

## V. 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 conducting and also collaborating with the IRS on a number of research initiatives. A primary focus of these efforts is to explore approaches impacting taxpayers' willingness and ability to comply while also minimizing taxpayer burden.

Following is a discussion of the research initiatives TAS is conducting or participating in for the remainder of fiscal year (FY) 2015 and during FY 2016.

### Impact of Taxpayer Advocate Service Assistance on Compliance

The IRS's budget has been reduced by about 17 percent in inflation-adjusted terms since FY 2010.<sup>1</sup> These cuts, along with certain IRS resource allocation decisions, have significantly eroded the quality of taxpayer service, resulting in unacceptably low service levels in FY 2015. For example, for the first four months of the 2015 filing season, the level of service (LOS) on the IRS's toll-free customer service lines was 37.3 percent, down from the already low 70.9 percent for the same period in FY 2014. Among taxpayers who got through, hold time was 22.9 minutes.<sup>2</sup>

The measures stakeholders and the IRS often apply to the IRS are exacerbating declining funding, because the measures do not acknowledge the importance of delivering service. Invariably, the focus is on reducing the tax gap through enforcement efforts, or improving efficiency as measured by return on investment (ROI). Because measuring the impact of service on compliance (*i.e.*, the ROI of IRS services) is difficult, the IRS currently does not provide detailed ROI calculations to support taxpayer service funding requests.

The National Taxpayer Advocate believes quality taxpayer service is a fundamental taxpayer right, and Congress should fund taxpayer services at a level that enables the IRS to provide the quality service taxpayers need to comply with their tax obligations.<sup>3</sup> In an attempt to justify taxpayer service investments in the context of its return on investment (ROI), in recent years TAS Research has studied whether taxpayer service, among other factors, impacts taxpayer compliance behavior.<sup>4</sup> The study results show taxpayer attitudes about the IRS, and in particular IRS services, are among the most important factors influencing

- 1 In FY 2010, the agency's appropriated budget stood at \$12.1 billion. In FY 2015, its budget was set at \$10.9 billion, a reduction of about 9.9 percent. Inflation over the same period is estimated at about 9.4 percent. Adjusting for the interactive effects of these cuts and the impact of the federal pay freeze, we estimate the inflation-adjusted reduction in funding was about 17 percent.
- 2 IRS, Joint Operations Center, *Snapshot Reports: Enterprise Snapshot* (for Accounts Management lines as of week ending April 18, 2015). See also *Review of the 2015 Filing Season*, *supra*.
- 3 See *Internal Revenue Oversight: Hearing Before the H. Comm. on Appropriations Sub. Comm. on Financial Services and General Government*, 113th Cong. (2014) (statement of Nina E. Olson, National Taxpayer Advocate). See also, *Progress on the Implementation of the Taxpayer Assistance Blueprint: Five-Year Progress Report: FY 2008-FY 2012* 45-47 (Apr. 22, 2013). Several Appropriations acts in recent years have given the IRS more funding by using a mechanism known as a "program integrity cap adjustment." A determination must be made, however, that the proposed additional expenditures will generate an ROI of greater than 1:1 (*i.e.*, the additional expenditures will increase federal revenue on a net basis).
- 4 See National Taxpayer Advocate 2013 Annual Report to Congress vol. 2, 33 (Research Study: *Small Business Compliance: Further Analysis of Influential Factors*). See also National Taxpayer Advocate 2012 Annual Report to Congress vol. 2, 1 (Research Study: *Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results*).

the compliance behavior of taxpayers with individual business income.<sup>5</sup> In FY 2016, TAS will conduct additional research to explore the impact of service on compliance.

TAS Research will develop a representative sample of taxpayers who sought TAS help with collection and examination related issues in FY 2009. We will measure their subsequent filing, payment, and reporting compliance during the next five years, and compare the resulting compliance rates to those of a control group built from a random sample of taxpayers with the same issues who did not use TAS services. We will use the comparison of the two groups' compliance rates to estimate the value of quality services to future taxpayer compliance. Our target to complete this research is the end of September 2016.

### Impact of Audits on Taxpayer Compliance

TAS Research is conducting a multi-year study to identify the major factors that drive taxpayer compliance behavior. Previously, we analyzed the results of a telephone survey, conducted by a vendor, using a representative national sample of taxpayers with sole proprietor income (*i.e.*, Schedule C, *Profit or Loss from Business (Sole Proprietorship)*).<sup>6</sup> One of the significant findings is trust in government, the tax laws, and the IRS is associated with the level of taxpayer compliance. However, TAS found no significant evidence economic deterrence (*i.e.*, the expected likelihood and cost of getting caught cheating) motivates sole proprietor compliance decisions.<sup>7</sup>

In the current phase of our study, TAS is exploring whether economic deterrence impacts sole proprietor tax compliance. Specifically, we are evaluating the impact of audits on the subsequent reporting compliance of sole proprietors. The IRS generally conducts audits to detect non-compliance by sole proprietors, since much of their income is not subject to third-party information reporting and cannot be detected by document matching. TAS published preliminary study results in Volume 2

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<sup>5</sup> See National Taxpayer Advocate 2013 Annual Report to Congress vol. 2, 41-43 (Research Study: *Small Business Compliance: Further Analysis of Influential Factors*). Statistics show underreporting of individual business income represents the largest portion of the tax gap (*i.e.*, taxes not voluntarily and timely paid). Individual business income includes income from sole proprietorships, farms, and pass-through income on Schedule E (Supplemental Income and Loss). Schedule E income includes income from partnerships, S-corporations, rents and royalties, and estates and trusts. See IR-2012-4, *IRS Releases New Tax Gap Estimates; Compliance Rates Remain Statistically Unchanged From Previous Study* (Jan. 6, 2012), available at <http://www.irs.gov/uac/IRS-Releases-New-Tax-Gap-Estimates;-Compliance-Rates-Remain-Statistically-Unchanged-From-Previous-Study>.

<sup>6</sup> The vendor also administered the survey to a sample of high and low compliance communities. Inclusion of the community sample enabled TAS to better evaluate whether sole proprietor taxpayers' affiliations within their communities appear to influence compliance behavior.

<sup>7</sup> See National Taxpayer Advocate 2013 Annual Report to Congress vol. 2, 33-56 (Research Study: *Small Business Compliance: Further Analysis of Influential Factors*). See also National Taxpayer Advocate 2012 Annual Report to Congress vol. 2, 1-70 (Research Study: *Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results*). Statistics show underreporting of individual business income represents the largest portion of the tax gap (*i.e.*, taxes not voluntarily and timely paid). See IR-2012-4, *IRS Releases New Tax Gap Estimates; Compliance Rates Remain Statistically Unchanged From Previous Study* (Jan. 6, 2012), available at <http://www.irs.gov/uac/IRS-Releases-New-Tax-Gap-Estimates;-Compliance-Rates-Remain-Statistically-Unchanged-From-Previous-Study>.

of the National Taxpayer Advocate's 2014 Annual Report to Congress.<sup>8</sup> These results suggest, overall, IRS audits have a modest but short-lived direct deterrent effect.<sup>9</sup>

Throughout 2015, TAS Research will work with independent researchers to further study the impact of audits on taxpayer compliance behavior. We expect to explore:

- Refinement of the control group, *i.e.*, the population of sole proprietor taxpayers with high Discriminant Index Function (DIF) scores who were not audited in 2007, by removing those audited in the years immediately before 2007 (the beginning of the study period) or during the study period;
- Study of whether the classification process that determines the type of audit, *i.e.*, correspondence, office, or field audit, introduced a selection bias we should address with refinements to our analysis of the subsequent reporting compliance behavior of the taxpayers in these audit groups;
- Possible explanations for the significant decline in both the treatment and control groups' DIF scores in the year following the audit;
- A more detailed analysis of the impact of multiple audits that considers both the number and timing of the audits with respect to the audit closed in 2007; and
- Alternative methodologies, such as panel regression, that would enable the addition of control variables (*e.g.*, demographic variables such as type of business, gender and age, prior audit experience) to better isolate and distinguish the impact of the audit from other potential factors.

We anticipate publishing the results of this collaborative effort by the end of 2015. We will also work with these researchers throughout 2015 and 2016 on a new study evaluating the impact of outreach and education on taxpayer compliance behavior (as discussed below).

### Impact of Outreach and Education on Tax Compliance

As discussed above, TAS is engaged in a multi-year study of a variety of factors on taxpayer compliance behavior. In the second phase, TAS found compliance norms and trust in government were the principal factors that appear to influence sole proprietor taxpayers' compliance behavior.<sup>10</sup> In the current study, TAS will explore whether outreach and education can favorably influence compliance norms and trust

8 See National Taxpayer Advocate 2014 Annual Report to Congress vol. 2, 27-42 (Research Study: *Estimating the Impact of Audits on the Subsequent Reporting Compliance of Small Business Taxpayers: Preliminary Results*).

9 Our results show a seven percent improvement in reporting compliance in the year following conclusion of the audit. This initial improvement diminishes in subsequent years, disappearing all together by year five. It should be noted that our study did not explore the indirect "ripple" effect audits have on compliance, *i.e.*, how taxpayers who were not audited are influenced by their awareness of the audits the IRS conducted on other taxpayers. Prior research suggests examinations may have an indirect "ripple" effect on compliance that is greater than the direct revenue produced by examinations, although this probably depends on the quality of the audit as low quality audits might decrease compliance. See, *e.g.*, Alan H. Plumley, *The Determinants of Individual Income Tax Compliance: Estimating The Impacts of Tax Policy, Enforcement, and IRS Responsiveness*, Publication 1916 (Rev. 11-96), Washington, DC, 2 (noting the importance of the "indirect effect," which includes the "ripple effect" of enforcement activities on other taxpayers as well as the "subsequent-year" effect on examined taxpayers). See also, Karyl A. Kinsey, *Deterrence and Alienation Effects of IRS Enforcement: An Analysis of Survey Data, WHY PEOPLE PAY TAXES*, 259, 276 (Joel Slemrod ed., 1992); American Bar Association Commission on Taxpayer Compliance, *Report and Recommendations on Taxpayer Compliance*, 41 *Tax Law*, 329, 364-365 (1988) (suggesting that low quality audits may be as bad or worse for compliance than no audit at all).

10 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 (Research Study: *Small Business Compliance: Further Analysis of Influential Factors*). See also National Taxpayer Advocate 2012 Annual Report to Congress vol. 2, 1 (Research Study: *Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results*).

in the IRS, resulting in improved taxpayer compliance.<sup>11</sup> In particular, the study will focus on whether taxpayer awareness and education of their right and ability to resolve various issues, and the protections afforded them during that process, can influence their trust in the IRS and their compliance behavior. TAS believes this issue is highly important, since the National Taxpayer Advocate has long urged the IRS to adopt a taxpayer bill of rights, which the IRS has done.<sup>12</sup>

TAS has contracted with independent researchers to help design the study, analyze the results, and produce a final report evaluating the results in detail, discussing the implications for tax administration, and recommending new IRS outreach and education initiatives. We anticipate the study will take two years to complete. In FY 2015, TAS will collaborate with the independent researchers to complete the study design. In FY 2016, TAS will conduct the study and collaborate with the independent researchers to prepare the final report.

TAS is also independently developing a study to evaluate the compliance impact of outreach on potentially noncompliant Earned Income Tax Credit (EITC) taxpayers. In this study, we will identify taxpayers who were not audited in 2015, but who had similar risk scores to taxpayers who were audited.<sup>13</sup> We will then draw two representative samples from this population to create separate control and test groups. Next, we will develop letters highlighting potential noncompliance concerns and send them to the test group of taxpayers at the beginning of the 2016 filing season.

Subsequently, we will estimate the compliance of each of the above groups (*i.e.*, the test group, the control group, and the group composed of taxpayers audited in 2015) using their 2016 dependent database (DDb)<sup>14</sup> risk scores and compare them to estimate the impact of our outreach letters relative to audits and no treatment at all. We anticipate completing this research by the end of December 2016.

### Taxpayer Delinquent Account Collectability Curve

TAS Research is quantifying how the aging of a delinquency affects dollars collected on Taxpayer Delinquent Accounts (TDAs). In past Annual Reports to Congress, the National Taxpayer Advocate noted many of the TDAs in the IRS Automated Collection Service (ACS) and the Collection Field function (Cff) have existed for several years. The following statistics highlight the age of the IRS TDA inventory:<sup>15</sup>

- Overall, 53 percent of the IRS Individual Master File (IMF) TDA inventory has been in the function assigned the delinquency for at least ten months (the delinquency may have been in TDA status much longer);

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11 The phase 2 study found 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. We are focusing solely on trust in the IRS, since we believe IRS can take actions to directly influence this component.

12 Internal Revenue Service, News Release IR-2014-72, *IRS Adopts "Taxpayer Bill of Rights;" 10 Provisions to be Highlighted on IRS.gov*, in *Publication 1* (June 10, 2014), available at <http://www.irs.gov/uac/Newsroom/IRS-Adopts-Taxpayer-Bill-of-Rights;-10-Provisions-to-be-Highlighted-on-IRSgov,-in-Publication-1>.

13 The IRS selects EITC returns for audit using a rule-based risk scoring algorithm that analyzes the dependents database (DDb), which contains relationship and residency information on taxpayers' dependents. We will use the DDb scores to identify non-audited taxpayers with high risk scores.

14 IRM 4.19.27.2.3, *Dependent Database* (Mar. 19, 2015).

15 IRS, *Collection Activity Report 5000-2*, (Oct. 3, 2014).

- Over 70 percent of the IMF TDAs in IRS inventory at the end of 2014 are tax year 2010 and prior liabilities; and
- Over 20 percent of the TDAs have less than four years remaining on the collection statute, meaning the delinquency has existed for over six years.

Throughout 2015, TAS Research will examine the IMF Accounts Receivable Dollar Inventory (ARDI) to determine how dollars collected fluctuate as time elapses. TAS Research plans to explore the dollars collected during the entire ten-year collection statute. We will also differentiate between dollars collected from refund offsets and other subsequent payments. Additional analyses may include differences that exist in collection trends as the underlying nature of the liability varies (*e.g.*, type of income tax liability, Trust Fund Recovery Penalty, liabilities stemming from additional assessments, size of the liability). We may also expand the analysis to Business Master File delinquencies.

This research is of particular importance in today's tight budgetary environment, since budgetary constraints will make the efficient and effective collection of delinquencies paramount. Good information on the time available to effectively collect various delinquencies will assist the IRS in determining what liabilities to collect first and whether it makes sense to defer the collection of smaller, more current liabilities in favor of older, larger ones. Furthermore, this research may yield insights into which delinquencies should be placed in the Collection TDA queue and which should be shelved. We anticipate completing this research by the end of December, 2015.

### Service Priorities Project

The National Taxpayer Advocate is concerned the ongoing cuts to the IRS's budget in FYs 2010-2015<sup>16</sup> have resulted in unacceptable taxpayer service. In response to these concerns, TAS and the Wage & Investment (W&I) division are developing a ranking methodology for the major taxpayer service activities offered by W&I. The new methodology will take taxpayer needs and preferences into account while balancing them against the IRS's need to effectively utilize limited resources, enabling the IRS to make resource allocation decisions that will optimize the delivery of taxpayer services given resource constraints.<sup>17</sup> Congress can 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 have delayed implementation.

The project team identified a number of "data gaps" while attempting a trial ranking, using a prototype ranking tool and available data. Recently available tax year 2013 data can fill some of these "data gaps," but other gaps remain. TAS Research and W&I Research have agreed to conduct another trial ranking using the newly available 2013 data. We anticipate completing this ranking in by the end of September, 2015. By the end of 2015, the team will identify all remaining data needs and develop a plan to meet them. Throughout 2016, TAS will implement the plan and collect the data needed to fill the remaining data gaps. To this end, TAS has initiated a procurement to obtain contractor services to develop and administer a telephone-based survey that will expand on the data collected in prior W&I surveys. Our goal is to complete survey administration in the final quarter of FY 2016.

16 In FY 2010, the agency's appropriated budget stood at \$12.1 billion. In FY 2015, its budget was set at \$10.9 billion, a reduction of about 9.9 percent. Inflation over the same period is estimated at about 9.4 percent. Adjusting for the interactive effects of these cuts and the impact of the federal pay freeze, we estimate the inflation-adjusted reduction in funding was about 17 percent.

17 We use the word "optimize" to mean 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.

## FOCUS FOR FISCAL YEAR 2016

- TAS will analyze data for taxpayers who had examination and collection issues for two groups of taxpayers – those who sought TAS assistance and those who did not. We will assess their filing, payment, and reporting compliance in the subsequent five years to determine if we can estimate the value of quality services on future taxpayer compliance;
- In a continuation of ongoing work, TAS will collaborate with independent researchers on a study evaluating the impact of audits on taxpayer compliance;
- TAS will complete a study on whether taxpayer awareness and education of their rights and ability to resolve various issues can influence their trust in the IRS and their compliance behavior;
- TAS will examine the IMF ARDI to determine how dollars collected fluctuate as time elapses to determine what should be collected first – current, smaller liabilities or older, larger liabilities; and
- TAS Research will continue working with W&I Research to develop a ranking method for the major taxpayer service activities offered by W&I in order to better determine how to allocate limited resources.