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NATIONAL RESEARCH PROGRAM (NRP) AUDITS: Compensate Taxpayers for “No Change” NRP Audits and Waive Assessment of Tax, Interest, and Penalties Resulting from NRP Audits

TAXPAYER RIGHTS IMPACTED¹

- *The Right to a Fair and Just Tax System*

PROBLEM

The IRS conducts random audits of taxpayers returns through its National Research Program (NRP).² This random audit program, which was established in 2000 and replaced a prior initiative called the Taxpayer Compliance Measurement Program (TCMP), benefits tax administration in several ways.³ First, NRP audits enable the IRS to gather strategic information about taxpayer compliance behavior to improve the allocation of resources to enforcement and other activities.⁴ Second, NRP audits assist the IRS in developing and updating its workload selection formulas so that it pursues productive examinations and does not unnecessarily burden taxpayers or waste resources.⁵ Third, NRP audits collect data with the goal of gathering insight into the causes of taxpayer reporting errors to aid in improving taxpayer service (*e.g.*, improved forms, communications, education, and suggesting legislative changes).⁶ Also, the IRS uses data from NRP audits to calculate and update estimates of the tax gap, which measures taxpayer noncompliance with the tax laws.⁷ In addition, besides benefitting tax administration, NRP studies benefit Congress by providing taxpayer compliance information that is useful in formulating tax policy.⁸ Finally, NRP audits ensure that the IRS is auditing the right

- 1 See Taxpayer Bill of Rights (TBOR), www.TaxpayerAdvocate.irs.gov/taxpayer-rights. The rights contained in the TBOR that were adopted by the IRS are now listed in the Internal Revenue Code (IRC). See Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, Div. Q, Title IV, § 401(a) (2015) (codified at IRC § 7803(a)(3)).
- 2 The IRS conducts different types of National Research Program (NRP) studies. The IRS’s NRP website lists four different types of reporting compliance research studies it is conducting: Form 1040 Individual Income Tax, Form 941 Employment Tax, Form 1120 Corporate Income Tax, and Form 720 Excise Tax. See IRS, *NRP Data Users and Researchers*, https://nrp.web.irs.gov/data_users.aspx (last visited Nov. 29, 2017).
- 3 For a thorough discussion of the NRP and its predecessor, the Taxpayer Compliance Measurement Program (TCMP), see Robert E. Brown and Mark J. Mazur, *The National Research Program: Measuring Taxpayer Compliance Comprehensively*, 51 U. KAN. L. REV. 1255 (2003). See also Internal Revenue Manual (IRM) 4.22.1, *National Research Program (NRP), National Research Program Overview* (Sept. 6, 2017); IRM 4.22.1.4, *NRP Benefits* (Sept. 6, 2017).
- 4 See Robert E. Brown and Mark J. Mazur, *The National Research Program: Measuring Taxpayer Compliance Comprehensively*, 51 U. KAN. L. REV. 1255, 1264-65 (2003). This article discusses three measures of taxpayer compliance: payment compliance, filing compliance, and reporting compliance.
- 5 See Robert E. Brown and Mark J. Mazur, *The National Research Program: Measuring Taxpayer Compliance Comprehensively*, 51 U. KAN. L. REV. 1255, 1265 (2003); IRM 4.22.1.4, *NRP Benefits* (Sept. 6, 2017). This IRM section notes that NRP data are used to update the IRS’s Discriminant Index Function (DIF) formulas, which are used to select tax returns for examination. See also IRM 4.1.2.7, *Discriminant Function (DIF) Overview* (Oct. 19, 2017).
- 6 See Robert E. Brown and Mark J. Mazur, *The National Research Program: Measuring Taxpayer Compliance Comprehensively*, 51 U. KAN. L. REV. 1255, 1265 (2003).
- 7 *Id.* The tax gap is the difference between what the IRS believes taxpayers owe and what taxpayers pay voluntarily and timely. See Nina E. Olson, *Minding the Gap: A Ten-Step Program for Better Tax Compliance*, 20 STAN. L. & POL’Y REV. 7, 8 (2009); Mark J. Mazur and Alan H. Plumley, *Understanding the Tax Gap*, Vol. LX, No. 3 NATIONAL TAX JOURNAL 569 (2007).
- 8 See IRS, *NRP Overview and Benefits*, https://nrp.web.irs.gov/Data_Users_Researchers/NRP_Overview_OMB_072012.pdf (last visited Nov. 29, 2017) (noting “At the 2014 IRS Research Conference, keynote speaker Senator Charles Grassley pointed out the importance of NRP studies to help guide Congress in its tax policy.”).

taxpayers, which builds trust by all taxpayers in the tax system, as it helps make sure both that the government uses its powers legitimately and that all taxpayers pay what is due under the law.

Although the NRP benefits tax administration, Congress, and taxpayers as a whole, it is burdensome for tens of thousands of individual taxpayers (or businesses) that are subject to these audits.⁹ These taxpayers, even if they are fully compliant, must contend with a random and intensive IRS audit that consumes their time and money (if they hire a tax professional to represent them before the IRS), and may impose an emotional toll.¹⁰ Taxpayers are not currently compensated for any costs they incur relating to NRP audits and the IRS may assess tax, interest, and penalties as it does during a regular audit. This undermines taxpayers' *right to a fair and just tax system*, as taxpayers selected for NRP audits are performing a public service by being subject to audits that are more comprehensive and significantly more intrusive than standard audits.

Example

A taxpayer with an impeccable history of compliance is selected by the IRS for a random NRP audit. The taxpayer spends a significant amount of time and money dealing with this audit, which is more intensive than a typical IRS audit, including producing documents and substantiation for each line on his Form 1040. After concluding the audit (which may have been expanded to include other years or related taxpayers or entities), the IRS does not make any change to the taxpayer's tax liability. The taxpayer is not reimbursed for any of his costs, feels used by the tax agency, and is left with a sense of unfairness about the entire process.

RECOMMENDATION

The National Taxpayer Advocate recommends that Congress amend the Internal Revenue Code (IRC) to:

- Provide compensation to taxpayers who are selected for NRP audits where the IRS does not make a change to the taxpayer's tax liability ("no change audits"); and
- Relieve taxpayers from the assessment of tax, penalties, and interest as a result of NRP audits absent fraud or an intent to evade federal taxes.

PRESENT LAW

There is no provision under present law that allows compensation of taxpayers who are audited under the NRP or provides relief from the assessment of tax, interest, and penalties imposed during an NRP audit.

⁹ See IRS, *NRP Data Users and Researchers*, https://nrp.web.irs.gov/data_users.aspx (last visited Nov. 29, 2017), which notes that the NRP Form 1040 Individual Income Tax Study focuses on Form 1040, 1040A, and 1040EZ returns and has a sample size of approximately 13,000-14,000 returns each year.

¹⁰ See IRS, *National Research Program Frequently Asked Questions*, https://nrp.web.irs.gov/FAQ_general.aspx (last visited Nov. 29, 2017) (noting that taxpayers selected for an NRP audit "will be subjected to a more intensive audit than usual."). See also Sarah B. Lawsky, *Fairly Random: On Compensating Audited Taxpayers*, 41 CONN. L. REV. 161, 169 (2008) (noting how a fully compliant taxpayer may suffer emotional distress as a result of a random audit).

REASONS FOR CHANGE

Taxpayers who are selected for NRP audits may be fully compliant with the tax laws but are randomly selected to serve as test subjects (*i.e.*, “guinea pigs”) for tax administration purposes, which has a future benefit for the IRS, Congress, and the taxpaying public as a whole. In July 1995, the House of Representatives Committee on Ways and Means, Subcommittee on Oversight, held a hearing on the NRP’s predecessor, the TCMP.¹¹ In her opening remarks, Chairman Nancy Johnson noted the burden of these audits on taxpayers:

TCMP audits are costly to taxpayers whether it is the cost of the taxpayer’s own time or whether that of a hired tax professional. In addition, the audits seem as unfair for those whose returns show no indication of a need for audit. We have to ask ourselves, is it fair for government to place a burden and expense on innocent people in order to better identify those who may not be so innocent? Should taxpayers be compensated for their participation? If so, how would that best be accomplished?¹²

The Subcommittee on Oversight received testimony during the hearing and in subsequent responses to questions that noted how burdensome TCMP audits were for taxpayers and how they were selected for a research project that benefits the tax system as a whole. Proposals mentioned at the hearing included compensating taxpayers selected for TCMP audits as well as possibly waiving tax, interest, and penalties assessed during the audit.¹³

After the TCMP hearing, Congress acknowledged the burden that TCMP audits placed on taxpayers and proposed legislation to compensate individual taxpayers by providing a tax credit of up to \$3,000 for TCMP-related expenses.¹⁴ The history of this proposal is noted in a Committee on Ways and Means report:

Testimony presented at the hearing indicated that while the data gathered through TCMP surveys is useful for tax administration purposes, the process is burdensome for the taxpayers whose tax returns are selected for TCMP audits. Information gathered at the hearing served the basis for a provision which was included in the Committee on Ways and Means title of H.R. 2491, the Balanced Budget Act of 1995, to provide a tax credit to individuals (not including estates, trusts, partnerships[,] or S corporations) for up to \$3,000 of expenses incurred in connection with a TCMP audit of the taxpayer. Subsequent to House passage of this measure, the IRS announced that it was canceling the planned TCMP, and the provision was dropped from the final conference agreement on H.R. 2491.¹⁵

11 *Taxpayer Compliance Measurement Program: Hearing Before H. Subcomm. on Oversight of the Comm. on Ways and Means, 104th Cong.* (1995).

12 *Id.* (statement of Rep. Nancy Johnson, Chariman, H. Subcomm. on Oversight).

13 See, e.g., *Taxpayer Compliance Measurement Program: Hearing Before H. Subcomm. on Oversight of the Comm. on Ways and Means, 104th Cong.* 55-6 (1995) (The hearing testimony included reference to an excerpt of meeting minutes of a Compliance Subgroup of the Commissioner’s Advisory Group from February 1, 1994. These minutes note that taxpayers selected for TCMP audits were participating in a research project that benefitted the tax system as a whole and that the Subgroup spoke to individuals, both inside and outside the IRS, who felt that this should be clearly recognized in the way TCMP audits are handled. The minutes note that the Subgroup heard a variety of views on this, including reimbursing compliant taxpayers for some portion of the cost of a TCMP audit and waiving certain penalties, interest, or tax).

14 See H.R. REP. No. 104-280, vol. 2, at 28 (1995).

15 H.R. REP. No. 104-872, at 55 (1997).

Thus, Congress has recognized the burden that IRS research audits place on taxpayers and the need to compensate taxpayers for this burden. Compensating taxpayers for NRP audits has also been proposed by academic commentators.¹⁶ Similarly, Congress has been presented with testimony regarding waiving tax, interest, and penalty assessments made during NRP audits, a proposal that has also been suggested by academics.¹⁷

The IRS attempts to make NRP audits less burdensome than their TCMP predecessor ones by conducting significant front-end work, through a process called “case-building,” before contacting taxpayers.¹⁸ The IRS is to be commended for this as it places less burden on taxpayers than that under the old TCMP program. Nonetheless, NRP audits are still burdensome and intensive for taxpayers, who must deal with time, financial, emotional, and even reputational costs. The proposed legislative change to compensate (through a tax credit or other means) taxpayers selected for an NRP audit and where no change is made to the taxpayer’s tax liability would demonstrate that the government cares about fundamental notions of fairness in the tax system and recognizes the financial costs incurred by taxpayers where they are serving as test subjects for the benefit of the IRS, Congress, and the tax system as a whole. In addition, waiving a tax assessment during an NRP audit might encourage taxpayers to let their guard down and be more forthcoming during an audit, thereby providing greater insight into taxpayer behavior.¹⁹

EXPLANATION OF RECOMMENDATION

The proposal to amend the IRC to provide compensation to taxpayers selected for NRP audits where the IRS does not make a change to the taxpayer’s tax liability could be carried out in the form of a refundable tax credit (capped at a certain amount). This proposal, which is substantially similar to prior proposed legislation, would recognize the fairness and compliance costs issues associated with NRP audits and promote taxpayers’ *right to a fair and just tax system*.

In addition, the proposal suggests waiving any assessment of tax, interest and penalties resulting from an NRP audit. Such an approach will likely encourage taxpayers to be more cooperative and forthcoming during these audits. However, this relief would not apply to returns where tax fraud or an intent to evade is uncovered in an NRP audit.

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- 16 See, e.g., Sarah B. Lawsky, *Fairly Random: On Compensating Audited Taxpayers*, 41 CONN. L. REV. 161 (2008) (proposing compensating taxpayers for random audits not because they are unfair but rather because compensation may help overcome taxpayer perceptions of unfairness and thereby increase overall tax compliance); Joseph Bankman, *Tax Enforcement: Tax Shelters, the Cash Economy, and Compliance Costs*, 31 OHIO N.U. L. REV. 1 (2004) (justifying government reimbursement of NRP costs through a sense of fairness and noting that reimbursement might also convince skeptical taxpayers that the government is considering taxpayer compliance costs in its audit strategy).
- 17 See *Taxpayer Compliance Measurement Program: Hearing Before H. Subcomm. on Oversight of the Comm. on Ways and Means*, 104th Cong. 55-6 (1995); Joseph Bankman, *Who Should Bear Tax Compliance Costs?*, Stanford Law School Working Paper 279 (2004), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=519783&rec=1&srcabs=1271168&alg=1&pos=10 (discussing the possibility of eliminating the revenue function of NRP audits) (last visited Nov. 29, 2017).
- 18 See Robert E. Brown and Mark J. Mazur, *The National Research Program: Measuring Taxpayer Compliance Comprehensively*, 51 U. KAN. L. REV. 1255, 1266-8 (2003); IRM 4.22.2.1.1, *Background* (Sept. 27, 2017) (noting that “One of the hallmarks of any NRP study is an enhanced focus on case building. Case building is the process of adding information to the case file, from both IRS and non-IRS sources, prior to classification. Use of this information during the classification process will identify or eliminate potential issues prior to contacting the taxpayer. The NRP approach maximizes the use of data available to the IRS and, to the extent possible, minimizes intrusiveness and taxpayer burden.”).
- 19 See Joseph Bankman, *Who Should Bear Tax Compliance Costs?*, Stanford Law School Working Paper 279 (2004), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=519783&rec=1&srcabs=1271168&alg=1&pos=10 (discussing the benefits of removing the revenue function of NRP audits but also noting the downside); National Taxpayer Advocate 2016 Annual Report to Congress vol. 3, 44-101 (Literature Review: *Behavioral Science Lessons for Taxpayer Compliance*).