer on a joint return; in such cases ERIS might not capture the tax assessed to and collected from a secondary taxpayer.
- 8 Office of the Chief Financial Officer, Financial Management, Office of Cost Accounting Cost-Based Performance Measures ASFR, FYs 2010 – 2014, available at [http://cfo.fin.irs.gov/FinMgmt/Cost\\_Accounting/docs/Cost-Study-Reports/FY2014/ASFR-Cost\\_Study-FY\\_2014.doc](http://cfo.fin.irs.gov/FinMgmt/Cost_Accounting/docs/Cost-Study-Reports/FY2014/ASFR-Cost_Study-FY_2014.doc) (last visited May 28, 2015). The \$89.5 million represents enforcement revenue collected by the ASFR program after an SFR notice has been issued and prior to the issuance of the first collection notice. Overall, IRS collected nearly \$11 billion of assessments made in FY 2011 through FY 2014; however, the costs associated with the post-assessment collection, abatement, and other downstream tax account administration cannot be easily determined, making an accurate return on investment (ROI) calculation difficult.
- 9 IRM 5.18.1.2, *What Is ASFR?* (Oct. 1, 2005). To meet ASFR processing criteria, the proposed tax liability must meet or exceed a predetermined dollar threshold established by the IRS for the ASFR program.
- 10 *Id.* The IRS can use information returns (e.g., Forms W-2 and 1099) filed by employers, banks, and other third parties to report various types of payments to individuals. These payments include wages, interest, and dividends, as well as payments to self-employed taxpayers for services rendered. The IRS collects and maintains this information through the Information Return Program (IRP).

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In FY 2011, there were 279,374 Automated Substitute for Return (ASFR) assessed modules in which IRS received a Form 1098 showing mortgage interest expense; 85,151 of these accounts, or 30 percent, had tax abated, which IRS might have anticipated since many were qualified to itemize deductions and thereby incur a lower tax.

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through correspondence. If the attempt is unsuccessful, the IRS is authorized by IRC § 6020(b) to prepare a substitute return for the taxpayer.<sup>11</sup>

Generally, a return delinquency meets ASFR criteria when information obtained through Information Returns Processing (IRP) is available for the delinquent tax module, the module is no older than five years prior to the current processing year, there are no related taxpayer delinquent accounts (TDAs), and the proposed tax liability is over a certain dollar threshold.<sup>12</sup> When the IRS selects a return delinquency for ASFR processing, the program calculates an estimated tax liability based on available income information with an assumed filing status of “single” or “married filing separate” with one exemption.<sup>13</sup>

Generally, this proposed liability exceeds what the taxpayer actually would owe on a self-reported return, because the ASFR return does not take into consideration the taxpayer’s actual filing status, dependency exemptions, and deductions or credits.<sup>14</sup> The IRS notifies the taxpayer of the proposed assessment via a “30-day letter.”<sup>15</sup> The taxpayer may respond with an original return, an agreement to the proposed ASFR assessment, or a statement indicating disagreement with the assessment. If the taxpayer disagrees or fails to resolve the return delinquency during this 30-day period (*i.e.*, does not respond to the 30-day letter), the IRS sends a Statutory Notice of Deficiency (90-day letter) to the taxpayer by certified mail.<sup>16</sup> If the taxpayer does not resolve the return delinquency or petition the U.S. Tax Court for relief within 90 days, the ASFR program assesses the proposed tax, penalties and interest, and collection action proceeds on any unpaid balance due.<sup>17</sup>

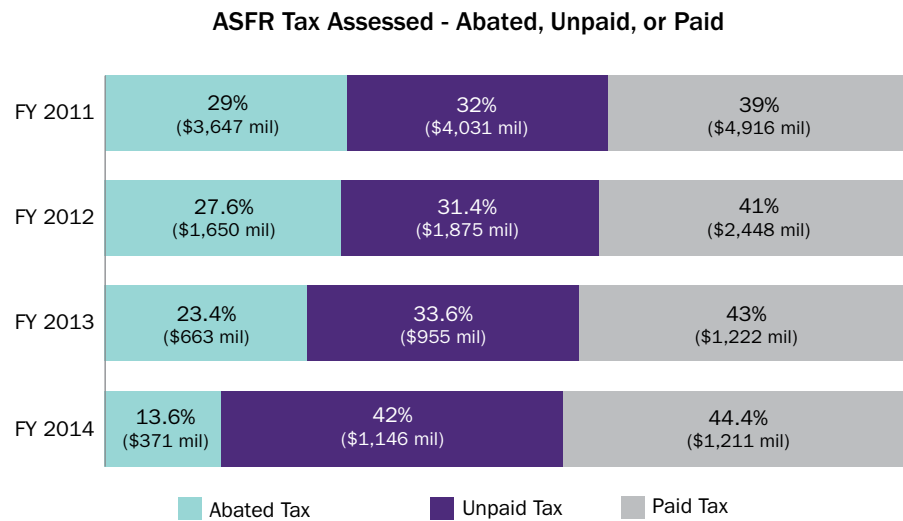
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- 11 IRC § 6020(b): “(b) Execution of return by Secretary. — (1) Authority of Secretary to execute return. — If any person fails to make any return required by any internal revenue law or regulation made thereunder at the time prescribed therefor, or makes, willfully or otherwise, a false or fraudulent return, the Secretary shall make such return from his own knowledge and from such information as he can obtain through testimony or otherwise. (2) Status of returns. — Any return so made and subscribed by the Secretary shall be *prima facie* good and sufficient for all legal purposes.” IRM 5.18.1.2, *What Is ASFR?* (Oct. 1, 2005). Some of the third-party forms used to match taxpayer data include Forms W-2 and Forms 1099 for miscellaneous, brokerage, interest, dividend, and cancellation of debt income.
- 12 IRM 5.18.1.3.1, *ASFR Criteria* (Dec. 9, 2014).
- 13 IRS response to TAS information request (Sept. 15, 2015). “ASFR uses a single filing status unless the taxpayer account shows a previous joint filing. Taxpayers with a previous joint filing receive a married filing separate filing status, consistent with SFR procedures. Per IRC § 6013(a).” IRS clarification (Dec. 11, 2015): “CCNIP (Case Creation Nonfiler Process) creates the tax calculation used to identify the Nonfiler population, including proposed liability amount and filing status. The calculation is forwarded to ASFR.”
- 14 Government Accountability Office, GAO-08-728, *IRS Has a Complex Process to Attempt to Collect Billions of Dollars in Unpaid Tax Debts* 15 (June 2008). “An example in which additional information leads to abatements involves ASFR assessments. The IRS uses the best information available when it prepares returns for taxpayers who failed to file returns. When responding to the IRS-prepared return, taxpayers may provide additional information, such as on deductions to which they are entitled, which would produce a lower tax assessment compared to the ASFR-generated assessment. Accordingly, the IRS abates any assessed taxes and any applicable penalties associated with the ASFR return.”
- 15 IRM 5.18.1.7.5, *Letter 2566 SC/CG (30-Day Letter)* (Feb. 24, 2015). The ASFR “30-day letter” provides the taxpayer with the proposed assessment amounts, and gives the taxpayer 30 days to respond. At the conclusion of the 30-day letter suspense period, if there is no/insufficient response, ASFR generates a Statutory Notice of Deficiency (90-day letter).
- 16 IRM 5.18.1.7.6, *Statutory Notice of Deficiency (ASFR 90-Day Letter)* (Oct. 1, 2005). The ASFR “90-day letter” (*i.e.*, the statutory notice of deficiency) notifies a taxpayer that the IRS intends to assess a tax deficiency. The notice also informs the taxpayer of the right to petition the Tax Court to dispute the proposed adjustments. The taxpayer has 90 days from the date of the notice to file a petition in the Tax Court before the tax is assessed.
- 17 IRM 5.18.1.7(1) (Oct. 1, 2005).

**Poor Collection Results and High Abatement Rates Show That ASFR’s Selection Criteria Are Inefficient and Lead to Inflated Liabilities that Are Later Abated**

*Inflated Assessments Lead to Poor Collection Results*

In FY 2011 through FY 2014, the IRS assessed nearly \$34 billion through its ASFR authority.<sup>18</sup> The IRS collected nearly one-third of this amount, about \$11 billion.<sup>19</sup> Figure 1.17.1 provides more specifics on the ASFR program’s performance during FY 2011 through FY 2014.<sup>20</sup>

**FIGURE 1.17.1**



*High Abatement Rate Is an Indication of Problematic Selection Criteria*

In addition to the small percentage of dollars collected when compared to dollars assessed, the ASFR program’s rate of abatement is significant. For ASFR assessments made in FY 2011 through FY 2014, the IRS abated nearly \$1 for every dollar collected.<sup>21</sup> The high abatement rate can be attributed in part to the IRS not considering deductions and credits when selecting cases for ASFR. Figure 1.17.2 shows the percentage of assessed tax later abated for FY 2011 through FY 2014.

18 IMF, ERIS on IRS CDW.

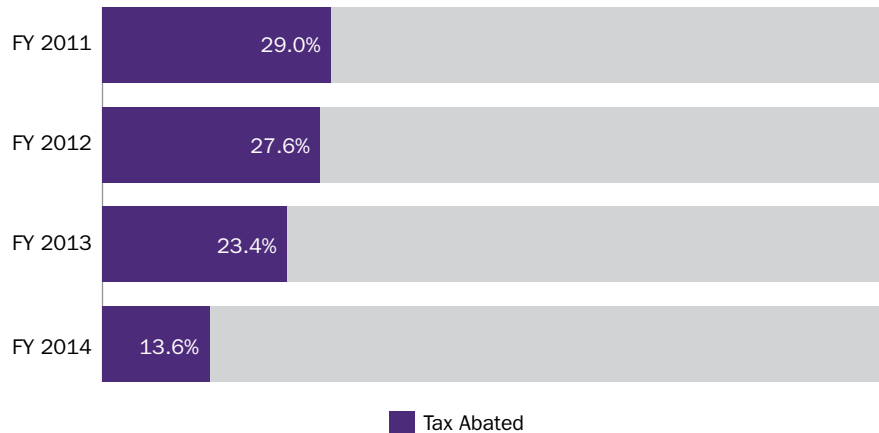
19 *Id.* The \$34 billion assessed includes tax, penalties and interest.

20 As noted above, some ASFR abatements occur after the taxpayer files as the secondary taxpayer on a joint return; in such cases ERIS might not capture the tax assessed to and collected from a secondary taxpayer.

21 IMF, ERIS on IRS CDW. Of the \$34 billion of tax, interest, and penalty assessed, the IRS collected \$10.7 billion and abated \$9.8 billion.

FIGURE 1.17.2

## Percent of ASFR Tax Abated Since Year of Assessment



As shown in the figure above, the amount of abatements is less in recent years, but these rates are likely to increase as time goes on, eventually reaching FY 2011 levels. As the IRS makes collection attempts (including refund offsets) on more recent ASFR assessments, taxpayers will file a return or provide documentation supporting deductions and credits, thereby resulting in a lower tax liability and abatement of the inflated ASFR liability. These abatement rates, coupled with the low collection results, indicate that the IRS should adjust its criteria for selecting cases for an ASFR assessment.

The approach of inflating a taxpayer's tax liability has several flaws. Inflating ASFR liabilities increases the number of ASFR cases that should not have been assessed in the first place. In other words, these cases only show a liability because the IRS did not consider deductions and credits. Specifically, the IRS could develop a selection algorithm that incorporates mortgage interest paid (as reported on Forms 1098), state income taxes paid (as reported on Forms W-2), and state sales tax per IRS tables. The IRS also could use historical data in the selection algorithm to include exemptions for dependents claimed on past returns and who were not claimed on another's return for the year in question. By including this information in the selection algorithm, the IRS will minimize the number of abatements, reducing both IRS rework and taxpayer burden.

### The Low Return on Investment Raises Questions About the Usefulness of the ASFR Program

When taking into account the costs of the ASFR program, along with the collection results, and abatement rate, the usefulness of the program is questionable. According to an IRS report, the ASFR program cost \$39.8 million in FY 2014. The \$39.8 million does not include the costs of later abating liabilities, or the expense of sending out collection notices or making collection attempts. The revenue associated with the program prior to the IRS sending a first collection notice to the taxpayer was \$89.5 million, which is a net gain of about \$50 million.<sup>22</sup> Further, the report stated that it collected \$2.25 for every \$1 spent on the ASFR program.<sup>23</sup> This is a low ROI when compared to other IRS collection programs, and even then the ROI is overstated because it does not take into consideration the significant downstream costs

22 Office of the Chief Financial Officer, Financial Management, Office of Cost Accounting Cost-Based Performance Measures ASFR, FY 2010 – FY 2014.

23 *Id.*

attributable to abatement.<sup>24</sup> For example, for every dollar invested in other IRS programs, there can be monetary returns ranging from 6-to-1 and even up to 20-to-1.<sup>25</sup> Improving the selection criteria for the program would increase the return on investment; otherwise, the program as currently configured raises the question of whether the \$39.8 million spent might be better applied elsewhere.

### Considering Additional Information Prior to Selecting Cases for ASFR May Increase Program's Efficiency While Reducing Burden on Taxpayers

As noted above, the ASFR program could yield better results by carefully selecting which cases to pursue. This could be accomplished by considering third-party documentation (*i.e.*, documents the IRS has available to it that would support deductions and credits like the mortgage interest deduction or education deductions and credits) and prior year filing statuses.

In an effort to identify what generates abatements, and what type of information would be useful for the IRS to consider when selecting ASFR cases, TAS analyzed reason codes entered on abatements of ASFR liabilities for FY 2014. Unfortunately, the reason codes used are often vague and nondescript, and provide little information as to why the liability was abated. For example, the reason code most commonly entered was “reconsideration allowed in full.” However, several of the codes did provide insight into what causes the abatement. The following are some of the most common reasons for abatement:

- Filing status (Married Filing Jointly);
- Filing status (Head of Household); and
- Itemized deductions.

In regards to the different filing statuses (*i.e.*, changing from married filing separately to married filing jointly or head of household), the IRS could look at the past three filed returns and, if the taxpayer elected married filing jointly or head of household on those past returns, it could at least consider the selected status for the purpose of determining if the case would be well suited for the ASFR program. This approach is particularly appropriate where the spouse from earlier years has not filed a return of his or her own for the ASFR year. If it would substantially reduce or eliminate the liability, the IRS could make a business decision to not prioritize this particular case for ASFR development, because there is a high probability of abatement.

Another common reason for abatement of ASFR assessments is application of itemized deductions. Unfortunately, the reason code does not specify what itemized deductions generated the abatement. However, TAS Research was able to identify ASFR assessments that were abated due to the mortgage interest deduction. In FY 2011, there were 279,374 ASFR assessed modules in which IRS received a Form 1098 showing mortgage interest expense; 85,151 of these accounts, or 30 percent, had tax abated, which IRS might have anticipated since many were qualified to itemize deductions and thereby incur a lower tax.<sup>26</sup> In fact, over 60 percent of all ASFR accounts with Form 1098 show mortgage interest expense amounts larger than the standard deduction, indicating these taxpayers likely qualify to itemize, yet the IRS calculates their tax at a higher rate.<sup>27</sup>

24 Also note that, overall, IRS collected nearly \$11 billion of assessments made in FY 2011 through FY 2014.

25 Statement of the Commissioner of Internal Revenue John Koskinen on the FY 2016 Budget (Feb. 2, 2015).

26 IMF, ERIS on IRS CDW. There were 2,230 modules with abated tax of about \$49 million attributable to TC 594 CC 84 (modules abated because the taxpayer filed as a secondary taxpayer on a joint return).

27 *Id.*

The IRS already possesses third-party documentation regarding the mortgage interest deduction, and for many other itemized deductions and credits. This documentation is just as reliable as the third-party documentation used to determine a taxpayer's income. If the IRS is confident using third-party documentation to determine income, it should also take into account third-party documentation that would support deductions or credits when making a determination as to the use of its SFR authority.

The following are examples of the type of information that should be considered when determining if a case should be selected for the ASFR program, or if an ASFR assessment would likely result in abatement:

**EXAMPLE 1:** Taxpayer failed to file a return for tax year 2014. In the three tax years prior to 2014, the taxpayer elected married filing jointly (MFJ) status and for those years either owed zero tax or was due a refund. Further research shows that the taxpayer's spouse did not file a separate return for 2014. The IRS made an ASFR assessment on the 2014 return and used the married filing separately status. By using the married filing separately status, the taxpayer had an ASFR liability that would have been lessened or possibly eliminated if the IRS used the MFJ filing status.

**EXAMPLE 2:** Taxpayer did not file a return for tax year 2014. For the past five years preceding 2014, the taxpayer has taken the mortgage interest deduction. By claiming this deduction, the taxpayer had a minimal tax liability. The IRS made an ASFR assessment on the 2014 return and did not include the mortgage interest deduction, even though the IRS has this information. As a result, the IRS assessed a liability that exceeded the minimal amount had the IRS considered the mortgage interest deduction.

**EXAMPLE 3:** Taxpayer failed to file his 2014 tax return. For the past three years, taxpayer claimed the maximum amount allowed for the education deduction for those years. As a result, taxpayer typically received a refund ranging from \$250 to \$500. The IRS made an ASFR assessment for 2014 and did not consider the education deduction, even though it has that information available to it. As a result, taxpayer was assessed an ASFR liability that would have been eliminated if the IRS considered information available on third-party information reports.<sup>28</sup>

The examples above illustrate that if the IRS had considered the taxpayer's prior filing status history, or third-party documentation that support credits or deductions, it might have decided to not include the case in the ASFR program. Not only would this strike a fairer balance in the ASFR program, thereby upholding a taxpayer's *right to a fair and just tax system*, it would also prevent the IRS from using resources to conduct an ASFR assessment on an account that would likely result in abatement if the taxpayer contacted the IRS and submitted documentation substantiating deductions and credits.

Although the IRS may ultimately decide that the case should not be included in the ASFR program after considering third-party documentation, it could instead send the taxpayer a letter saying, "We have information that you may be able to claim a tax credit and we haven't received your return. Please file." This might bring in the return without doing an unproductive ASFR. This approach promotes the taxpayer's obligation to timely file a return without producing an incorrect assessment that requires abatement.

<sup>28</sup> See IRS Form 1098-T *Tuition Statement*. "You, or the person who can claim you as a dependent, may be able to claim an education credit on Form 1040 or Form 1040A."



### Narrowing the Field of ASFR Cases Will Improve Case Resolution

If the IRS reduced the number of ASFR cases by using additional third-party documentation, it could focus on the remaining ASFR cases and attempt to actually contact the taxpayer. More specifically, IRS employees could first send out a soft notice that provides information about the ASFR and how to contact the IRS. This notice could inform taxpayers of the amount the IRS believes the taxpayer owes but also acknowledges that the enclosed list of third-party documentation shows the taxpayer may be entitled to certain deductions and credits.

Currently, the IRS does not disclose in its notice that it possesses any third-party information indicating that the taxpayer might qualify for additional deductions or credits, much less share them to assist the taxpayer with preparing a return.

If the IRS does not hear back from the taxpayer in a specified period of time, an IRS employee would attempt a phone call to reach this taxpayer and discuss avenues for resolution, including collection alternatives. Going this extra step with a smaller batch of ASFR cases — chosen through refined selection criteria — would ensure that the taxpayer's failure to respond was not due to an undelivered notice.<sup>29</sup> This approach will improve case resolution by focusing on a smaller number of cases and adding the element of in-person contact with taxpayers. It will also reduce rework and use the IRS's most expensive touches (phone calls and actual proposed assessment letters) with a much smaller pool of potentially delinquent taxpayers.

## CONCLUSION

It is critical that the IRS designs its programs and its interactions with the public to encourage voluntary filing. The IRS designed the ASFR program to motivate taxpayers who had not filed a return, but had a requirement to do so, to contact the IRS and file such a return. However, as discussed above, the ASFR program largely fails to drive such behavior. Further, enforced collection actions are harming taxpayers and tying up IRS's own resources with unproductive cases where after applying exemptions, deductions and credits, information about which the IRS has in its possession through third-party reporting, the liability would be reduced to zero. The taxpayers would be better served if the IRS used selection criteria that considered additional third-party documentation in calculating a taxpayer's liability. This would ensure that the ASFR cases were worthy of IRS resources.

## RECOMMENDATIONS

The National Taxpayer Advocate recommends that the IRS:

1. Review annually where ASFR assessments have had the most success in getting taxpayers to file an original return and adjust the ASFR selection process to focus on similar types of cases.
2. Refine ASFR abatement reason codes, making them more specific, so the IRS can use this information when determining if a case should be selected for the ASFR program.
3. When selecting cases for ASFR, consider third-party documentation that supports exemptions, deductions, and credits before making ASFR assessments.

<sup>29</sup> National Taxpayer Advocate 2010 Annual Report to Congress 21.