

TAS Research Initiatives

The National Taxpayer Advocate is a strong proponent for the role of theoretical, cognitive, and applied research in effective tax administration. The Office of the Taxpayer Advocate is currently conducting a number of new and continuing research initiatives. A primary focus of TAS research initiatives is to better understand taxpayer compliance behavior and to evaluate IRS programs by balancing the goals of taxpayer compliance with minimizing taxpayer burden.

Following is a discussion of several research initiatives TAS will begin or continue to conduct for the remainder of fiscal year (FY) 2017 and FY 2018.

EFFECTIVENESS OF THE IRS OFFER IN COMPROMISE (OIC) PROGRAM

TAS Research is conducting a study to evaluate the effectiveness of the IRS Offer in Compromise (OIC) program. The IRS conducted an OIC study over a decade ago that examined the frequency of taxpayers submitting multiple offers within a short period of time, the future compliance of taxpayers with accepted offers, and a comparison of the dollars collected when an OIC was rejected or returned versus dollars collected through other collection methods.¹ Similar to the previous study, TAS will:

- Quantify the number of taxpayers who have submitted multiple OICs in a short amount of time;
- Examine the subsequent filing and payment compliance for the next five years after the IRS accepts a taxpayer's OIC;
- Determine if subsequent compliance continues beyond the five years required as part of the accepted OIC agreement;
- Compare the amount the IRS could have collected on a rejected or returned² OIC to the amount actually collected subsequently; and
- Determine if the IRS estimation of the reasonable collection potential on liabilities of rejected offers is actually realized.

The TAS OIC study will particularly focus on dollars collected from taxpayers with rejected or returned OICs versus what the IRS could have collected if it had accepted the offers from the taxpayers. TAS will evaluate whether the IRS left money on the table when it rejected or returned a taxpayer's offer in favor of pursuing other collection methods such as refund offsets, voluntary payments, or levies. We anticipate beginning this study in FY 2017 and completing it in FY 2018.

TRUST IN THE IRS AND THE EFFECT ON VOLUNTARY COMPLIANCE

A previous TAS Research study showed that trust in government has a significant impact on the compliance of taxpayers whose Schedule C returns were audited by the IRS.³ The current TAS study hopes to validate that trust in the IRS, as well as taxpayers' perceptions of legitimacy or coerciveness of the IRS powers to enforce compliance, affect taxpayers' accurate voluntary reporting of income and expenses.

1 IRS, *Offer in Compromise Program: An Analysis of Various Aspects of the OIC Program* (Sept. 2004).

2 Last year, the IRS implemented new procedures, which require an offer to be returned as unprocessable if research shows the taxpayer has unfiled returns. IRS, *Internal Guidance Memorandum (IGM)* (Apr. 13, 2016). Previously, the IRS worked with the taxpayer to secure any unfiled returns, so that the OIC could still be considered.

3 National Taxpayer Advocate 2012 Annual Report to Congress vol. 2 (Research Study: *Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results*).

During FY 2017, TAS worked with a contractor to develop a survey document, which TAS Research tested at the IRS Ogden Developmental Center by simulating an actual telephone survey. Based on watching the test respondents' reactions to questions, an analysis of their responses, and a debriefing session, we adjusted the survey to ensure that respondents interpreted the questions as intended. The contractor has reviewed the revised survey instrument and made final adjustments to the questions. TAS has received approval from the Office of Management and Budget to begin the data collection.

TAS Research is currently determining the exact sampling frame. The initial sample groups will consist of taxpayers filing Schedule C who were audited and who have continued to file a Schedule C after the audit. These groups will be divided by whether the audit was conducted by a correspondence audit, an office audit, or field audit, as well as by whether the audit outcome showed an increase in tax, a decrease in tax, or no change in tax. We will pair these various groups with a control group of similar taxpayers who were not audited. We will compare the survey responses of both groups, in addition to their subsequent compliance as measured by their Discriminate Income Function score.

We plan to administer the survey at the end of FY 2017 and the beginning of FY 2018. We will analyze the results and publish a study of our findings during FY 2018.

SERVICE PRIORITIES PROJECT

As noted last year, TAS and the Wage & Investment (W&I) Division are developing a ranking methodology for the major taxpayer service activities offered by W&I in response to the National Taxpayer Advocate's concerns that cuts to the IRS's budget in FYs 2010–2015, and the IRS's response to those cuts, have resulted in unacceptable taxpayer service for taxpayers. This methodology will balance taxpayer needs and preferences against the IRS's need to effectively use limited resources, enabling the IRS to make resource allocation decisions that will optimize the delivery of taxpayer services given resource constraints. Congress will also be able to use the results of this methodology to determine whether it is adequately funding core taxpayer service activities. However, limitations imposed by the lack of available data continue to delay implementation.

In early 2016, TAS procured contractor services to address these data needs. TAS worked with the contractor to develop and administer a telephone-based survey that will expand on the data collected in prior W&I surveys. However, data collection difficulties resulted in delayed data delivery and revised goals. The project team will need to update the data included from internal sources and add the data collected from the survey currently underway. TAS's revised goal is to complete survey administration by the end of June 2017, update the data, and complete the ranking of the major W&I taxpayer services by the end of FY 2018.

EFFECT OF OUTREACH AND EDUCATION ON TAX COMPLIANCE

TAS is engaged in several studies exploring the impact of a variety of factors on taxpayer compliance behavior. In a previous phase of the study, TAS found that compliance norms and trust in government were the principal factors that appear to influence sole proprietor taxpayers' compliance behavior.⁴

⁴ TAS employed factor analysis and logistic regression to analyze the results of a national survey of taxpayers with sole proprietor income (*i.e.*, Schedule C, *Profit or Loss from Business (Sole Proprietorship)*). See National Taxpayer Advocate 2013 Annual Report to Congress vol. 2, 33 (*Small Business Compliance: Further Analysis of Influential Factors*). See also National Taxpayer Advocate 2012 Annual Report to Congress vol. 2, 1 (*Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results*).

In this study, TAS will explore whether outreach and education can favorably influence compliance norms and trust in the IRS, resulting in improved taxpayer compliance.⁵ TAS has contracted with independent researchers to collaborate with TAS to design the study, analyze the results, and produce a final report evaluating the results in detail, discussing their implications for tax administration, and recommending new IRS outreach and education initiatives.

The team of independent researchers has completed an initial proposed study design that involves testing different types of outreach to taxpayers with outstanding tax liabilities whose cases are in the collection queue awaiting assignment. TAS is currently reviewing the proposed study design. Subsequent to agreeing on a sample design, we will begin to extract the sample data. We hope to agree on the sampling frame during FY 2017, with the actual testing of the collection notices conducted in FY 2018.

ALLOWABLE LIVING EXPENSE (ALE) STANDARDS

The IRS developed the allowable living expenses (ALEs) in 1995 to establish consistency in the application of expense allowances, such as food expenses, household expenses, medical expenses, housing expenses, and transportation expenses, in determining monies that taxpayers will have available to meet their U.S. tax liabilities.⁶ The IRS updates the expense amounts annually.

The IRS states that ALEs should allow taxpayers to provide for the taxpayer and his or her family's health, welfare, and production of income. Defining ALE from this starting point⁷ will allow for a structure that accommodates taxpayer needs. TAS will collaborate with the IRS to work on a new ALE methodology, which bases allowable expenses on needs, as opposed to expenditures. The development of new standards will not be an easy undertaking, as data sources are limited. Ultimately, the IRS may need to collaborate with other federal agencies to develop new sources of data. Although this research is expected to begin in FY 2017, it will continue throughout FY 2018. In the meantime, TAS will initiate a separate study also expected to continue into early FY 2018, which will examine the following items:

- Incidence rate of taxpayers submitting expenses in excess of the ALE standard, the types of expenses submitted, and whether the actual expense is allowed; and
- Incidence of taxpayers claiming specific items currently not included as a part of the ALE standards (including child care expenses, retirement, education, internet access, and basic recreation items) and whether the IRS has allowed these expenses.

TAS is currently reviewing and refining its methodologies to begin both the long-term and short-term ALE studies. TAS intends to work these projects in collaboration with IRS Collection personnel.

STUDY OF CASES REQUIRING REWORK

The IRS spends considerable resources to rework a variety of its cases. A prior study published by the National Taxpayer Advocate showed that Earned Income Tax Credit (EITC) audits were often appealed to the United States Tax Court even though the IRS should have been able to ascertain the appropriate facts

5 The phase 2 study found that all three components of trust in government studied, *i.e.*, trust in the federal government, the tax laws and the IRS appear to influence compliance behavior. TAS is focusing solely on trust in the IRS, since TAS believes that the IRS can take actions to directly influence this component.

6 Small Business/Self-Employed (SB/SE), *2015 Allowable Living Expenses Project* (Sept. 2015).

7 Internal Revenue Manual (IRM) 5.15.1.7, *Allowable Expense Overview* (Oct. 2, 2012).

and agree on the case outcome with the taxpayer at the audit stage.⁸ Specifically, TAS reviewed a sample of 256 fully-conceded EITC Tax Court cases. Some findings from this study included:

- Taxpayers or their representatives spoke to an IRS employee by telephone in 216 of the 256 cases, or 84 percent of the time;
- Taxpayers spoke to the IRS before filing their Tax Court petitions in 162 of the 256 cases, or 63 percent of the time; and
- These 162 taxpayers continued to communicate, speaking to the IRS about five times on average.

Taxpayers were unable to resolve these cases administratively, and they thus petitioned the U.S. Tax Court, requiring expensive IRS administrative and legal resources.

During FY 2018, TAS will select an IRS workload to analyze the amount of rework or other unnecessary downstream consequences occurring in that work stream. TAS may select Collection Due Process Cases for review. In many instances, the taxpayer must exercise his or her appeal rights prior to any case development on the part of the IRS. As a result, the Appeals Officer must either collect the initial facts or return the case to Collection for case development before continuing the hearing. Accordingly, the IRS will use more expensive resources to resolve a case that could have been resolved at a much lower level, without even requiring an appeal. In many other instances, the IRS has the information to make an appropriate determination; however, Collection personnel are often reluctant to be responsible for the decision, even though it is supported by the facts, thereby requiring Appeals to rework the case.

KINK POINTS IN THE APPLICATION OF THE FAILURE TO DEPOSIT PENALTY

Prior research has found that taxpayers exhibit reporting behavior that prevents their income from rising to the next highest tax bracket if their income is approaching the limit. That is, taxpayers report only up to the level that keeps them in their current tax bracket. Researchers have observed this phenomenon at the lowest marginal tax rate. Similar behavior exists in the claiming of the EITC, where taxpayers claim income near or at the level that maximizes their credit. An analysis of this type looks for “kink” points where taxpayers tend to cluster. TAS is applying this “kink” analysis to the application of the failure to deposit (FTD) penalty for employment taxes. To avoid penalties, taxpayers must make their deposits in the proper amount, on time, and in the right manner. Taxpayers that fail to do so are subject to a four-tier FTD penalty:

- Two percent if the correct deposit is one to five days late;
- Five percent if the correct deposit is six to 15 days late;
- Ten percent if the correct deposit is more than 15 days late; and
- Fifteen percent if the correct deposit is not paid on or before the earlier of ten days after the first notice of delinquency or the day on which notice and demand is given for immediate payment.

TAS research is recreating the computation of the FTD penalty to determine if taxpayers cluster around the kink points in the penalty structure for untimely tax deposits. Specifically, we are looking at FTD penalties assessed in calendar year 2016 to determine if taxpayers tend to make deposits shortly before the number of days at which the penalty increases.

8 See National Taxpayer Advocate 2012 Annual Report to Congress vol. 2, 72-104.

Similar to EITC, civil tax penalties provide a financial incentive to engage in certain behavior. Certain penalties have kink points where the marginal penalty rate increases. If taxpayers' compliance behavior is motivated by penalties, as assumed by the simple deterrence model of tax compliance, we would expect to see bunching around these kink points. If we do not see bunching, then we may be able to conclude that the penalty – or at least the marginal increase in the penalty rate at a particular kink point – does not affect behavior. These findings may become important considerations as policy makers reform existing penalty structures or implement new ones.

USE OF TAS SERVICES

TAS plans to conduct a study to estimate how many taxpayers qualify for but do not use TAS services. This study will help us quantify potential service demands and better understand the underserved taxpayer population and how to reach and communicate with this audience. The study will focus on existing branding and avenues such as mobile and social media trends. This information will expand TAS's understanding of its constituent base and help guide future priorities and decisions for the organization. The analysis will allow TAS to identify trends, where possible. Efforts may include a telephone survey, focus group interviews, and a marketing analysis, which identifies social behaviors, defines attitudes of population segments, and other related information.

This research will help gauge the need for TAS services in various market segments and whether these market segments are currently underserved by TAS. We will use the survey results to ascertain the percentage of taxpayers in these market segments who experienced a problem with the IRS within the past two years and the proportion of these taxpayers who were aware of TAS services. The results of this effort will update prior research on TAS awareness and allow TAS to use the updated information as a reference point in designing, conducting, and measuring the effectiveness of its future outreach efforts. This effort will begin in FY 2017 and be completed in FY 2018.

FOCUS FOR FISCAL YEAR 2018

In Fiscal Year 2018, TAS will:

- Update the previous IRS OIC study with a focus on the effectiveness of collection after the IRS rejects a taxpayer's offer. We will analyze the dollars the IRS could have collected if it accepted the initial offer versus what the IRS ultimately collected from the taxpayer;
- Administer and analyze the results of a TAS survey on trust in the IRS. We will survey taxpayers who were audited and taxpayers with similar profiles who were not audited and compare the attitudes of the two groups toward the IRS. We will also compare the future compliance of both groups of taxpayers;
- In a continuation of efforts to populate the data for the Service Priorities Project, analyze telephone survey data to fill in data gaps, and work with W&I to update the existing operational data. These updates will allow TAS to update and implement the ranking tool of W&I taxpayer services;
- Build upon prior work in the arena of compliance among sole proprietor communities. Previous research found that social norms heavily influenced compliance behavior in these communities. TAS will explore the effects of outreach and education activities on compliance in these groups;
- Begin work on both long- and short-term ALE studies. The long-term study will be in collaboration with the IRS to develop a new ALE methodology. The short-term study will focus on gaps in the current ALEs and areas where taxpayers submit expenses in excess of the ALEs;

- Analyze a subset of the IRS workload to determine the amount of rework conducted in the selected work stream. TAS may look at the Collection Due Process work stream;
- Analyze the behavior of taxpayers who are assessed the FTD penalty to see if taxpayers are motivated to submit their Federal Tax Deposits just before the FTD penalty will increase to the next level. Information about the ability of penalties to change or deter certain behavior may assist in the development of future tax penalties; and
- Engage in research to identify the population of taxpayers who qualify for TAS assistance but do not use TAS. TAS will use this information to better reach underserved populations and to refine our communication methods going forward.