

## IV. 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 collaborating with the IRS on a number of research initiatives to determine how best to minimize taxpayer burden, while also supporting the IRS's efforts to increase voluntary compliance.

The following is a discussion of the research that TAS is conducting or participating in during the remainder of FY 2013 and FY 2014.

### A. Earned Income Tax Credit Two-Year Ban Study

When the IRS disallows the EITC to taxpayers as a result of deficiency procedures, and determines that the taxpayers' claims for the credit were due to reckless or intentional disregard of EITC rules and regulations, the IRS bars these taxpayers from claiming EITC for two tax years afterward.<sup>1</sup> The National Taxpayer Advocate is concerned that the IRS may be applying this ban routinely, rather than carefully reviewing the taxpayers' individual circumstances. To address this concern, TAS will conduct a study to determine if the IRS is exercising appropriate discretion when applying the EITC ban.

TAS Research will develop a representative sample of 450 taxpayers who were subjected to the two-year ban after an audit of their tax year 2011 returns. A team drawn from other TAS functions will evaluate each case in the sample to determine whether the IRS examiner exercised appropriate care and judgment. The team members will also complete a data collection instrument (DCI) for each case detailing the procedures followed by the IRS examiner. TAS Research will summarize the results of this analysis. TAS is targeting the end of December 2013 for completion of this study.

### B. Study of Underserved Spanish-Speaking Taxpayers

To ensure that TAS is effectively serving U.S. Hispanics with limited English proficiency (LEP), we need to understand the characteristics of Hispanic LEP taxpayers who may qualify for assistance from TAS. We also need to determine the extent to which eligible LEP taxpayers are either not aware of or are not using our services (i.e., are "underserved"). This information is not readily available from existing sources. To collect the data, TAS Research is working with other TAS functions and a vendor on a survey to identify and characterize Spanish-speaking TAS underserved taxpayers who may have limited English proficiency. This survey complements research TAS conducted in 2012 to better understand English-speaking underserved taxpayers.

<sup>1</sup> IRC § 32(k)(1)(B)(ii). See also IRM 21.6.3.4.2.7.15 (Oct. 1, 2011).

The survey will be administered by phone, which given the target population will be more representative than an online survey. The vendor will field the phone survey to 1,000 U.S. Hispanic adults using an RDD (random digit dialing) methodology focused on HDHA (High Density Hispanic Areas) with Hispanic populations of 33 percent or higher. The sample will be weighted to the characteristics of the overall Hispanic population based on data from the U.S. Census Bureau.

The results will provide an informative profile of our Spanish-speaking taxpayer population, including attributes such as age, income, family size, preparer usage, attitudes about the IRS, awareness of TAS services, health care coverage, and Internet usage (among others). We hope to finish the survey by the end of November 2013.

### C. Study of Factors Impacting Taxpayer Compliance

TAS Research is collaborating with two senior TAS attorney advisors on a multi-year study of the factors that motivate taxpayer compliance behavior. Broadly speaking, these factors include not only the expected likelihood and cost of getting caught cheating (called “economic deterrence”), but compliance norms, trust in the government and the tax administration process, the complexity and convenience of complying, and the influence of preparers.

For the first phase of the study, TAS contracted with a vendor to help design and conduct a telephone-based survey with the principal objective of identifying the major factors that drive taxpayer compliance behavior. TAS gauged the respondents’ level of compliance by using the IRS’s Discriminant Index Function (DIF), a mathematical risk scoring technique.<sup>2</sup>

The vendor administered the survey to two different groups of taxpayers with sole proprietor income (*i.e.*, Schedule C, Profit or Loss from Business (Sole Proprietorship)): a representative national sample of taxpayers and a sample of high and low-compliance communities. Inclusion of the community sample enabled TAS to better evaluate whether taxpayers’ affiliations within their communities appear to influence compliance behavior.

TAS Research published the preliminary study findings in Volume 2 of the National Taxpayer Advocate’s 2012 Annual Report to Congress. Significant findings from the national survey included:

- Taxpayers in the high-compliance group expressed more trust in government and the IRS.
- Those in the low-compliance group expressed less trust in preparers. Although most used a preparer, they were less likely to follow the preparer’s advice.

<sup>2</sup> IRM 4.1.3.2 (Oct. 24, 2006). DIF uses information obtained and periodically updated from the National Research Program (NRP) to create these mathematical formulas. Returns with high DIF scores generally have a higher probability of being adjusted on audit than other returns of the same type.

- Taxpayers in the low-compliance group were more likely to participate in local organizations. They were also significantly more likely to report that other participants view the tax laws and the IRS negatively.
- Responses do not show that economic deterrence motivates compliance decisions. Those in the low-compliance group were less likely to agree that noncompliance goes unpunished.

Significant findings from the community survey included:

- There were many more low-compliance communities than high-compliance communities because taxpayers with high compliance were not concentrated in communities.
- Respondents from the low-compliance communities were suspicious of the tax system and its fairness, whereas those from the high-compliance communities viewed government positively.
- The low-compliance community respondents reported more participation in civic institutions than their high-compliance counterparts. They were also more likely to report that other participants view the tax laws and the IRS negatively.

In the first study phase, TAS Research looked individually at each of the factors to identify which ones appeared to be influencing compliance decisions. We are now using discriminant analysis and logistic regression<sup>3</sup> to help quantify the extent to which each factor appears to influence compliance behavior. Since our preliminary results did not show that economic deterrence motivates compliance decisions, we are conducting new analyses to explore the extent to which audits impact subsequent taxpayer compliance. Our goal is to complete these analyses by the end of this year.

#### D. Automated Substitute for Return (ASFR) Study

The IRS uses the ASFR program to enforce filing compliance by individual taxpayers who have not filed returns, but have incurred a “significant” tax liability.<sup>4</sup> The program estimates the liability by computing tax, penalties, and interest based on information reported by third-party payers. When a taxpayer with reported income is delinquent in filing, the IRS attempts to secure the return through correspondence. If the attempt is unsuccessful, the IRS can, under the IRC, prepare a return for the taxpayer.<sup>5</sup>

In the 2011 Annual Report to Congress, the National Taxpayer Advocate expressed concerns about the IRS’s wholesale use of automated “enforcement assessments” such as

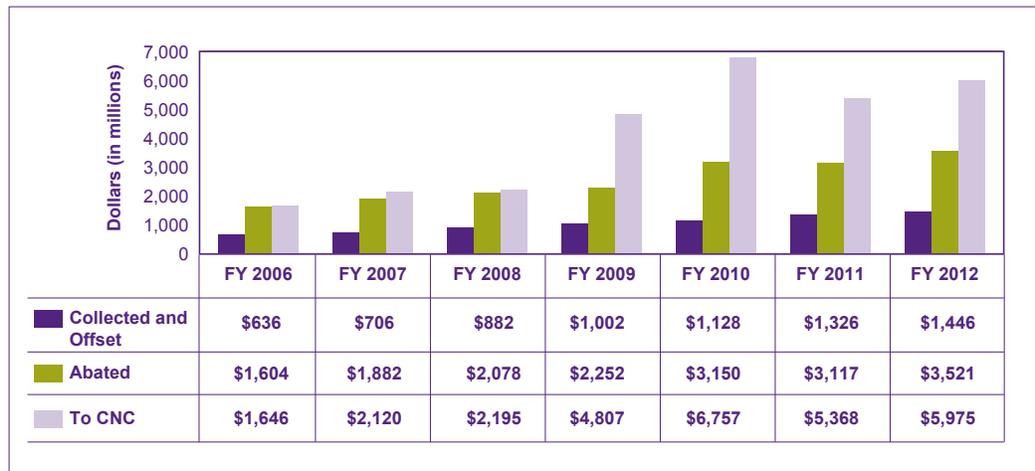
<sup>3</sup> Discriminant analysis and logistic regression are two different mathematical modeling approaches that produce estimates of the extent to which each of a number of factors, represented as independent variables, contribute to a binary outcome, such as whether a taxpayer is compliant or noncompliant.

<sup>4</sup> IRM 5.18.1.2 (Oct. 1, 2005). To meet ASFR processing criteria, the proposed tax liability must meet or exceed a predetermined dollar threshold.

<sup>5</sup> IRC § 6020(b).

ASFR.<sup>6</sup> The report pointed out that the IRS actually collected less than ten percent of the ASFR assessments from FY 2006 through FY 2011.<sup>7</sup> Moreover, as shown below, the IRS abates or reports as currently not collectible a significant percentage of these accounts.

**FIGURE IV.1, ASFR PROGRAM RESULTS (IN MILLIONS) (FY 2006-2012)**



Partially in response to the National Taxpayer Advocate’s recommendations, the IRS changed the program. For example, in fiscal year (FY) 2012, the IRS opened fewer ASFR cases so the staff could handle the workload timely. The number of assessments fell by 50 percent from FY 2011,<sup>8</sup> and dollars assessed declined 54 percent.<sup>9</sup>

The National Taxpayer Advocate is concerned, however, that the IRS has not made some necessary changes recommended in the 2011 report. Placing more emphasis on pre-assessment contacts with taxpayers, and ending the practice of making assessments in cases where the IRS has no confirmed address for a taxpayer, would protect taxpayer rights, improve service, and make the best use of IRS resources.

To evaluate whether additional changes to the ASFR Program are needed, TAS Research will compare ASFR assessments against taxpayers whose mail was undeliverable to other ASFR assessments. The analysis will compare dollars collected and how the cases were resolved, in addition to subsequent filing and payment compliance.

6 See National Taxpayer Advocate 2011 Annual Report to Congress 93 (Most Serious Problem: Automated “Enforcement Assessments” Gone Wild: IRS Efforts to Address the Non-Filer Population Have Produced Questionable Business Results for the IRS, While Creating Serious Burden for Many Taxpayers); see also National Taxpayer Advocate 2007 Annual Report to Congress 246 (Most Serious Problem: Nonfiler Program).

7 See National Taxpayer Advocate 2011 Annual Report to Congress 97 (Most Serious Problem: Automated “Enforcement Assessments” Gone Wild: IRS Efforts to Address the Non-Filer Population Have Produced Questionable Business Results for the IRS, While Creating Serious Burden for Many Taxpayers).

8 IRS, Collection Activity Report NO-5000-139, *National Delinquent Return Activity Report* (Sept. 2011-2012).

9 *Id.*

TAS Research will also explore what happens to ASFR cases that the IRS transfers to the collection queue within one year of assessment, and compare their dollars collected and case resolutions to other ASFR assessments in which the IRS uses different collection processes. TAS Research has a target date of the end of 2013 for completion of this study.

### E. Impact of Revenue Officer (RO) Field Presence study

When a taxpayer does not pay a liability, the IRS may assign the case to a revenue officer (RO) in the Collection Field function (Cff), to a group of Automated Collection System (ACS) employees in centralized call sites, or to the “queue” to wait until collection resources become available to work the case. Thus, the IRS has to decide which cases to assign to ROs, ACS, or the queue, and which to prioritize.

Direct comparisons between ACS employees and ROs present challenges. The IRS-wide measures, Collection Coverage and Collection Efficiency, assume ACS is more effective than ROs because ACS generally works “fresh” cases, and closes them using fewer resources and lower-graded employees. These measures create an incentive for IRS executives to divert resources from the Cff to ACS, even though ROs might bring in more dollars by protecting revenue (*e.g.*, preventing future delinquencies) and increasing voluntary compliance. For example, ROs work priority Federal Tax Deposit (FTD) Alerts – cases where employment tax deposits have inexplicably dropped. One recent IRS study found that ROs working these cases

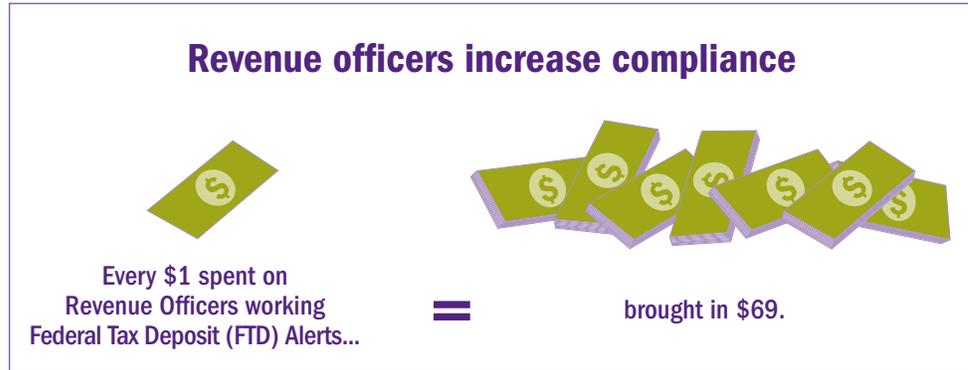
- Improved the likelihood that the taxpayer would become compliant by 12 percentage points (from 28 percent to 40 percent);
- Increased future tax deposits by an average of \$1,832 per case over a 12-month period; and
- Reduced the average penalties assessed against the taxpayer, as compared to priority Alerts that were not worked.<sup>10</sup>

The study also concluded that every dollar spent on ROs working FTD Alerts brought in \$69 by preventing future FTD noncompliance. ACS employees do not undertake similar proactive activities. Thus, the IRS needs to know the relative impact of ACS and ROs on voluntary compliance for different types of cases. Such information could help to improve both IRS “decision analytics” and “business rules” used to assign cases, as well as collection performance measures.

TAS Research is collaborating with a TAS senior attorney advisor to compare the effectiveness of the Cff and ACS when working employment tax cases. Specifically, TAS will identify similar cases that were assigned to an RO, the ACS, or the queue, and then compare the collection results. We will compare the revenue collected, the revenue protected,

<sup>10</sup> Small Business/Self-Employed Division (SB/SE) Research, *Federal Tax Deposit Alerts-P3 (Do Alerts Impact Compliance?)* (Feb. 10, 2012); SB/SE Research, *Federal Tax Deposit Alerts-P2 (Cost and Benefit Evaluation)* (Jan. 6, 2012).

penalties assessed, and future payment compliance by each group of taxpayers. We anticipate completing a this study by the end of December 2013.



**F. Determining Whether Accuracy-Related Penalties Improve Future Reporting Compliance of Schedule C Filers**

TAS Research is collaborating with a senior attorney advisor on a study that will focus on the taxpayers and penalties that could have the greatest impact on the tax gap – accuracy-related penalties<sup>11</sup> – applied to Schedule C filers. 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 IRS 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.<sup>12</sup> The study will use changes in the taxpayer’s DIF score as a proxy for changes in voluntary compliance.

The study will identify two similar groups of Schedule C taxpayers who were subject to an examination that uncovered a tax deficiency.<sup>13</sup> One group will include those who were assessed an accuracy-related penalty, and the other group will include those who were not.<sup>14</sup>

11 IRC § 6662. 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. Negligence penalties are another type of accuracy-related penalty. 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 a tax return; or fails to keep adequate books and records or substantiate items properly.

12 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 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). 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.

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

14 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, and whether the taxpayer was previously subject to exam activity. TAS’s ability to conduct this study will depend on its ability to find comparable groups of taxpayers.

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 defaulted statutory notice of deficiency (*i.e.*, an assessment imposed after the taxpayer failed to petition the Tax Court);<sup>15</sup>
2. Whether the taxpayer requested reconsideration of the penalty;
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 TAS can determine if the penalty is for a substantial understatement or negligence and whether the penalty is 20 percent or 40 percent).

The study has a target completion date of the end of December 2013.

#### **G. Survey of Low Income Taxpayer Clinic (LITC) Users' Needs**

TAS Research is working with a vendor to develop a telephone survey of potential LITC users to identify the needs of this population with respect to resolution of tax controversies and education about their rights and responsibilities as U.S. taxpayers. The sample will include 1,000 randomly selected respondents drawn from the national population of taxpayers with incomes at or below 250 percent of the federal poverty level. This should include about 50-60 Spanish-speaking respondents, which will be increased to 200 such respondents in a separate survey. The survey will use a sampling frame representative of the population of both landline and cellphone users. TAS anticipates this research will be completed by the end of June 2014.

<sup>15</sup> At this preliminary stage, TAS anticipates that it may be difficult to identify some taxpayers who have requested reconsideration or abatement of the penalty.