

National Taxpayer Advocate

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RESEARCHING THE CAUSES
OF NONCOMPLIANCE:
AN OVERVIEW OF UPCOMING STUDIES

Researching the Causes of Noncompliance: An Overview of Upcoming Studies

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EXECUTIVE SUMMARY

The National Taxpayer Advocate long has advocated for research on how to increase voluntary tax compliance.¹ She has proposed that the IRS undertake studies and has sponsored research.² The National Taxpayer Advocate's 2007 Annual Report to Congress contained a study (the "2007 Study") that surveyed tax compliance literature to identify factors found to affect voluntary compliance.³ The National Taxpayer Advocate has also discussed with tax administrators and academics from around the world their efforts to study and influence voluntary compliance.

Broadly speaking, the factors identified by the 2007 Study and other research include not only the expected likelihood and cost of getting caught cheating (called "economic deterrence"), but other factors such as compliance norms, trust in the government and the tax administration process, complexity and the convenience of complying, and the influence of preparers. Perhaps surprisingly, this literature suggests that factors other than deterrence may have the greatest impact.⁴ Having surveyed the literature and identified potential factors, the Taxpayer Advocate Service (TAS) is undertaking research to learn more about why taxpayers comply or fail to do so.

Because different taxpayers comply for different reasons, this research will focus on the segment responsible for the largest portion of the tax gap – participants in the cash economy (*i.e.*, taxpayers with income not subject to information reporting).⁵ Such participants are often sole proprietors who file Form 1040 Schedule C, *Profit or Loss from Business (Sole Proprietorship)*.⁶

The IRS is least likely to be able to detect or deter noncompliance by this segment without expending significant enforcement resources. Relatively inexpensive measures, such as document matching and correspondence examinations, cannot reliably detect income that is not subject to withholding or information reporting. Thus, it is particularly important for policymakers to gain a better understanding of how to improve compliance among this group of taxpayers using levers other than economic deterrence.

TAS is embarking on a multi-year study in this area. As the first stage of the research, this discussion summarizes TAS's initial plans for designing it. As a first step, TAS plans to survey a random nationwide sample of Schedule C filers by telephone. The survey will seek to identify which factors have the greatest impact on tax compliance.

¹ See, e.g., National Taxpayer Advocate 2007 Annual Report to Congress vol. 2, 1 (*A Comprehensive Strategy for Addressing the Cash Economy*).

² See, e.g., National Taxpayer Advocate 2009 Annual Report to Congress 300.

³ See National Taxpayer Advocate 2007 Annual Report to Congress vol. 2, 138-50 (Marjorie E. Kornhauser, *Normative and Cognitive Aspects of Tax Compliance*) (hereinafter "2007 Study").

⁴ 2007 Study at 139 (stating "the rational cost/benefit analysis of traditional economic theory – explains so little of tax compliance").

⁵ See generally, National Taxpayer Advocate 2007 Annual Report to Congress vol. 2, 1 (*A Comprehensive Strategy for Addressing the Cash Economy*); IRS, *Reducing the Federal Tax Gap, A Report on Improving Voluntary Compliance 2* (Aug. 2, 2007).

⁶ See IRS, *Reducing the Federal Tax Gap, A Report on Improving Voluntary Compliance 15* (Aug. 2, 2007).

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This research could find, for example, that compliance by self-employed taxpayers in one industry is driven primarily by complexity and misconceptions about the rules, but is driven primarily by mistrust of the government in another. Such a finding might suggest the IRS should focus its resources on simplifying the rules and educating those in the first industry and on fostering trust of the IRS by those in the second.

As a second step, TAS plans to over-sample taxpayers in specific geographic areas using the same survey. Because norms and attitudes are often formed locally, this may allow TAS to gain a clearer picture of the geographically-based factors that influence compliance.

INTRODUCTION

Unreported income from the cash economy accounts for the largest portion of the “tax gap.”

Most people timely and voluntarily comply with the requirement to file and pay taxes. Out of \$2.112 trillion in taxes due in 2001 (the latest year for which IRS estimates are available), taxpayers timely and voluntarily reported and paid \$1.767 trillion – 83.7 percent.⁷ The remaining 16.3 percent or \$345 billion not timely and voluntarily reported and paid represents the “tax gap.”⁸ Unreported business income, mostly from the cash economy (*i.e.*, income not subject to information reporting), is responsible for the largest portion of the tax gap – more than \$100 billion in 2001.⁹

Increasing voluntary compliance is the only practical way to reduce the tax gap.

Recognizing the importance of voluntary compliance, the IRS’s goal is to narrow the tax gap by raising the voluntary compliance rate by 2.3 points – from 83.7 percent in tax year 2001 to 86 percent by tax year 2009.¹⁰ Based on the latest IRS estimates for FY 2001, a 2.3 point increase in voluntary compliance could have generated another \$48.8 billion that year¹¹ – significantly more than the \$33.8 billion the IRS brought in directly through all enforcement activities in 2001.¹² The IRS would need to increase direct enforcement revenue by 144 percent (\$48.8 billion / \$33.8 billion) to match gains from a mere 2.3 point increase in voluntary compliance. Thus, increasing voluntary compliance is the only practical way for the IRS to significantly reduce the tax gap.

Deterrence promotes voluntary compliance by some.

Examinations indirectly increase voluntary compliance by reinforcing the perception that the IRS is likely to detect tax cheating, thereby discouraging or “detering” taxpayers from cheating in the first place.¹³ By some estimates, these indirect revenue gains are between

⁷ IRS, *Tax Gap Map for Year 2001* (Feb. 2007), http://www.irs.gov/pub/irs-utl/tax_gap_update_070212.pdf.

⁸ The 2004 IRS National Research Program (NRP) study estimates the 2001 gross tax gap at \$345 billion and the net tax gap – the amount that remains unpaid after IRS enforcement efforts – at \$290 billion. IRS, *Tax Gap Map for Year 2001* (Feb. 2007). These figures do not include unpaid tax on income from illegal activities.

⁹ See *id.*

¹⁰ See, e.g., IRS, *Reducing the Federal Tax Gap, A Report on Improving Voluntary Compliance* 10 (Aug. 2, 2007); IRS Strategic Plan, 2009-2013 (2009), http://www.irs.gov/pub/newsroom/long_term_measures.pdf. As of this writing, the IRS goal had not been updated.

¹¹ By dividing the \$345 billion dollar tax gap for 2001 by the 16.3 percent noncompliance rate, we see that a one percent improvement in that rate could bring in \$21.2 billion. IRS, *Tax Gap Map for Year 2001* (Feb. 2007). If a one percent improvement brings in \$21.2 billion, a 2.3 point improvement could bring in \$48.8 billion (2.3 * \$21.2 billion).

¹² IRS, *Fiscal Year 2008 Enforcement Results* (2009), http://www.irs.gov/pub/irs-news/2008_enforcement.pdf. Of the \$33.8 billion in FY 2001 enforcement revenue, \$24.3 billion was from collections, \$7.9 billion was from examinations, and \$1.6 billion was from document matching (*e.g.*, the Automated Underreporter Program (AUR)). *Id.*

¹³ They may also improve future compliance by educating taxpayers about the rules. However, correspondence examinations may not educate taxpayers as effectively as other types of examinations. Yet, the IRS is conducting an increasing number of examinations by correspondence. Correspondence examinations accounted for 71 percent of all examinations in FY 2009 (1,128,369 out of 1,578,444), up from 54 percent in FY 2000 (387,009 out of 715,915). Compare IRS Pub. 55B, Data Book, *Table 9a* (2010), <http://www.irs.gov/pub/irs-soi/09db09aex.xls>, with IRS Pub. 55B, Data Book, *Table 10* (2001), <http://www.irs.gov/pub/irs-soi/00db10ex.xls>.

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six and 12 times the amount of any proposed audit adjustment.¹⁴ The deterrence model is based on the economic theory that people comply when the potential sanction multiplied by the perceived likelihood of getting caught outweighs the economic gain from cheating.¹⁵ Tax gap data show that people are, in fact, more likely to voluntarily report and pay taxes on income that is subject to withholding or otherwise reported to the IRS by third parties.¹⁶ Information reporting makes filing more convenient because taxpayers can easily transfer information from these documents to a tax return. Withholding is also convenient because it increases the likelihood a taxpayer will obtain a refund rather than make a significant payment with the return. Thus, information reporting and withholding promote compliance by making it more convenient. However, they may also promote compliance, at least for some taxpayers, by increasing the perception that the IRS would notice if the income reported to the IRS does not show up on a tax return (*i.e.*, through deterrence).

Deterrence is not the only factor driving voluntary compliance.

Deterrence may be least effective among taxpayers operating in the cash economy – the largest component of the tax gap – precisely because the IRS cannot reliably detect unreported income that is not subject to information reporting. Deterrence will also be ineffective with respect to taxpayers whose noncompliance is unintentional. In such cases, applying penalties, particularly severe ones, could cause taxpayers to lose confidence in the fairness of the tax system, potentially reducing compliance.

Moreover, social science research suggests that it takes an extremely high investment of enforcement resources to have any noticeable effect on citizens' assessments of the likelihood of being caught.¹⁷ Even if an increase in IRS enforcement activities is significant enough to increase this assessment, not all enforcement activities will have the same effect. For example, audits that do not detect underreporting could reduce voluntary compliance if they show taxpayers the limits of the IRS's ability to detect cheating. Enforcement activities and procedures that reduce trust in government or the tax system could also reduce voluntary compliance.

In addition, scholars have concluded that the deterrence model is incomplete because it seems economically irrational for so many taxpayers to comply given the low probability of

¹⁴ Alan H. Plumley, Pub. 1916, *The Determinants of Individual Income Tax Compliance: Estimating The Impacts of Tax Policy, Enforcement, and IRS Responsiveness* (Oct. 1996); Jeffrey A. Dubin, Michael J. Graetz and Louis L. Wilde, *The Effect of Audit Rates on the Federal Individual Income Tax, 1977-1986*, 43 Nat. Tax J. 395, 405 (1990). Some studies suggest, however, that the threat of an audit reduces compliance. See, e.g., Marsha Blumenthal, Charles Christian, and Joel Slemrod, *Determinants of Income Tax Compliance: Evidence from a Controlled Experiment in Minnesota*, Working Paper 6575, Nat'l Bureau of Econ. Research (May 1998) (hypothesizing that taxpayers who were informed they would be audited underreported their liabilities to a larger extent than other taxpayers because they viewed the audit as a negotiation and wanted to begin negotiations at a low figure).

¹⁵ See, e.g., Eric A. Posner, *Law and Social Norms: The Case of Tax Compliance*, 86 Va. L. Rev. 1781 (2000).

¹⁶ Taxpayers report more than 95 percent of all income subject to substantial information reporting but less than 50 percent of the income not reported to the IRS on information returns. See IRS, *Tax Gap Map for Year 2001* (Feb. 2007).

¹⁷ See, e.g., Lawrence H. Ross, *Social Control Through Deterrence: Drinking-and-Driving Laws*, Ann. Rev. Sociol. 10:21-35 (1984) (discussing the difficulty of relying on deterrence to reduce drunk driving).

getting caught cheating.¹⁸ According to one recent survey, 92 percent of taxpayers responded that personal integrity influences their tax compliance behavior whereas only 63 percent cited the fear of an audit.¹⁹ A large body of research suggests that people voluntarily comply with tax laws for a variety of reasons other than economic deterrence.²⁰ According to one study, research “clearly shows that financial incentive, as well as the risk of detection and punishment, is less important than the influence of norms and moral values.”²¹

Why research noncompliance by participants in the cash economy?

It would be very difficult to design research to determine why every type of taxpayer complies or fails to do so. As noted above, however, small businesses that receive income not subject to information reporting may be responsible for the largest portion of the tax gap and also among the least responsive to deterrence. As a result, an understanding of the reasons – other than deterrence – why Schedule C filers report their income or fail to do so could be particularly helpful in reducing the tax gap.

As noted above, TAS is embarking on a multi-year study in this area. This discussion summarizes TAS’s initial plans.

DISCUSSION

Besides deterrence, why do taxpayers voluntarily comply?

A review of the 2007 Study and other tax compliance literature suggests that in addition to economic deterrence, the following factors may have an impact on voluntary compliance.

Compliance norms.

According to social norms and reciprocity theories, taxpayers who believe most other taxpayers comply are more likely to reciprocate by complying.²² Those taxpayers who are members of a group of compliant taxpayers may exert social pressure on others to comply

¹⁸ This is so even after accounting for the fact that some people incorrectly compute the probability of detection and others are averse to risk. 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, 640-642 (2009) (summarizing studies). For further discussion of taxpayer beliefs regarding audit probability, see Sarah B. Lawsky, *Probably? Understanding Tax Law’s Uncertainty*, 157 U. Pa. L. Rev. 1017, 1023 (2009).

¹⁹ IRS Oversight Board, 2009 Taxpayer Attitudes Survey (Feb. 2010), <http://www.treas.gov/irsob/reports/2010/IRSOB%20Taxpayer%20Attitude%20Survey%202009.pdf>.

²⁰ See, e.g., 2007 Study (summarizing existing literature). These normative motivations are not unique to tax compliance. For example, many people comply with anti-littering laws even when such compliance cannot be explained by deterrence.

²¹ Swedish Tax Agency, *Right from the Start: Research and Strategies* 6 (2005); see also 2007 Study.

²² See, e.g., Dan M. Kahan, *The Logic of Reciprocity: Trust, Collective Action, and Law*, 102 Mich. L. Rev. 71 (Oct. 2003). Conversely, in communities with noncompliance norms, some taxpayers may not be able to afford to compete with noncompliant competitors while paying taxes. Thus, local market prices themselves may communicate local compliance norms. If it were credible, however, publicity suggesting that most small businesses comply might be particularly effective in promoting compliance by others because of the way small businesses are idealized in American history. See Alexis de Tocqueville, *Democracy in America* vol. 2, § 2, ch. 19 (1840) (stating what “astonishes me in the United States is not so much the marvelous grandeur of some undertakings as the innumerable multitude of small ones”); S. Rep. No. 79-47, at 3 (Feb. 12, 1945) (suggesting that small business “stimulates expression of the fundamental virtues of thrift, industry, intelligence, schooling, home ties, and family pride – in short, those fireside virtues which have counted for so much in developing our strength and character”); Barry C. Lynn, *American Small Businesses Needn’t Go Extinct*, Washington Post (Feb. 21, 2010) (discussing 20th-cent. “restoration of the republic of small proprietors established by Thomas Jefferson and James Madison in the early 19th century”).

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(e.g., shaming), and members who cheat may feel guilty when they break the norm if it has been adopted as the taxpayer's own tax morale.²³ For example, the Minnesota tax agency increased compliance by informing taxpayers that most Minnesotans fully complied with their tax obligations.²⁴ Other research suggests that for taxpayers complying because of tax morale or social norms, compliance may decline if they receive the message that cheating is rampant (i.e., the real norm) or if they begin to rationalize that their own compliance is based, instead, on the threat of government sanctions.²⁵

Trust in government and the tax administration process.

Those who trust the government and feel the tax laws and procedures are fair and fairly enforced may be more likely to feel a moral obligation to comply, even if the outcome of those procedures is unfavorable.²⁶ Conversely, others may use unfair rules or procedures, unreasonable penalties, bad experiences with the IRS, or a lack of faith in government or the IRS to justify either reducing efforts to comply or active noncompliance. Researchers have suggested that this could help explain the finding by some studies that an IRS audit has a negative effect on future compliance.²⁷

²³ Similar concepts are sometimes described as social sanctions for cheating, and social or moral commitments to comply. See, e.g., *Taxpayer Compliance, Volume 1: An Agenda for Research*, 73, 91, 112-13 (Jeffrey A. Rother, John T. Scholtz, and Ann Dryden Witte eds., Univ. of Penn. Press 1989).

²⁴ See generally Stephen Coleman, *The Minnesota Income Tax Compliance Experiment: State Tax Results* (April 1996); Richard H. Thaler and Cass R. Sunstein, *Nudge: Improving Decisions About Health, Wealth, and Happiness* 66 (New Haven, Conn.: Yale Univ. Press, 2008). Software products that prompt taxpayers to claim deduction amounts based on statistical averages may have a similar effect that could reduce compliance.

²⁵ See, e.g., Dan M. Kahan, *Signaling or Reciprocating? A Response to Eric Posner's Law and Social Norms*, 36 U. Rich. L. Rev. 367 (May 2002) (citing a study that found taxpayers who were exposed to information emphasizing the severity of tax-evasion penalties claimed more deductions than similarly situated taxpayers exposed either to a moral appeal or to no information at all; citing another study which found that individuals who were shown press accounts of an IRS plan to attack the "tax gap" with stepped-up auditing displayed a weaker commitment to paying their own taxes.); Eric Fleisig-Greene, *Law's War with Conscience: The Psychological Limits of Enforcement*, 2007 B.Y.U. L. Rev. 1203 (2007) (citing a study in which individuals who had experienced recent audits reported less income than those who had not; citing another study in which taxpayers receiving a letter informing them that their returns would receive scrutiny reported less income); *Taxpayer Compliance, Volume 1: An Agenda for Research* 79 (Jeffrey A. Rother, John T. Scholtz, and Ann Dryden Witte eds., Univ. of Penn. Press 1989) (discussing a randomized study by Schwartz and Orleans, which "concluded that normative appeals [appearing in a tax compliance survey] appear to increase levels of compliance, while deterrence threats have little or no effect").

²⁶ See, e.g., Swedish Tax Agency, *Right From The Start, Research and Strategies* 6-7, 38-51 (Aug. 2005) (after surveying many papers from various disciplines, concluding that trust for tax agencies is an important determinant of voluntary compliance); Kristina Murphy, *The Role of Trust in Nurturing Compliance: A Study of Accused Tax Avoiders*, 28 Law and Human Behavior 187 (Apr. 2004) (finding that perceptions of procedural fairness and trust in the taxing authority had an impact on the motivation to comply); Tom R. Tyler, *Why People Obey the Law* 58-62 (Princeton Univ. Press 2006) (finding that "legitimacy" (defined as the perceived obligation to follow the law even if it is morally wrong, and respect and support for legal institutions, such as police and courts) has a significant positive impact on compliance after controlling for other variables). See also Joint Committee on Taxation, JCS-6-98, *General Explanation of Tax Legislation Enacted in 1998*, 19 (Nov. 24, 1998) (describing the 1998 IRS reorganization as needed to restore public confidence in the IRS, in large part, because "the Congress believed that most Americans are willing to pay their fair share of taxes, and that public confidence in the IRS is key to maintaining that willingness."); *Taxpayer Compliance, Volume 1: An Agenda for Research* 118 (Jeffrey A. Rother, John T. Scholtz, and Ann Dryden Witte eds., Univ. of Penn. Press 1989) (summarizing various studies that suggest commitment, attitudes toward the IRS, law, and government may have an impact on tax compliance).

²⁷ See, e.g., *Taxpayer Compliance, Volume 1: An Agenda for Research* 93-96 (Jeffrey A. Rother, John T. Scholtz, and Ann Dryden Witte eds., Univ. of Penn. Press 1989) (discussing various studies).

Complexity and the convenience of compliance.

Taxpayers who face complicated rules may be unable to comply, or may use complexity as a reason to justify noncompliance.²⁸ Some have suggested that when tax laws are complicated or ambiguous, taxpayers may simply resolve uncertainty in their favor.²⁹

Conversely, as noted above, withholding and information reporting could improve compliance not only through deterrence, but also because they make compliance more convenient. Figures can be transferred conveniently from information returns to tax returns, and taxpayers do not have to make payments with their returns if enough tax has been withheld.³⁰ Similarly, laws can make compliance inconvenient. For example, certain tax rules may require the recipient of a gift to inquire about the donor's tax basis in the gift – a socially awkward inquiry that may force the donor to disclose how much he or she paid.³¹

Reliance on tax preparers.

Tax preparers may have a significant effect on tax compliance.³² About 60 percent of all individual income tax filers used paid tax return preparers in 2008.³³ Taxpayers may use preparers because they perceive the rules as too complex, to save time, or to avoid paying more than required.³⁴ Some research suggests preparers meet these expectations by enhancing compliance with unambiguous rules, but reducing it with respect to ambiguous ones.³⁵ Other research suggests that preparers neither enhance compliance with unambiguous rules nor prevent taxpayers from paying too much, at least with respect to issues facing

²⁸ See, e.g., *Taxpayer Compliance, Volume 1: An Agenda for Research* 118, 128-129 (Jeffrey A. Rother, John T. Scholtz, and Ann Dryden Witte eds., Univ. of Penn. Press 1989) (discussing various studies suggesting that compliance burdens and complexity have an impact on tax compliance).

²⁹ *Id.* at 128-129.

³⁰ Notwithstanding the convenience of withholding, it initially encountered vigorous opposition. In 1913, Congress enacted withholding, but repealed it in 1917 after public criticism. Congress enacted payroll tax withholding in 1935 and income tax withholding in 1943 over opposition on grounds of administrative burden. See Randolph Paul, *Taxation in the United States* 326-49 (Boston: Little, Brown & Co., 1954); Charlotte Twight, *Evolution of Federal Income Tax Withholding: The Machinery of Institutional Change*, 14 *Cato J.* 3 (Winter 1995); Dennis J. Ventry, Jr. and Joseph J. Thorndike, *The Plan that Slogans Built: The Revenue Act of 1943*, 76 *Tax Notes* 1241 (Sept. 1, 1997); Milton and Rose D. Friedman, *Two Lucky People: Memoirs* 120-23 (Chicago: Univ. of Chicago Press, 1998).

³¹ See IRC § 1015 (carry-over basis); National Taxpayer Advocate 2005 Annual Report to Congress 433.

³² See National Taxpayer Advocate 2007 Annual Report to Congress Vol. 2, 44 (Leslie Book, *Study of the Role of Preparers in Relation to Taxpayer Compliance with Internal Revenue Laws*). A study conducted for the IRS found 98 percent of the respondents (taxpayers who were offered electronic filing but declined) said they trusted their preparer completely or very much. Russell Marketing Research, Pub. 4350, *Findings from One-On-One efile Research Among Taxpayers and Preparers* 24 (June 2004).

³³ IRS, CDW Tax Year 2008 (Dec. 6, 2010).

³⁴ *Taxpayer Compliance, Volume 1: An Agenda for Research* 174 (Jeffrey A. Rother, John T. Scholtz, and Ann Dryden Witte eds., Univ. of Penn. Press 1989) (citing other studies).

³⁵ See Steven Klepper, Mark Mazur, and Daniel Nagin, *Expert Intermediaries and Legal Compliance: The Case of Tax Preparers*, 34 *J. L. and Econ.* 205 (1991). See also Kim M. B. Bloomquist, Michael F. Albert, and Ronald L. Edgerton, *Evaluating Preparation Accuracy of Tax Practitioners: A Bootstrap Approach*, Proceedings of the 2007 IRS Research Conference 77 (2007) (finding preparers reduce math errors, but increase the incidence of potential misreporting).

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low income taxpayers.³⁶ The impact of the preparer on compliance probably depends on the issue and also on the combination of both the taxpayer and the preparer's views toward compliance.³⁷ Regardless of whether they improve or erode voluntary compliance, these studies suggest that preparers have a significant impact on it.

Different taxpayers or groups of taxpayers may be motivated by different factors. Even each instance of noncompliance by a single taxpayer could result from a different factor or combination of factors. Some factors could be more important for certain types of errors.

³⁶ See General Accounting Office (GAO), GAO-02-509, *Tax Deductions: Further Estimates of Taxpayers Who May Have Overpaid Federal Taxes by Not Itemizing* (2002) (finding in 1998 about two million taxpayers overpaid by failing to itemize even though about half used a preparer); Treasury Inspector General for Tax Administration (TIGTA), *Analysis of Statistical Information for Returns with Potentially Unclaimed Additional Child Tax Credit* (2003) (finding about 230,000 returns filed by paid preparers in 2002 where taxpayers appeared eligible for Additional Child Tax Credits they did not claim); Janet Holtzblatt and Janet McCubbin, *Issues Affecting Low-Income Filers*, in *The Crisis in Tax Administration* 148, 159 (Henry J. Aaron and Joel Slemrod eds., 2004) (observing that about two-thirds of EITC returns, which have high levels of noncompliance, were prepared by paid preparers); Government Accountability Office (GAO), GAO-06-563T, *Paid Tax Return Preparers: In a Limited Study, Chain Prepares Made Serious Errors* 5, 23 (Apr. 4, 2006) (finding preparers made significant mistakes on 17 of the 19 returns prepared for GAO employees posing as taxpayers, including the omission of income on ten); TIGTA, Ref. No. 2008-40-171, *Most Tax Returns Prepared by a Limited Sample of Unenrolled Preparers Contained Significant Errors* 2 (Sept. 3, 2008) (finding preparers made mistakes on 17 of the 28 returns prepared for TIGTA employees posing as taxpayers, including six willful or reckless errors).

³⁷ Assume there are three types of preparers and taxpayers: (1) those who want to comply with the letter and spirit of the law, (2) those who are willing to be more aggressive, particularly in areas where the law is unclear, and (3) those who are willing to cheat. Type one preparers may increase compliance by type two and type three taxpayers. Alternatively, those taxpayers may seek out type two or type three preparers. However, type two and type three preparers may reduce compliance by type one taxpayers unless those taxpayers either seek out type one preparers or are particularly resistant to the preparer's suggestions for tax savings. Similarly, type three taxpayers may pressure type one or type two preparers to be more aggressive than usual.

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What are some other ways to describe different types of noncompliance and the reasons for it?

Other researchers have identified at least eight types of noncompliance.³⁸ These are reflected on the following table along with the reasons (drawn from the factors described above) that seem most likely to be driving each type of noncompliance.

TABLE 2.4.1, Typology of Noncompliance and Potentially Operative Factor(s) Identified by the Literature

Type	Description	Potentially operative factor(s)
Procedural	Failed to follow complicated procedural rules, such as quarterly filing requirements	<ul style="list-style-type: none"> ▪ Complexity/convenience
Lazy	Failed to follow burdensome procedural rules, such as recordkeeping requirements	<ul style="list-style-type: none"> ▪ Complexity/convenience
Unknowing	Misunderstood the legal rules	<ul style="list-style-type: none"> ▪ Complexity/convenience ▪ Preparers
Asocial	Motivated by economic gain	<ul style="list-style-type: none"> ▪ Deterrence
Brokered	Acted on the advice of a professional	<ul style="list-style-type: none"> ▪ Preparers
Symbolic	Perceived the law or the IRS as unfair	<ul style="list-style-type: none"> ▪ Trust
Social	Acted in accordance with social norms and peer behavior	<ul style="list-style-type: none"> ▪ Norms
Habitual	Knowingly repeated previous noncompliance	<ul style="list-style-type: none"> ▪ Complexity/convenience ▪ Norms ▪ Deterrence ▪ Trust ▪ Preparers

³⁸ See Robert Kidder and Craig McEwen, *Taxpaying Behavior in Social Context: A Tentative Typology of Tax Compliance and Noncompliance*, 2 *Taxpayer Compliance* 57, 56-62 (1989); Leslie Book, *The Poor and Tax Compliance: One Size Does Not Fit All*, 5 *Kans. L. Rev.* 1, 23-33 (2003).

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Similarly, when the IRS audits individual taxpayers for purposes of the National Research Program, the auditors are asked, for each issue they identify, to characterize the reason for the noncompliance.³⁹ The following table reflects the reason codes available to auditors and the potentially corresponding noncompliance typology.

TABLE 2.4.2, IRS Noncompliance Categories (Reason Codes) and Potential Noncompliance Typologies

IRS Description	IRS Example/Definition	Potential Typology
Taxpayer unaware of tax laws or record keeping requirements	Taxpayer unaware of law or record keeping requirements pertinent to taxpayer's situation. Can include lack of formal education or language barrier.	<ul style="list-style-type: none"> ■ Procedural ■ Unknowing
Disregarded record keeping rules	Taxpayer understood law and requirements, but taxpayer's poor record keeping contributed to errors on the return and to the inability to substantiate amounts reported on the return.	<ul style="list-style-type: none"> ■ Procedural ■ Lazy
Action or advice of Return Preparer - No penalty asserted	The error resulted from action or advice of paid preparer. The nature or amount of adjustment was not sufficient to warrant a penalty.	<ul style="list-style-type: none"> ■ Brokered ■ Unknowing
Inadvertent understatement or overstatement of income or deductions	Taxpayer understood the law but misstated income, deductions and/or credits to incorrectly compute the tax liability. The misstatement may have caused either more or less than the correct amount of tax to be paid.	<ul style="list-style-type: none"> ■ Procedural ■ Unknowing
Taxpayer entered item on the wrong form, schedule, or line	Taxpayer entered an item on the wrong form, schedule, or line which caused an error in computing the tax liability.	<ul style="list-style-type: none"> ■ Procedural ■ Lazy ■ Unknowing
Intentional disregard of tax laws - No penalty asserted	Taxpayer understood income was taxable or expenses were not deductible, but made a decision to omit income or to overstate deductions, credits or prepayments. However, the nature or amount of the adjustment was not sufficient to warrant a penalty.	<ul style="list-style-type: none"> ■ Asocial ■ Brokered ■ Symbolic ■ Social ■ Habitual
Relied on advice of IRS Staff or Publications	Taxpayer indicates that the error was based upon advice from IRS personnel or information in IRS publications.	<ul style="list-style-type: none"> ■ Procedural ■ Unknowing ■ Brokered
Used "gray area" in the law or regulations	Taxpayer took position on issue based on interpretation of law.	<ul style="list-style-type: none"> ■ Unknowing ■ Asocial ■ Brokered ■ Social ■ Symbolic ■ Habitual
Intentional misstatement of income, deductions, credits, or prepayments	Taxpayer understood income was taxable, expenses were not deductible, or credit or prepayments were incorrect but made decision to omit income or decision to use claimed amounts anyway. This also includes where taxpayer intentionally shifted income, including timing manipulations of income/deductions reported in the wrong tax period with significant tax impact requiring adjustment. (Should only be used if a penalty is recommended.)	<ul style="list-style-type: none"> ■ Asocial ■ Brokered ■ Symbolic ■ Social ■ Habitual
Income/expenses entered on wrong form to reduce tax or increase credits	Income or deductions were intentionally misclassified to avoid or reduce tax. For example, moving deductions from Schedule A to Schedule C to avoid SE Tax. (Should only be used if a penalty is recommended.)	<ul style="list-style-type: none"> ■ Asocial ■ Brokered ■ Symbolic ■ Social ■ Habitual

³⁹ For further discussion of the results, see *A Closer Look at the Size and Sources of the Tax Gap*, Hearing Before the Subcommittee on Taxation and IRS Oversight, S. Finance Comm., 109th Cong. 4 (July 26, 2006) (statement of Nina E. Olson, National Taxpayer Advocate), <http://finance.senate.gov/hearings/hearing/?id=e6c3a246-9500-957b-6e04-b81474f97a2e>.

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IRS Description	IRS Example/Definition	Potential Typology
Action or advice of Return Preparer - Penalty asserted	The error resulted from action or advice of paid preparer and was sufficiently blatant to warrant a penalty. (Should only be used if a penalty is recommended.)	<ul style="list-style-type: none"> ■ Unknowing ■ Asocial ■ Brokered ■ Social ■ Symbolic ■ Habitual
Fraud	The taxpayer omitted income or overstated deductions with the intent to evade taxes. (Should only be used if a penalty is recommended.)	<ul style="list-style-type: none"> ■ Asocial ■ Brokered ■ Symbolic ■ Social ■ Habitual
Abusive Schemes	Taxpayer asserts standard frivolous filer arguments or has used other abusive schemes. (Should only be used if a penalty is recommended.)	<ul style="list-style-type: none"> ■ Asocial ■ Brokered ■ Symbolic ■ Social ■ Habitual

Estimating the relative importance of each factor and how much of each type of noncompliance exists would make it easier for the IRS to formulate an effective response.

It would be helpful if the IRS could reliably estimate the amount of noncompliance in each category. It could use such estimates to allocate an appropriate level of resources to address each type of noncompliance. For example, audits and penalties might be a good way to address asocial noncompliance, but they are probably not the most efficient way to address unknowing, lazy, procedural, brokered, or symbolic noncompliance. If the IRS had reliable data suggesting a disproportionate amount of the tax gap were due to unknowing noncompliance by small business on a particular item, outreach and education would probably be the most efficient and effective way to address the problem.

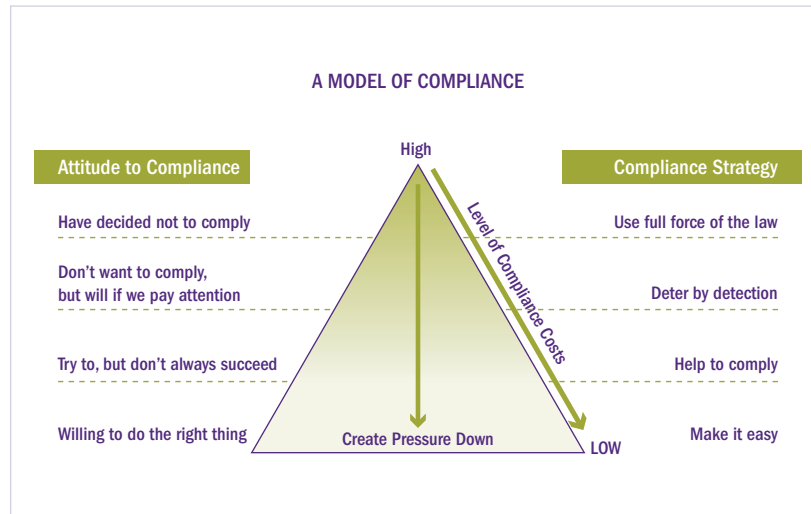
Such an approach is consistent with the so-called “responsive regulation” compliance model, which has been endorsed by the Organization for Economic Co-operation and Development (OECD) Forum on Tax Administration Compliance Sub-group, and a number of tax agencies throughout the world.⁴⁰ These organizations believe a tax administrator should be responsive to the reason for the noncompliance and the taxpayer’s motivational posture, as illustrated below.⁴¹

⁴⁰ See OECD, Forum on Tax Administration Compliance Sub-group, *Managing and Improving Tax Compliance*, 47 (Oct. 2004), <http://www.oecd.org/dataoecd/44/19/33818656.pdf>. See also Valerie Braithwaite and Jenny Job, *The Theoretical Base for The ATO Compliance Model*, Centre for Tax System Integrity – Research Note 5 (2003), <http://ctsi.anu.edu.au/publications/RN5.pdf>. As part of a survey of a large number of papers from various disciplines, the Swedish Tax Agency suggested the model is consistent with the conclusions in these papers, at least if taxpayers trust the tax agency and it is implemented properly. *Swedish Tax Agency, Right from the Start, Research and Strategies* 8, 110-116 (Aug. 2005).

⁴¹ Australian Tax Office (ATO), *Introduction to the Compliance Model* (Mar. 29, 2009), <http://www.ato.gov.au/corporate/content.asp?doc=/content/5704.htm>. According to the Australian Tax Office, this graduated compliance model encourages voluntary compliance and discourages taxpayers from operating in the cash economy where they can more easily avoid paying taxes. See, e.g., ATO, *Improving Tax Compliance in the Cash Economy* 24 (Apr. 1998). For a discussion of the shift toward responsive regulation, see, e.g., Sagit Leviner, *A New Era of Tax Enforcement: From ‘Big Stick’ to Responsive Regulation*, 42 U. Mich. J.L. Reform 381, 386 (Winter 2009).

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CHART 2.4.3, Responsive Regulation Compliance Model



Under responsive regulation, the tax administrator is cooperative and trusting at first, tougher if that trust is abused, but forgiving if trust and cooperation are finally restored.⁴² Even though the IRS has not formally adopted responsive regulation, it would be helpful for any tax administrator to understand why taxpayers fail to comply and how many fall into each bucket when formulating an informed strategy to reduce the tax gap.

Why doesn't the IRS have reliable data on the reasons for noncompliance?

Among issues that IRS auditors examined that resulted in a change in tax liability, the auditors listed 67 percent as inadvertent mistakes, 27 percent as computational errors or errors that flowed automatically, and only three percent of errors as intentional.⁴³ According to the GAO, however, the IRS does not regard this reason code data (described above) obtained from auditors as reliable because:

- The database containing the reason codes is incomplete;
- Some auditors closed examinations without assigning a reason for noncompliance or by assigning the same reason to all instances of noncompliance, regardless of the situation;
- The IRS did not train all examiners to ensure consistent understanding and use of the codes; and

⁴² See, e.g., Ian Ayres and John Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate*, ch. 2 (NY: Oxford Univ. Press, 1992). The responsive regulation approach is based, in part, on research suggesting that a strategy based mostly on punishment will undermine compliance by those motivated by a sense of responsibility. *Id.* Moreover, such an approach is likely to foster trust by all taxpayers to a greater extent than a seemingly arbitrary detection scheme that sometimes results in severe penalties for unintentional mistakes.

⁴³ *A Closer Look at the Size and Sources of the Tax Gap*, Hearing Before the Subcommittee on Taxation and IRS Oversight, S. Finance Comm., 109th Cong. 5 (July 26, 2006) (statement of Nina E. Olson, National Taxpayer Advocate). Other researchers reached similar conclusions. See Kathleen M. Carley, *Predicting Intentional and Inadvertent Non-Compliance*, Presentation at the 2010 IRS Research Conference, 5 (analyzing the reason code data and concluding that most errors are inadvertent).

- The data do not represent the full population of noncompliant taxpayers but rather only those whose returns the IRS examined.⁴⁴

Even with the best training and data validation, it is difficult for auditors to determine a taxpayer's intent.⁴⁵ Some examiners may be predisposed to believe that all errors are intentional, whereas others may avoid using reason codes that are inconsistent with their decision to propose or not propose a penalty – a decision that may be based on other factors.

Surveys seeking to identify the reasons for noncompliance often rely on self-reported levels of compliance, but this approach could also be problematic.⁴⁶ For example, taxpayers whose noncompliance is unknowing will report that they are compliant and those who are knowingly noncompliant may do so as well. One study found no correlation between audit results and levels of compliance reported on surveys.⁴⁷ Thus, because it is difficult to obtain accurate information about compliance and attitudes from either taxpayers or auditors, it is challenging for researchers to design a study that ties attitudes to objective measures of compliance.

How will TAS design its research?

How will TAS tie attitudes to objective measures of compliance?

TAS research will attempt to quantify the impact of the factors identified above on voluntary compliance. To avoid having to rely on an auditor's subjective judgment about a taxpayer's motivations and attitudes toward compliance, TAS will survey taxpayers themselves. However, TAS considered a number of different approaches to avoid having to rely entirely on subjective self-reported levels of compliance by taxpayers.

One approach that TAS rejected was to survey taxpayers who had already been selected at random for audit by the IRS as part of its National Research Program (NRP). This would allow TAS to tie survey results to an objective assessment of the taxpayer's compliance—the NRP audit results. To avoid bias resulting from the audit itself, the survey could be administered before the taxpayer was informed he or she had been selected for audit. This approach would also have allowed TAS to administer a post-audit survey to identify how attitudes toward compliance changed following the audit. Moreover, if the IRS improved the reliability of its reason codes (described above), TAS could compare the taxpayer survey data to the auditor's reason codes.

⁴⁴ GAO, GAO-06-208T, *Multiple Strategies, Better Compliance Data, and Long-Term Goals Are Needed to Improve Taxpayer Compliance* 12-13 (Oct. 26, 2005), <http://www.gao.gov/new.items/d06208t.pdf>.

⁴⁵ IRS, *Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance* 6 (Aug. 2, 2007) (stating “the IRS does not have sufficient data to distinguish clearly the amount of noncompliance that arises from willful, as opposed to unintentional, mistakes. Moreover, the line between intentional and unintentional mistakes is often a grey one”). TAS is working with the IRS to determine if it is feasible for an auditor to determine the reasons for a taxpayer's noncompliance.

⁴⁶ See, e.g., Tom R. Tyler, *Why People Obey the Law* 58-62 (Princeton Univ. Press 2006) (relying on self-reported compliance).

⁴⁷ See, e.g., *Taxpayer Compliance, Volume 1: An Agenda for Research*, 54 (Jeffrey A. Rother, John T. Scholtz, and Ann Dryden Witte eds., Univ. of Penn. Press 1989) (citing a study carried out in the Netherlands in 1986).

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However, because of the small number of NRP audits conducted each year, TAS might need to conduct surveys over several years to obtain enough respondents to be able to project results to the national population of Schedule C filers. Conducting the survey over an extended period could also reduce the accuracy of the results. If, during this extended period, taxpayers learned that the IRS was surveying views about tax compliance before conducting in-depth audits of the same taxpayers, few would be likely to answer the questions truthfully.⁴⁸ Asking taxpayers to donate their time for a survey when, unbeknownst to them, they were about to receive an in-depth audit might also be somewhat disingenuous. Therefore, TAS rejected this approach.

Instead, TAS tentatively plans to survey a random and nationally representative sample of Schedule C filers. TAS will seek to gauge the respondents' reporting compliance primarily using the IRS's computer algorithms (one of which is called "DIF") that estimate the likelihood that an audit of the taxpayer's return would produce an adjustment.⁴⁹ Such measures provide an objective (albeit imperfect) estimate the taxpayer's level of compliance.

TAS will also obtain some information about reporting compliance from audit results. The IRS is likely to audit many of the respondents with high DIF scores, and by sheer coincidence might audit some with low DIF scores. Each of these (including DIF and actual examinations) will provide only imperfect indications of the taxpayer's actual compliance. For example, auditors often fail to detect unreported cash income. However, because audits are objective measures, they may be less susceptible to bias than self-reported levels of tax compliance.

How will TAS study local differences in attitudes?

As a practical matter, TAS could sort and analyze the national survey results by ZIP code and add observable information about each community (by ZIP code) to enhance the analysis.⁵⁰ However, this approach might yield only a few survey responses from a given community – potentially too few to provide a complete picture of the views held by the entire community. In an effort to be able to draw conclusions about the cause and effect of differences in attitudes at the local level, TAS plans to survey a greater number of taxpayers in otherwise similar communities with particularly high or low levels of compliance.

This local research may explore questions such as: What type of communities have homogenous compliance attitudes? What local social practices, institutions (*e.g.*, volunteer, educational, and religious institutions), or attitudes increase or decrease compliance at the

⁴⁸ This approach would also require potentially lengthy discussions and coordination between TAS and the NRP.

⁴⁹ 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); IRM 4.1.24.1 (Mar. 23, 2010). It develops DIF score algorithms based on information obtained and periodically updated from NRP 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).

⁵⁰ See Gary King, Robert O. Keohane and Sidney Verba, *The Importance of Research Design in Political Science*, 89 *Amer. Pol. Sci. Rev.* 475, 476 (1995) (noting the importance of "observable implications" in research design).

community level and why? Do taxpayers in communities with notably high or low levels of compliance identify more with the nation as a whole or the local community? While it may difficult to convert some of these findings into actionable policy prescriptions, others could provide unexpected insight into concrete steps the government could take to improve compliance.

How will TAS develop the survey?

TAS is reviewing surveys used by other researchers to identify attitudes toward compliance with the law. Many of the questions used on other surveys attempting to assess tax compliance behavior generally align with the categories identified above, including:⁵¹

- **Affiliations:** Demographic information, occupation, education, union membership, political affiliation, religious denomination, ethnicity, social or business group identity.
- **General attitudes, morals, and tax compliance:** Goals and effectiveness of government and government spending; general moral principles; the seriousness of various types of noncompliance, including tax noncompliance, particularly underreporting cash transactions; the respondent's participation in the cash economy and actual tax noncompliance.
- **Norms:** Views held by various third parties about government, the tax system, and tax compliance; compliance by these third parties.
- **Deterrence:** The likelihood of getting caught cheating (e.g., understating income, overstating deductions, or failure to file or pay) and the likely consequences.
- **Trust:** Experiences with and attitudes regarding the fairness of government, law enforcement, tax laws, and the tax office; specific experiences and communications with the tax office; how to improve trust in government and the tax office; how the respondent would prefer the tax office to communicate with them.
- **Complexity and convenience:** The extent to which tax law complexity exists and is unfair; the extent to which it allows other taxpayers to pay less than their fair share; the extent to which the respondent is willing to use complexity to game the system; adequacy of information provided by the tax office on forms, instructions, or by telephone.
- **Preparers and other third parties:** The need for assistance and the reliance on third parties (e.g., friends, family, associates, professionals) for tax planning and preparation; views held by those persons who assisted with tax planning or preparation.

⁵¹ See, e.g., Elaine Doyle and Jane Frecknall-Hughes, *Cognitive Ethical Reasoning of Tax Practitioners: A Preliminary Investigation Using a Tax-Specific Version of the Defining Issues Test (DIT)* (2007), <http://www.irs.gov/taxstats/article/0,,id=164273,00.html>; Valerie Braithwaite, *The Community Hopes, Fears and Actions Survey: Goals And Measures*, Working Paper No 2 (March 2001), <http://dspace-prod1.anu.edu.au/bitstream/1885/41621/1/WP2.pdf> (hereinafter, "Community Hopes, Fears and Actions Survey") (450 survey questions); Valerie Braithwaite and Monika Reinhart, *Preliminary Findings and Codebook for the Australian Tax System – Fair or Not Survey*, Working Paper No. 79 (Nov. 2005), <http://vab.anu.edu.au/pubs/79fullATSFONS.pdf> (hereinafter, "Fair or Not Survey") (350 survey questions); Pauline Niemiowski and Chris Mobbs, *The Determinants of Australian Taxpayers' Compliance Behaviour: The Influence of Tax Related Values, Beliefs, Attitudes and Behaviour*, ATO Research Report 53, Appendix I (March 2002) (hereinafter, "Determinant Survey").

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TAS will continue to review these surveys to develop questions in each of these categories. TAS will also seek the assistance of an independent contractor with experience designing telephone surveys.

To obtain pertinent data, TAS will obviously need to ask questions about federal income taxes and the IRS. Individual responses will be confidential. However, respondents are less likely to provide truthful answers if they believe the survey results may be transmitted to the IRS and potentially used in an audit. Therefore, in addition to assuring taxpayers that their individual responses will be confidential, TAS will use an independent survey firm to conduct the survey. The firm may also ask specific questions about the IRS and federal income tax system only near the end of the survey so that the respondent's answers to other questions are less likely to be tainted by the suspicion that the survey is sponsored by the IRS. Because the survey is telephonic, respondents cannot change answers to prior questions if later questions evoke such suspicions.

CONCLUSION

TAS's research will seek to answer questions such as:

- Why do most participants in the cash economy report and pay taxes, notwithstanding a lack of credible deterrence and strong economic incentives to cheat?
- Which factors (*e.g.*, norms, trust in government and tax administration, complexity and convenience, or preparers) have the most influence on reporting compliance by participants in the cash economy?
- To what extent do these factors vary by industry and by locality?
- What can the IRS do to leverage these factors to promote reporting compliance?