

RESEARCH PROSPECTUS:
WHEN DO ACCURACY-RELATED
PENALTIES IMPROVE FUTURE
REPORTING COMPLIANCE BY
SCHEDULE C FILERS?

Research Prospectus: When Do Accuracy-Related Penalties Improve Future Reporting Compliance by Schedule C Filers?

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EXECUTIVE SUMMARY

The National Taxpayer Advocate and other stakeholders have long urged the IRS to research the effect of penalties on voluntary compliance. Given the large number of penalties, the likelihood that each one may affect different taxpayer groups in different ways, and IRS data limitations, TAS will focus on the taxpayers and penalties that could have the greatest impact on the tax gap: accuracy-related penalties applied to Schedule C filers.

One objective of this study is to determine if an accuracy-related penalty assessment improves reporting compliance by the taxpayer in the future.¹ In light of the IRS's increasing use of automated processes to assess penalties before communicating with the taxpayer, this study will also try to measure the effect of "default" penalty assessments, those appealed by the taxpayer (*i.e.*, through an audit reconsideration or the IRS Appeals function), and those that the IRS ultimately abates.

INTRODUCTION

Stakeholders have long urged the IRS to research the effect of penalties on voluntary compliance and the tax gap. According to Congress and the IRS, civil tax penalties should be used to enhance voluntary compliance with the Internal Revenue Code (IRC).² 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.³

As early as 1989, Congress recommended that the IRS "develop better information concerning the administration and effects of penalties."⁴ 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"⁵

¹ Penalties may affect the future compliance of both the taxpayer in question and other taxpayers who learn about them. However, it is difficult to measure the effect of a penalty on other taxpayers, in part, because it is difficult to identify which other taxpayers are affected by the penalty.

² 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).

³ See *IRS Task Force Report I* at 9-10.

⁴ H.R. Rep. No. 101-386, at 661 (1989) (Conf. Rep.).

⁵ Policy Statement 20-1 (June 29, 2004).

Similarly, IRS researchers have observed the need to examine the effect of IRS enforcement actions on compliance as follows:

IRS enforcement programs identify and collect some of the tax gap directly from the taxpayers they contact. That *direct effect* is observed and known. What we need to estimate is the extent to which those contacts (and even non-enforcement contacts) indirectly influence the voluntary compliance of the general population—both the subsequent compliance of those contacted, and the compliance of those who were not contacted. The mechanism of this *indirect effect* could be deterrence (*e.g.*, changing the public’s perceptions of the certainty, severity, and celerity of getting caught in noncompliance), but it could also involve education (clearing up misunderstandings) or shaping attitudes (*e.g.*, changing the public’s perceptions of the extent to which the law is applied and enforced fairly). Very few empirical studies have attempted to estimate the magnitude of these indirect effects....⁶

Observing that the IRS lacked any significant analysis or research concerning accuracy-related penalties, the National Taxpayer Advocate and others recommended that the IRS study the effect of penalties on voluntary compliance.⁷ Accordingly, TAS plans to initiate research in this area.

DISCUSSION

Underreported small business income represents the largest portion of the tax gap.

According to the IRS’s most recent estimate, the gross tax gap — the difference between the taxes people owe and the amount they timely pay — stood at \$450 billion in 2006.⁸ The largest portion of the tax gap is due to underreporting of business income by individuals (\$122 billion) (*i.e.*, self-employed individuals).⁹ Another significant amount is attributable to underreported self-employment tax (\$57 billion).¹⁰ Because underreporting by unincorporated businesses represents the largest portion of the tax gap, it is important to understand how so-called “accuracy-related” penalties, which target underreporting, can affect reporting compliance by Schedule C filers.

⁶ Alan H. Plumley, *The Impact of the IRS on Voluntary Tax Compliance: Preliminary Empirical Results*, Nat’l Tax Assoc., 95th Ann. Conf. on Tax’n 2 (Nov. 2002), <http://www.irs.gov/pub/irs-soi/irsvtc.pdf>.

⁷ See, *e.g.*, National Taxpayer Advocate 2008 Annual Report to Congress vol. 2, 2 (*A Framework for Reforming the Penalty Regime*).

⁸ See IRS Research, Analysis & Statistics, *Federal Tax Compliance Research: Tax Year 2006 Tax Gap Estimation 2* (Mar. 2012), <http://www.irs.gov/pub/irs-soi/06rastg12workprr.pdf>. The IRS computes the net tax gap by subtracting the \$65 billion that the IRS estimates it will eventually collect through enforcement and late payments from the \$450 billion gross tax gap—the difference between the taxes people owed and the amount they voluntarily and timely paid. *Id.*

⁹ *Id.*

¹⁰ See *id.* The percentage of income that goes unreported (or the net misreporting percentage) is lowest (at one percent) for income subject to information reporting and withholding, such as wages, and highest (at 56 percent) for income subject to little or no information reporting, such as cash receipts earned by sole proprietors. *Id.* at 3.

Accuracy-related penalties 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 understatement" of income tax.¹¹ 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.¹² 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.¹³

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.¹⁴ 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.¹⁵ 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.¹⁶

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.¹⁷ The most important factor in establishing reasonable cause is the extent of the taxpayer's effort to determine the correct tax liability.¹⁸ 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.

¹¹ 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.

¹² IRC § 6662(c); Treas. Reg. § 1.6662-3(b).

¹³ IRM 4.10.6.2.1 (May 14, 1999).

¹⁴ 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).

¹⁵ IRC § 6662(d)(2)(A).

¹⁶ IRC § 6662(d)(2)(B). No reduction is permitted, however, for any item attributable to a tax shelter. IRC § 6662(d)(2)(C)(i).

¹⁷ IRC § 6664(c)(1).

¹⁸ Treas. Reg. § 1.6664-4(b)(1).

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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,¹⁹ but others comply voluntarily for a variety of reasons other than deterrence.²⁰ Penalties may help taxpayers understand what compliance requires.²¹ So-called “tax morale” may play a role for those who value integrity, honesty, and the benefits of government; and “social norms” may play a role for those who want to comply only if they believe that other similar taxpayers do so. 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. The IRS generally acknowledges that such perceptions drive compliance and excessive or undeserved penalties can discourage it.²²

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.²³ 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.²⁴ Thus,

¹⁹ 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).

²⁰ See, e.g., National Taxpayer Advocate 2007 Annual Report to Congress vol. 2, 138-50 (Marjorie E. Kornhauser, *Normative and Cognitive Aspects of Tax Compliance: Literature Review and Recommendations for the IRS Regarding Individual Taxpayers*) (summarizing existing literature on “tax morale”); National Taxpayer Advocate 2010 Annual Report to Congress vol. 2, 71-89 (*Researching the Causes of Noncompliance: An Overview of Upcoming Studies*); Swedish Tax Agency, *Right from the Start: Research and Strategies* 6 (2005); Michael Doran, *Tax Penalties and Tax Compliance*, 46 HARV. J. ON LEGIS. 111, 113 (Winter 2009) (summarizing the “norms theory”) and [*Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results, supra/infra.*]

²¹ 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. on 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).

²² 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.”).

²³ See, e.g., IRC § 6664(c).

²⁴ 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.

the structure and application of a penalty may affect the extent to which it promotes or discourages voluntary compliance.

Accuracy-related penalties may not promote compliance when proposed automatically.

The IRS sometimes proposes penalties automatically, before performing a careful analysis of the relevant facts and circumstances.²⁵ As shown on 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.

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

Program	Address research?	Common letter used to propose a penalty	Examiner's contact information is on letter?	Examiner calls to solicit explanation for discrepancy?	Penalty assessed if taxpayer cannot be located?
Field Exam	Yes ²⁷	Letter 950 ²⁸	Yes ²⁹	Yes ³⁰	Not usually ³¹
Office Exam	Yes	Letter 915 ³²	Yes	Yes	Not usually
Correspondence Exam	No	Letter 525 ³³	No	No	Yes ³⁴

Automatic penalty assessments 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.”³⁴ Other stakeholders have expressed similar concerns.³⁵ Penalties that the IRS proposes automatically (as well as default assessments) do not take the taxpayer’s effort to comply into account — at least not before being

²⁵ See e.g., National Taxpayer Advocate 2007 Annual Report to Congress 275 (Most Serious Problem: *The Accuracy-Related Penalty in the Automated Under-reporter 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*).

²⁶ IRM 4.10.2.7.2 (Apr. 2, 2010); IRM 4.10.2.7.2.7 (Apr. 2, 2010); Form 1900-B.

²⁷ IRM 4.10.8.11 (Aug. 11, 2006).

²⁸ IRM 4.19.10.1.6 (Feb. 24, 2011).

²⁹ IRM 4.10.6.3.5 (May 14, 1999); IRM 4.10.6.4(3) (May 14, 1999); IRM 4.10.6.8.3 (May 14, 1999).

³⁰ IRM 4.10.2.7.2.7 (Apr. 2, 2010) (penalty not assessed unless non-assessment would undermine compliance).

³¹ IRM 4.10.8.11 (Aug. 11, 2006).

³² IRM 4.19.10.1.6 (Feb. 24, 2011).

³³ IRM 20.1.5.7.1(5) (Jan. 24, 2012).

³⁴ H.R. Conf. Rep. No. 101-386, at 661 (1989).

³⁵ 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).

proposed — nor do they promote the sense that the tax system is fair, as other penalties do.³⁶ Thus, automatic penalty assessments may not have the same positive effect on voluntary compliance as other penalty assessments.³⁷

Accuracy-related penalties could have a different effect on voluntary compliance when applied incorrectly or appealed.

It is difficult for penalties to promote future compliance if imposed when the taxpayer has actually complied. Although some people might try to avoid further entanglement with the IRS by taking more conservative positions in the future, undeserved penalty assessments are probably more likely to discourage taxpayers from complying by communicating that the system is unfair and that they may be penalized even if they try to comply. Similarly, when a taxpayer appeals a penalty assessment or asks the IRS to reconsider it, he or she may also consider the penalty unfair. Accordingly, penalty assessments that result in reconsiderations or appeals may not have the same (positive) effect on voluntary compliance as other penalty assessments. Another possibility is that some taxpayers who ask the IRS to reconsider a penalty assessment or appeal it are less predisposed to trust the IRS or comply with the tax rules.³⁸ Any analysis of the impact of penalties on voluntary compliance should consider these factors.

TAS will analyze the impact of accuracy-related penalties on subsequent reporting compliance.

As noted above, TAS will try to determine if and how accuracy-related penalty assessments affect subsequent reporting compliance by Schedule C taxpayers. Because only some compliance can be measured directly, TAS will seek to gauge reporting compliance using the IRS's computer algorithms (called a Discriminant Index Function or "DIF" score) that estimate the likelihood that an audit of the taxpayer's return would produce an adjustment.³⁹ The study will use changes in the taxpayer's DIF score as a proxy for changes in voluntary compliance.

³⁶ Surveys consistently find that taxpayers report that personal integrity is the strongest factor influencing tax compliance. See, e.g., Roper ASW, *IRS Oversight Board 2011 Taxpayer Attitude Survey 5* (Jan. 2012), <http://www.treasury.gov/irsob/reports/2012/IRSOB-Taxpayer%20Attitude%20Survey%202012.pdf>.

³⁷ Some taxpayers may deliberately avoid contact with the IRS in an effort to avoid collection, however. It is unclear what impact a penalty would have on subsequent compliance by these taxpayers.

³⁸ For a discussion of the impact of trust on voluntary compliance, see *Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results*, [supra/infra].

³⁹ See, e.g., IRM 4.19.11.1.4 (Nov. 9, 2007). The IRS selects some returns for examination using the Discriminant Index Function (DIF) computer scoring system. IRM 4.1.1.2.6 (Oct. 24, 2006). It develops DIF score algorithms 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.

The study will identify two similar groups of Schedule C taxpayers who have been subject to an examination that uncovered a tax deficiency.⁴⁰ One group will include those who were assessed an accuracy-related penalty, and the other group will include those who were not.⁴¹

TAS will analyze the impact of the accuracy-related penalty on reporting compliance, as measured by changes to the taxpayer's DIF score. TAS will also try to estimate the extent to which the following factors affect the results:

1. Whether the penalty resulted from a default assessment (*i.e.*, one imposed before communicating with the taxpayer);
2. Whether the taxpayer requested an abatement (or reconsideration) of the penalty;⁴²
3. Whether the taxpayer appealed the penalty to Appeals;
4. Whether the penalty was ultimately abated; and
5. The amount of the tax understatement and proposed penalty (*e.g.*, so that TAS can determine if the penalty is for a substantial understatement or negligence and whether the penalty is 20 percent or 40 percent).

CONCLUSION

Accuracy-related penalties are meant to improve reporting compliance. This study will try to verify that accuracy-related penalty assessments do in fact improve subsequent reporting compliance among Schedule C filers.

The effect of such penalties on compliance may depend upon whether the IRS is perceived as applying them fairly. If automated penalty assessments, or those that are later appealed or abated, are more likely to be perceived as unfair, they may not have the same (positive) effect on voluntary compliance. Alternatively, such taxpayers' future compliance behavior may differ from the control group in other ways for different reasons. Thus, the study will also try to identify the impact of default penalty assessments, assessments appealed by the taxpayer (*i.e.*, through an audit reconsideration or the IRS Appeals function), and assessments that are ultimately abated.

⁴⁰ TAS will try to ensure the groups are balanced with respect to other factors that could influence compliance behavior, such as industry and previous compliance history.

⁴¹ To help reduce bias and improve the likelihood that the sample will represent all Schedule C taxpayers, TAS will stratify and/or weight the sample by DIF score and EAC, the industry listed as the source of the self-employed income, and whether the taxpayer was previously subject to collection or exam activity. TAS's ability to conduct this study will depend on its ability to find comparable groups of taxpayers.

⁴² At this preliminary stage, TAS anticipates that it may be difficult to identify some taxpayers who have requested reconsideration or abatement of the penalty.

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