MSP #11 WORKLOAD SELECTION: The IRS Does Not Sufficiently Incorporate the Findings of Applied and Behavioral Research into Audit Selection Processes as Part of an Overall Compliance Strategy

RESPONSIBLE OFFICIALS

Debra Holland, Commissioner, Wage and Investment Division
Karen Schiller, Commissioner, Small Business/Self-Employed Division
Sunita B. Lough, Commissioner, Tax Exempt/Government Entities

DEFINITION OF PROBLEM

The IRS generally strives to audit only taxpayers it believes are not in compliance with the tax laws.[1] At the same time, it cannot audit every return it believes contains an error. Congressional bodies have recommended that the IRS select returns to audit on the basis of research, with the goal of not only correcting errors, but also enhancing *future* tax compliance.[2] For tax administration today, the research required to carry out this recommendation is broader than just numbers derived from tax returns, and a successful audit strategy is broader than just the audit.

IRS audit selection processes should support the Taxpayer Bill of Rights (TBOR) by comprising part of an overall compliance strategy—one that will drive future compliance, not only by the taxpayer under audit, but also by other taxpayers in similar situations.[3] Because a compliance strategy based on applied and behavioral research allows the IRS to adopt the least intrusive enforcement measure necessary in light of known taxpayer behaviors and motivators, it protects taxpayers' *right to privacy*. Because such a strategy reaches noncompliant taxpayers and addresses their outstanding tax liabilities, it promotes taxpayers' *right to finality*. Using research about taxpayers' characteristics and behaviors to design a compliance strategy that takes into account their facts and circumstances promotes the right to a *fair and just tax system*.

1 *See*, *e.g.*, Internal Revenue Manual (IRM) 4.22.1.5, *Benefits of NRP* [National Research Program] (Oct. 1, 2008), noting "The IRS should audit those returns most likely to have errors. Various methods are used to identify errors with the most common method using Discriminant Function (DIF) formulas [discussed below] to select returns for examination."

2 *See* National Commission on Restructuring the Internal Revenue Service, *A Vision for a New IRS*, 26-7 (1997). *See also* H.R. 2292, 105th Cong. (1998) and S. 1096, 105th Cong. (1997) that culminated in the IRS Restructuring and Reform Act of 1998, Pub. L. No. 105-206, 112 Stat. 685 (1998), referencing the need for targeted compliance and enforcement initiatives, in addition to taxpayer service and education.

3 Taxpayer Bill of Rights (TBOR), *available at* http://www.taxpayeradvocate.irs.gov/About-TAS/Taxpayer-Rights.

In order to succeed, however, such a strategy must be based on various types of data—numeric, return-based,[4] geographic,[5] demographic,[6] socio-demographic,[7] and psychographic[8]—as well as the impact of tax morale and the impact of perceptions of fairness on tax compliance.[9] It should incorporate not only audits but also education and outreach that leverage partner relationships and it should include an effective communication strategy.[10]

The IRS has not integrated this type of research into an overarching compliance strategy, essentially because it perceives doing so as too difficult.[11] The IRS claims to recognize the value of a holistic approach to encouraging compliance, but it actually intends to continue to base its compliance initiatives primarily, if not exclusively, on tax data.[12] Without a more expansive definition of research to drive its initiatives, and without using pilots to test and evaluate initiatives before implementing them, IRS compliance initiatives will not drive future compliance. Audit selection will continue to be only a tactic rather than part of an overall compliance strategy.

4 As discussed below, the IRS generally selects returns for audit on the basis of return characteristics or numeric targets.

5 *See*, *e.g.*, National Taxpayer Advocate 2012 Annual Report to Congress, vol. 2 1-70 (Research Study: *Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results*) (discussing TAS's survey of taxpayers at random in certain communities which revealed, among other things, that taxpayers with low compliance levels clustered in geographic communities, while those with high compliance levels were more dispersed).

6 *See*, *e.g.*, Russell Research, *Findings From The TAS Benchmark Awareness & Usage Study* (2002), report prepared for the IRS and Cossette Post, showing that the underserved taxpayer audience divided into seven segments based upon demographics, behavior, and personal situations: Surviving Spouses; Struggling Young Families; Unmarried Low Income; Affluent Families; Empty Nesters; Stable Middle Class; and Income Secretive.

7 *See*, *e.g.*, Russell Research, *Report Of Findings From 2007 Market Research For The Taxpayer Advocate Service* (2007), report prepared for TAS, updating its 2002 report and also segmenting taxpayers on a socio-demographic basis: Affluent Families; Upper-Middle Unmarrieds; Middle-Income Families; Low-Income Singles; Low-Income Families; and Financially Distressed.

8 *See*, *e.g.*, Russell Research, *Report Of Findings From 2007 Market Research For The Taxpayer Advocate Service* (2007), report prepared for TAS, updating its 2002 report and identifying an additional segment of underserved taxpayers based on attitudes toward the IRS and TAS: Rejectors; Distrusters; Indifferents; Accceptors; Doubters; and Believers.

9 *See* National Taxpayer Advocate 2007 Annual Report to Congress, vol. 2 138-80 (Research Study: Marjorie Kornhauser, *Normative and Cognitive Aspects of Tax Compliance: Literature Review and Recommendations for the IRS Regarding Individual Taxpayers*) noting: "[t]raditional methods of enforcement through audit and penalties explain only a small fraction of voluntary tax compliance. Theorists and researchers attribute the vast majority of compliance to what they loosely describe as internal motivations or 'tax morale.'"

10 National Commission on Restructuring the Internal Revenue Service, *A Vision for a New IRS*, 27 (1997), noting that "[t]axpayer education is core to voluntary compliance. There are many facets to taxpayer education, including outreach programs, post office and library programs, small business education programs, programs at post and secondary educational institutions, practitioner education, pro bono tax clinics, emergency assistance, media information programs, volunteer tax assistance, and the distribution of tax forms and publications. Professional educators and adult education techniques facilitate greater compliance by emphasizing education over enforcement. If properly designed, taxpayer education and outreach can be a proactive method of enhancing compliance."

11 *See*, *e.g.*, GAO 13-151, *TAX GAP IRS Could Significantly Increase Revenues by Better Targeting Enforcement Resources* 26 (Dec. 2012).

12 *Compare* Internal Revenue Service FY 2015 Budget Request, Congressional Budget Submission 187, discussed below, *available at* http://cfo.fin.irs.gov/SPB/BudgetFormulation/FY%202015/FY_2015_CJ_Submission.pdf *with* W&I and SB/SE Compliance ConOps (Concept of Operations) v2.2, July 31, 2014, on file with the National Taxpayer Advocate. The ConOps, discussed below, indicates that W&I and SB/SE will attempt to use third-party data and will engage in limited pre-filing initiatives but the ConOps does not envision a comprehensive strategy based on research.

ANALYSIS OF PROBLEM

Background

A Congressional Commission Directed the IRS to Adopt Audit Selection Processes that Would Prevent Noncompliance.

The National Commission for Restructuring the IRS, noting that "[t]he IRS constantly struggles to ensure compliance with the tax law in a system that depends on citizens to voluntarily calculate and pay their taxes," urged the IRS to select returns for audit on the basis of more than just discriminant index function formulas, or DIF scores.[13] Rather, the IRS was to use analytic tools to increase effectiveness of audit selection—and to "emphasiz[e] research to prevent noncompliance before it occurs."[14]

Scholars have echoed the Commission's recommendation, and pointed out the relevance of research in fields such as behavioral economics and psychology, cognitive psychology, and social psychology in understanding the dynamics of taxpayer compliance.[15] As one writer explained:

> Research shows that tax compliance is affected by (social and personal) norms such as those regarding procedural justice, trust, belief in the legitimacy of the government, reciprocity, altruism, and identification with the group. Cognitive processes, such as prospect theory, also influence an individual's reaction to tax issues. Studies also indicate that certain demographic factors such as age, gender and education correlate with tax morale.[16]

Similarly, the Senate Appropriations Committee has included the following language (or language that is almost identical) in its IRS appropriations bills for the past four fiscal years:

> The Committee remains concerned that absent a better understanding of the current sources of noncompliance, efforts to improve compliance may be hampered, misdirected, and difficult to measure. To gain meaningful insights into taxpayer behavior, the Committee strongly supports the work of the National Taxpayer Advocate and the IRS Office of Research to examine factors that influence taxpayer compliance behavior, including how and the extent to which

13 National Commission on Restructuring the Internal Revenue Service, *A Vision for a New IRS*, 26-7 (1997). IRM 4.19.11.1.5.1, *How DIF Works*, (Nov. 9, 2007), provides: "(1) DIF is a mathematical technique used to score income tax returns as to examination potential. (2) Under this concept, mathematical formulas are developed based on available TCMP data and are programmed into the computer. (3) The computer identifies returns by assigning weights to certain basic return characteristics. (4) These weights are added together to obtain a systemic composite score for each return processed. (5) This score is used to systemically rank the returns in numerical sequence (highest to lowest). (6) Generally, the higher the score the greater is the probability of significant tax change. (7) The highest scored returns are made available to Examination upon request. (8) DIF mathematical formulas are confidential in nature and are distributed to IRS personnel only on a need-to-know basis. (9) DIF formulas are for official use only and will not be discussed with unauthorized personnel. (10) Furthermore, the DIF score assigned to a return should not be disclosed. (11) Many returns, both individual and corporate, that are examined each year are DIF returns."

14 National Commission on Restructuring the Internal Revenue Service, *A Vision for a New IRS*, 26 (1997).

15 *See* National Taxpayer Advocate 2007 Annual Report to Congress, vol. 2 138-80 (Research Study: Marjorie Kornhauser, *Normative and Cognitive Aspects of Tax Compliance: Literature Review and Recommendations for the IRS Regarding Individual Taxpayers*).

16 National Taxpayer Advocate 2007 Annual Report to Congress, vol. 2 138 (Research Study: Marjorie Kornhauser, *Normative and Cognitive Aspects of Tax Compliance: Literature Review and Recommendations for the IRS Regarding Individual Taxpayers*).

various factors influence such behavior, and how the establishment of a cognitive learning and applied research laboratory might facilitate continued evaluation.[17]

The IRS Selects Returns for Audit Without an Overall Compliance Strategy and Without Considering Audits' Effects on Future Compliance.

The IRS selects examination work by taking into account one or more of the following:

- DIF scores indicating a high probability of noncompliance;[18]
- Scores assigned by or query results from other IRS systems that indicate a high probability of noncompliance or fraud;[19]
- A study or other analysis identifying "a group of individuals such as those within an occupation, industry, geographic area or specific economic activity or event" with compliance issues;[20]
- The anticipated amount of dollars to be assessed;[21]
- Anticipated no change-rates;[22]
- Emerging issues;[23]
- Referrals from the field;[24]
- Any requirement to examine a specific return;[25] and
- Special audit programs.[26]

---

17 S. Rep. No. 113-80, at 25 (2013); S. Rep. No. 112-177 (2012); S. Rep. No.112-79 (2011), S. Rep. No. 111-238 (2010). The Senate Appropriations Committee has expressed its continued interest in this approach by including the same language in the draft of the FY 2015 appropriations bill it posted on its website. S. Rep. No. 113-000, at 27 (2014), Financial Services and General Government Appropriations Bill, 2015, at 27, 113th Cong., (2014) (draft for use of the Committee and its staff only, in preparation for markup), *available at* http://www.appropriations.senate.gov/sites/default/files/FSGG%20Report%20w%20Chart%2003REPT.PDF.

18 *See*, *e.g.*, IRM 4.19.11.1.4, *Sources of Returns for Classification*, (Nov. 9, 2007).

19 *See*, *e.g.*, IRM 4.19.14.1, *Earned Income Tax Credit (EITC) Revenue Protection Strategy (RPS)*, (Nov. 25, 2011), noting "Exam receives the majority of its EITC work from the Dependent Data Base (DDb) and Electronic Fraud Detection System (EFDS)." The Tax Exempt and Government Entities (TE/GE) division uses software to analyze data from Forms 990, *Return of Organization Exempt From Income Tax*, to select some cases for examination. TE/GE response to TAS information request (Oct. 16, 2014).

20 See IRM 4.1.4.3.8, *Compliance Initiative Projects (CIP)*, (Oct. 24, 2006); TE/GE response to TAS information request (Oct. 16, 2014) (describing TE/GE's past use of questionnaires, *e.g.*, for group exemption parents to "perform triage" in selecting cases for audit).

21 *See*, *e.g.*, IRM 4.1.5.1.2, *Discriminant Function (DIF) System*, (Aug. 24, 2012) noting that "[m]any returns…that are examined each year are above the DIF cutoff score. Therefore, a significant portion of the classifiers' work will be to screen DIF returns," and IRM 4.1.5.1.5.1.1, *Materiality – Significance of the Issue*, (Oct. 24, 2006), providing that "[c]lassifiers should compare the potential benefits to be derived from examining a return to the resources required to perform the examination. Although you may identify some potentially good issues on the return, if they would not yield a significant adjustment, the return should be accepted as filed."

22 *See*, *e.g.*, IRM 4.1.5.1.5.2, *Review of Performance*, (Aug. 24, 2012), noting that classifiers will be evaluated on whether their "[a]ccepted returns have little or no examination potential or if examined would probably result in no change cases."

23 *See*, *e.g.*, IRM 4.40.2.1.4.1, *Industry Knowledge and Expertise*, (Mar. 1, 2002), describing how Examination Technical Advisors "identify novel and/or controversial tax treatment of transactions" to assist in planning and developing audits of emerging issues.

24 *See*, *e.g.*, IRM 4.23.3.1, *Overview*, (Jan. 25, 2011), noting that "The Employment Tax Examination Program is a lead-driven program."

25 *See*, *e.g.*, IRM 4.1.24.6.1.1, *Joint Committee Claims*, (Aug. 1, 2007) noting that "[a]ny tentative carryback allowance (form 1139) or claim (1120X), in excess of $2,000,000 to the same taxpayer must be selected for examination. These claims meet Joint Committee criteria."

26 *See*, *e.g.*, 4.1.21.2.2.1, *Front End Loaded Planning Time*, (Aug. 1, 2007), noting that for some matters, such as cases with abusive tax avoidance transactions and coordinated industry cases, LB&I examination resources "are allocated, after consideration of work in process, prior to committing resources available to other compliance initiatives."

None of these approaches involves considering the extent to which an audit plan would prevent non-audited taxpayers, or even the audited ones, from becoming or remaining noncompliant in the future, *i.e.*, audits' indirect effects. The IRS also selects returns to maintain audit "coverage ratios"—examining a given percentage of various categories of returns.[27] These audits may affect future noncompliance by influencing taxpayers' perceived threat of being audited, but the IRS does not establish coverage ratios on the basis of research about taxpayer behavior, or with the objective of maximizing these indirect effects.[28] Moreover, because none of these methods are based on applied or behavioral research that would allow the IRS to take into account taxpayers' facts and circumstances or calibrate its actions to be as least intrusive as possible, taxpayers' *right to a fair and just tax system* and *right to privacy* are impaired.[29]

The IRS does not attempt to measure, *post hoc*, the effect of an audit initiative on noncompliance. Its measures relate only to whether an audited return was in fact noncompliant and employees' effectiveness in carrying out the audit.[30] Because the IRS does not know whether its audits help taxpayers to avoid future audits, perhaps for the very same misstep, it cannot tell whether audits enhance taxpayers' *right to finality*. The IRS has been forthright about the shortcomings of its approach to allocating examination resources.[31]

Despite Language in its FY 2015 Budget Submission to Congress, the IRS Does Not Integrate Data About Taxpayer Behavior Into a Compliance Strategy.

The IRS reported to Congress, in its FY 2015 budget request, that its Market Segmentation Compliance Program (MSCP):

> seeks to establish a data-driven decision matrix for implementing approaches that work for the individual taxpayer. By integrating market segmentation with internal IRS data and certain external data, the IRS can incorporate taxpayer perspectives, compliance behavior, and attitudes to design and tailor compliance treatments so that the right treatment is delivered to the right taxpayer at the right time. RAS [IRS Research, Analysis and Statistics] is currently

27 *See* Policy Statement P-4-21, 1.2.13.1.10 (June 1, 1974), noting the need to "select[] sufficient returns of all classes of returns in order to assure all taxpayers of equitable consideration" and IRS Statistics of Income Data Book Tables 9a, 9b, 10-13, *available at* http://www.irs.gov/uac/SOI-Tax-Stats-IRS-Data-Book for examples of various groups for which the IRS calculates audit coverage.

28 GAO 14-605, *IRS 2015 BUDGET Long-Term Strategy and Return on Investment Data Needed to Better Manage Budget Uncertainty and Set Priorities* 24 (June 2014), *available at* http://gao.gov/products/GAO-14-605. The IRS first attempted to quantify the indirect effects of audits on compliance levels in 1996. *See* Alan H. Plumley, *The Determinants of Individual Income Tax Compliance: Estimating the Impacts of Tax Policy, Enforcement, and IRS Responsiveness*, Publication 1916 (Rev. 8-96).

29 The TBOR *right to a fair and just tax system* includes the right to expect the tax system to consider facts and circumstances that might affect their underlying liabilities, ability to pay, or ability to provide information timely. The *right to privacy* includes the right to expect that any IRS inquiry, examination, or enforcement action will be no more intrusive than necessary. TBOR, *available at* http://www.taxpayeradvocate.irs.gov/About-TAS/Taxpayer-Rights.

30 These measures include: Cases started; Cases closed; Time per case; Number of fraud referrals; Dollars per hour; Dollars per return; Total dollars assessed; Percentage of agreed cases; Amount of revenue protected; No change rate; Cycle time; Accuracy; Timeliness; and Professionalism. SB/SE response to TAS information request (July 17, 2014) and SB/SE Operating Division Fact Check (Dec. 19, 2014).

31 Internal Revenue Service FY 2015 Budget Request, Congressional Budget Submission 193, *available at* http://cfo.fin.irs.gov/SPB/BudgetFormulation/FY%202015/FY_2015_CJ_Submission.pdf., noting "Net revenue is maximized only when resources are allocated according to marginal direct and indirect return on investment [ROI], but those ratios are much more challenging to estimate than the average ROI shown here." Similarly, the IRS responded to a 2012 GAO recommendation that "While we agree with your recommendation in principle, developing meaningful estimates of marginal and indirect effects remains a challenge as it will require improved data systems and new estimation techniques. These will take years to implement, not months." GAO 13-151, *TAX GAP IRS Could Significantly Increase Revenues by Better Targeting Enforcement Resources* 26 (Dec. 2012).

> working on an effort with enforcement programs, *i.e.*, Examinations, Collections, Offer in Compromise (OIC), and Underreporter, to influence and improve taxpayer compliance.[32]

The IRS went on to note:

> Social science research reveals that the traditional deterrence theory, fear of detection and/or punishment, contributes a portion to actual compliance rates. Recent studies indicate that social norms, personal values, and attitudes may have a large impact on compliance decisions. Market segmentation approaches—behavioral, psychographic, and attitudinal, are widely used in commercial marketing to develop, design, and position products and services towards the right customer base. The knowledge gained from both social science and marketing research can assist the IRS with appropriate identification and alignment to the proper taxpayer. The MSCP is helping the IRS improve its methods of communication with taxpayers. For example, response rates from taxpayers improved after several notices were tailored for specific taxpayer segments.[33]

Despite these representations to Congress, the IRS informed TAS that it is not actually pursuing the MSCP. Instead, "[t]he market segmentation approach is still in a conceptual phase. It is being considered as part of the Compliance ConOps. At this time no decision has been made regarding the implementation of a market segmentation approach to compliance."[34] In other words, the IRS continues to approach compliance, including audit selection, as it always has, largely on the basis of return characteristics. Like other compliance initiatives the IRS has launched in the past that "seemed to represent a fundamental change in the way the IRS thought about its mission," the MSCP risks "not materializ[ing] into any fundamental change in the way that IRS [does] business."[35]

The IRS Lags Years Behind Other Jurisdictions in Providing Taxpayer Services Designed to Enhance Compliance.

In 2014, the IRS formed the Compliance Capabilities Initiative, led by senior leaders across various IRS divisions, which "seeks to enhance taxpayer experience and deliver transformative improvements to tax administration by 2019."[36]

When implemented, the Initiative is expected to allow the IRS to better interact with taxpayers throughout their compliance lifetimes by taking into consideration individual characteristics. For example, a taxpayer who historically files returns and pays taxes timely might receive pre-filing notification of tax law changes that might apply to that taxpayer (*e.g.*, provisions of the Affordable Care Act). The taxpayer might also receive information that reflects transitions through life stages (*e.g.*, as retirement approaches). If this compliant taxpayer is audited (resulting in no change to his or her tax liability), the IRS could adjust its audit selection processes so taxpayers like this one are not also selected for audit in later years or later in the filing season.

---

32 Internal Revenue Service FY 2015 Budget Request, Congressional Budget Submission 187, *available at* http://cfo.fin.irs.gov/SPB/BudgetFormulation/FY%202015/FY_2015_CJ_Submission.pdf.

33 *Id*.

34 SB/SE response to TAS information request (Sept. 15, 2014). The referenced Compliance ConOps, or Compliance Concept of Operations, is the IRS's vision of how it will implement its compliance programs. According to the Compliance ConOps draft, the IRS's insight into taxpayer compliance will be based on its analysis of tax returns. W&I and SB/SE Compliance ConOps v2.2, July 31, 2014, on file with the National Taxpayer Advocate.

35 Adrienne Poulton, *Addressing Noncompliance at the Internal Revenue Service* 8, submitted to the National Commission on Restructuring the Internal Revenue Service, describing the evolution and demise of Compliance 2000, on file with TAS.

36 Compliance Capabilities Initiative, Draft Blueprint for the Vision 1 (June 19, 2014), on file with the National Taxpayer Advocate.

A taxpayer who is newly employed, with no history of return filing, might be treated differently. To ensure that this first-time filer does not become a nonfiler, the IRS might work with employers or other external partners to ensure they provide this "new hire" with information about filing and payment obligations, including a link to a withholding calculator. When the IRS receives third-party information returns for this taxpayer, it might send the taxpayer information about the requirement to file a return. If this taxpayer does not file by April 15, the IRS would intervene quickly and resolve the taxpayer's case within the current tax year. The IRS would then remind this taxpayer to file in the following year.[37]

These initiatives are appropriate uses of tax return data. Chile is one jurisdiction that has had this type of taxpayer service in place for over a decade as a means of encouraging compliance.[38] Since the early 2000's, Chilean taxpayers have been able to access their online tax accounts, view any third party reporting of their income or income tax withholding, and pay their income, value-added (VAT), and real estate taxes online.[39] Since 2008, business taxpayers in Chile have been able to create personal pages through the government website and receive information and published guidance pertinent to their specific lines of businesses, in real time as it is published.[40] The Chilean tax authority also provides taxpayer education through its Tax Education Portal, which includes material aimed at children and classroom tools teachers can use to explain basic tax concepts.[41]

The IRS Does Not Incorporate Existing Relevant Research Into its Audit Selection Processes.

In 2013, the IRS developed the Individual Reporting Compliance Model (IRCM).[42] In a simulation experiment, the model estimated the direct and indirect effects of taxpayer audits.[43] However, the IRS does not view these research results as directly translatable into the development of audit selection formulas or methods, in part because "the state of knowledge about taxpayer behavior is limited."[44] Moreover, according to the IRS, "[m]any of the variables ('characteristics' or 'behaviors') that would be associated with indirect effects would be taxpayer personal characteristics considered inappropriate to use for selecting particular returns for audit—assuming that data about these characteristics were actually available."[45]

The National Taxpayer Advocate would be the first to condemn "audit profiling" on the basis of taxpayers' unrelated personal characteristics, as opposed to audit selection based on research about what drives taxpayer compliance. However, the IRS's obligation to respect taxpayers' rights does not excuse it from developing compliance initiatives based on unbiased, applied research about taxpayer behavior.

37 The IRS would tailor its approach to other groups of taxpayers (*e.g.*, victims of identity theft, or those who file returns but do not fully pay the tax) along these lines. Compliance Capabilities Initiative, Draft Blueprint for the Vision (June 19, 2014), on file with the National Taxpayer Advocate.

38 See Caroline Musalem, Commissioner's Special Advisor For International Affairs And Cooperation, Chilean Internal Revenue Service, *Successful practices in the use of electronic means to improve compliance: the Chilean example*, *available at* http://cstest.s4tp.org/wp-content/uploads/2010/10/15-musalem.pdf.

39 See *id*. at 3.

40 *See id*. at 8, *Successful practices in the use of electronic means to improve compliance: the Chilean example*, *available at* http://cstest.s4tp.org/wp-content/uploads/2010/10/15-musalem.pdf.

41 *See* www.siieduca.cl.

42 Kim Michael Bloomquist, IRS Office of Research, *Incorporating Indirect Effects in Audit Case Selection: An Agent-Based Approach* (June 2013), *available at* http://research.web.irs.gov/compliance.htm.

43 Of four audit strategies analyzed, the strategy with the highest combined direct and indirect effect on voluntary reporting compliance was one with a relatively high coverage rate of business audit classes and a minimum coverage of nonbusiness audit classes.

44 Additionally, the IRCM is a prototype representing a particular geographic area and is not a nationwide model. SB/SE response to TAS information request (Sept. 15, 2014).

45 SB/SE response to TAS information request (Sept. 15, 2014).

Other research on the earned income tax credit provides insight about the causes of compliance and taxpayers' compliance behavior, and the National Taxpayer Advocate has made specific recommendations based in part on that research.[46] As part of a multi-year study to identify the major factors that drive taxpayer compliance, TAS has also recently researched the effects of audits on certain small business taxpayers' subsequent compliance.[47] The findings suggest that audits may minimally deter future noncompliance, on returns filed immediately after the audit, but this effect disappears within five years. Field and office audits may be more effective deterrents than correspondence audits, and audits that result in large assessments may be more effective in promoting future compliance. However, there may be a group of taxpayers for whom audits do not have a deterrent effect.[48] TAS is willing to work with the IRS to incorporate these research findings into an overall strategy.

For Compliance Initiatives to Promote Future Compliance, They Must be Driven by Social Science Research and Tested Before Implementation.

As discussed above, the IRS articulates its commitment to integrating research into its overall compliance strategy, and has advanced technology to do so, but is not actively seeking the data it needs.[49] Without the data social science research would yield, the IRS cannot consider return information in the light of other variables—such as whether a given population of taxpayers, taking into account its demographics and other factors, is likely to comply in the future in response to an audit or whether education and outreach would drive future compliance. The IRS's general approach to compliance will consist only of tactics and will not constitute a compliance strategy.

IRS audit selection processes should support the Taxpayer Bill of Rights (TBOR) by comprising part of an overall compliance strategy—one that will drive future compliance, not only by the taxpayer under audit, but also by other taxpayers in similar situations.

Other IRS initiatives have different hallmarks. For example, before launching the Payment Card Compliance Program, designed to address income underreporting by small businesses, the IRS adopted a "multi-year test, learn and build" approach.[50] The approach allows the IRS to test its matching program on a sample of taxpayers and adjust its practices in the light of initial experience with the program.[51]

---

46 Leslie Book, *The Poor and Tax Compliance: One Size Does Not Fit All*, 51 Kan. L. Rev. 1145 (2003); *Internal Revenue Service Oversight: Hearing Before the H.R. Comm. on Appropriations Subcomm. on Financial Services and General Government*, 113th Cong. 42-47 (2014) (written testimony of Nina E. Olson, National Taxpayer Advocate), describing the IRS Tax Year 2006–2008 National Research Program Compliance Study (Feb. 12, 2014).

47 *Estimating the Impact of Audits on the Subsequent Reporting Compliance of Small Business Taxpayers: Preliminary Reports*, vol. 2, *infra*.

48 *Id*.

49 *See, e.g.*, IRS Information Technology News, *CADE 2 & You: the implementation of the CADE 2 database* (Nov. 7, 2012) *available at* http://mits.web.irs.gov/News/20121107HTLCADE2&You-DatabaseImplementation.htm, describing the IRS's relational database, Customer Account Data Engine (CADE) 2 as "the most complex database in the world."

50 Consolidated W&I and SB/SE response to TAS information request (Sept.15, 2014) (providing IRS Office of Compliance Analytics *Payment Card Program Pilot, Preliminary Year 1 Results Update* slide 2 (June 29, 2014)).

51 See Jaime Arora, *SB/SE Payment Card Reporting Program Still In Pilot Stage*, 2013 TNT 215-6 (Nov. 6, 2013), quoting the IRS Small Business/Self-Employed Division Commissioner inviting practitioners to send him any "horror stories" they had from the program; Letter from Sam Graves, Chairman, Committee on Small Business, to Faris Fink, Commissioner, IRS Small Business/Self-Employed Division (Aug. 9, 2013), describing concerns with the IRS "soft notice" (letter advising taxpayers they may have underreported their gross receipts) (on file with TAS); SB/SE Office of Compliance Analytics, *Payment Card Case Management Tech Demo Phase II* (Sept. 17, 2014), on file with the National Taxpayer Advocate.

Other Jurisdictions Have Adopted a More Comprehensive Approach to Tax Compliance.

Practices of other tax authorities also provide useful insights, particularly with respect to the use of a broad approach to taxpayer characteristics and norms to identify the most effective compliance touch. For example, the United Kingdom's (UK) tax authority has an external research program, the Behavioural Evidence and Insight Team. In 2012, the team researched why small and medium sized businesses enter and operate in the hidden economy, identified six hidden economy "typologies," and provided insights about how to reach each group and advice on what messages to avoid for each group.[52] The team then presented four options for gathering additional information about participants in the hidden economy, such as surveys or samples.[53]

The UK's compliance strategy also includes "campaigns" directed at taxpayers in certain occupations where underreporting is known or suspected, with the objective of improving tax compliance generally and not just from evaders.[54] An electricians' campaign, for example, consisted of first surveying electricians about their views and attitudes about tax evasion. The electricians were then advised, through letters, radio spots,[55] trade media,[56] flyers,[57] and outdoor posters,[58] that they would be treated leniently if they came forward and disclosed previously unreported income. The disclosure period lasted from February through August of 2012, after which the tax authority targeted for audit those whom it suspected should have disclosed but who did not.[59] The campaign concluded with another survey to measure electricians' changes in attitudes towards tax evasion as a result of the campaign.

The UK also seeks to prevent tax noncompliance in ways that involve the tax authority only indirectly. For example, the Security Industry Authority (SIA), the organization responsible for regulating the private security industry in the UK, carries out a risk assessment of businesses that apply for a license.[60] The evaluation, intended "[t]o assess the overall risk your business represents to our regulatory objectives," includes tax compliance as a component of a separate risk category, "financial probity."[61] Once approved,

52 HM Revenue & Customs, Business Customer & Strategy, Behavioural Evidence & Insight Team *Understanding key problems for SMEs: Hidden Economy Levers, Ghosts and Moonlighters, Identifying effective levers to reduce entrants into, and encourage SMEs out of the Hidden Economy* (May 2012), *available at* https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/344827/report208.pdf.

53 HM Revenue & Customs, Business Customer & Strategy, Behavioural Evidence & Insight Team, *Hidden Economy: Quantitative Feasibility Study, Establishing effective research methods for future quantitative analysis of the Hidden Economy* (May 18, 2012), *available at* https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/344826/report209.pdf.

54 *See, e.g.*, HM Revenue and Customs Research Report 260, *HMRC Electricians Tax Safe Plan Research Report* (Apr. 2013), *available at* https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/344773/report260.pdf.

55 The radio script was: "SFX [sound effects]: The click of an electric switch. MVO [male voice over]: Us electricians can't afford to take chances with safety. There's a responsibility to do the job right, so our customers stay safe and so do we. This responsibility also applies to our tax. If we don't declare our earnings, we're running a risky business. Revenue and Customs want electricians to talk to them about undeclared income by May 15th. Or they'll come looking. So stay safe. Contact them before they contact you. Call HMRC [Her Majesty's Revenue and Customs] now on 0845 601 5041." *Id.*, at 55.

56 An ad placed in trade press, captioned "HMRC to pull the plug on electricians" explained how electricians could come forward and report previously undisclosed income, noting that "a low rate penalty charge will be made to any electricians who complete a notification form, but this is better than facing a possible criminal investigation." *Id.*

57 A flyer directed at electricians described a previous successful campaign directed at plumbers and announced, "We are now looking closely at electricians and we are using a number of different sources to help us target those who have not declared their full income. We are building on the same methods that we used for the plumbers' campaign—because they work." *Id.*, at 54.

58 An outdoor sandwich board featured a picture of a multimeter (a device electricians use to measure various characteristics of an electrical circuit) captioned "Electricians you have until 15 May to check your tax affairs are in order" with an explanation of how to come forward, by email, text, or phone, and report previously unreported income. *Id.*, at 53.

59 By November 2012, the campaign had raised more than 2.2 million pounds. *Id.*, at 12.

60 Security Industry Authority (SIA), *available at* http://www.sia.homeoffice.gov.uk/Pages/home.aspx

61 SIA, Risk Assessments, *available at* http://www.sia.homeoffice.gov.uk/Pages/business-risk.aspx.

"a business license holder must provide a yearly return as and when it is due" or risk suspension of or withdrawal of the license.[62]

CONCLUSION

Sixteen years after the National Commission for Restructuring the IRS directed the IRS to base its audit selection process on research—which for tax administration today means applied social science research about taxpayer behavior—the IRS's approach to compliance, including audit selection, continues to be driven primarily by tax return data. Tax authorities in other jurisdictions rely on social science research in determining how to promote taxpayer compliance, and the service they provide to taxpayers as part of an overall compliance strategy is more advanced than at the IRS. The IRS is aware that it should adopt a holistic approach to compliance, and articulates its commitment to doing so, but has not wholeheartedly embraced that commitment.

62 SIA, Approval Conditions, *available at* http://www.sia.homeoffice.gov.uk/Pages/business-conditions.aspx.

RECOMMENDATIONS

The National Taxpayer Advocate recommends that the IRS:

1. Adopt "increasing voluntary compliance" as the primary measure for evaluating both enforcement and taxpayer service initiatives.
2. Not only incorporate applied and behavioral research into all of its compliance initiatives, but also fund or activate compliance initiatives only after adopting an integrated strategy that articulates how the IRS will:
   a. Use education, outreach, partners, assistance, non-invasive compliance touches, and enforcement touches to increase compliance;
   b. Test the initiative before full deployment, and use tests or pilots to project the effect on future compliance;
   c. Measure the initiative's success, including conducting surveys and focus groups both before and after the initiative; and
   d. Adjust its overall compliance plan in the light of continuing research findings and trends.