

V. 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 conducting and also collaborating with the IRS on a number of research initiatives. A primary focus of these efforts is 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 initiatives that TAS is conducting or participating in for the remainder of fiscal year (FY) 2014 and during FY 2015.

A. Impact of Audits on Taxpayer Compliance

TAS Research is working together with a TAS senior attorney advisor on a multi-year study exploring 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 also compliance norms, trust in the government and the tax administration process, the complexity and convenience of complying, and the influence of preparers.

During the first two study phases, TAS analyzed the results of a telephone survey conducted by a vendor of a representative national sample of taxpayers with sole proprietor income (*i.e.*, Schedule C, *Profit or Loss from Business (Sole Proprietorship)*).¹ The principal objective was to identify the major factors that drive taxpayer compliance behavior. There were a number of significant study findings, including (among others) that trust in government, the tax laws, and the IRS are associated with the level of taxpayer compliance. Surprisingly, however, TAS found no significant evidence that economic deterrence motivates sole proprietor compliance decisions.²

In the third study phase, TAS will further explore whether economic deterrence impacts sole proprietor tax compliance. Specifically, we will evaluate the impact of audits on the subsequent reporting compliance of taxpayers. TAS will gauge the taxpayers' level of compliance by using the IRS's Discriminant Index Function (DIF), a mathematical technique used to score the audit potential of a tax return.³ We will use a test and control group. The test group will be comprised of sole proprietor taxpayers with high DIF scores⁴ who were audited in the first study year. The control group will be the population of sole proprietor

1 The vendor also administered the survey to 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.

2 See National Taxpayer Advocate 2013 Annual Report to Congress Vol. 2 at 33 (*Small Business Compliance: Further Analysis of Influential Factors*). See also National Taxpayer Advocate 2012 Annual Report to Congress Vol. 2 at 1 (*Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results*).

3 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.

4 We will classify taxpayers with DIF scores in the top 20 percent as high DIF score taxpayers.

taxpayers with high DIF scores who were not audited in the first year of the study. We will track the test groups' DIF scores for the five years following the audit and compare them to the control groups' DIF scores during the same period.

We will also explore whether certain factors influenced subsequent DIF scores, including:

- The type of audit, *i.e.*, correspondence, field audit or office audit;
- The amount of the audit assessment; and
- A subsequent audit of the test group taxpayers, *i.e.*, those audited in year one.

We anticipate completing this research by the end of December 2014.

B. Allocating Funding for Taxpayer Services Among Competing Alternatives

The National Taxpayer Advocate is concerned that the ongoing cuts to the IRS's budget in FY 2010 through FY 2013 have significantly eroded the quality of taxpayer service. In the long run, this erosion increases taxpayer burden, undermines taxpayers' faith in the tax system, and ultimately reduces voluntary compliance.⁵

In response to the National Taxpayer Advocate's concerns, the Wage & Investment (W&I) Division and TAS are collaborating on an initiative, the Service Priorities Project, that will enable the IRS to identify a proper balance between automated and personal services. The project team is developing a ranking methodology for IRS taxpayer services that takes taxpayers' needs and preferences into account. The methodology will value each of the major taxpayer services offered by the IRS from both the government's and the taxpayer's perspective. Research showed that the included services, *i.e.*, those we are evaluating, represent the vast majority of individual taxpayer service needs (see Figure V. 1 below). The IRS will be able to use this ranking methodology to make resource allocation decisions based on highest valued services in the face of budget or staffing constraints.

5 See *Progress on the Implementation of the Taxpayer Assistance Blueprint: Five-Year Progress Report: FY 2008-FY 2012* 45-47 (Apr. 22, 2013).

FIGURE V.1, SERVICE INTERACTIONS BY ISSUE, TAX YEAR (TY) 2007-2011⁶

Issue	TY 2007	TY 2008	TY 2009	TY 2011
Refund information	14%	24%	21%	30%
Get form or publication	23%	26%	26%	19%
Notice ¹	11%	14%	13%	12%
Tax law question while preparing a return ²	6%	8%	9%	10%
Return preparation assistance	10%	10%	8%	9%
Payment information	5%	6%	5%	5%
Obtain prior year tax return	6%	6%	5%	4%
Obtain Tax ID number	2%	3%	2%	2%
Tax law information after filing return	n/a	n/a	3%	3%
Make a payment	n/a	n/a	4%	6%
Other ³	23%	3%	4%	0%

¹ This service covers IRS assistance to taxpayers who are responding to IRS notices.
² TY 2007 and 2008, includes before and after filing the return.
³ In TY 2007, includes questions about the Economic Stimulus Package.

The methodology measures “value” using separate sets of criteria for taxpayers and the IRS. This is necessary because taxpayers and the IRS have different priorities. The IRS is concerned with conserving scarce resources, especially in a tight budget environment. Taxpayers need services that will enable them to understand their tax obligations and resolve tax issues without imposing undue burden. Frequently, these needs are best met by personal services that are more costly to the IRS than automated services, such as Internet-based services.

TAS Research will continue to work with W&I to complete development of the methodology and a preliminary ranking of the covered services by the end of FY 2015. The team will also develop recommendations to ensure that the data supporting the methodology is periodically updated.

6 *Progress on the Implementation of The Taxpayer Assistance Blueprint: Five-Year Progress Report: FY 2008 - FY 2012* 6 (Apr. 23, 2012), Information for tax year 2010 is missing because the information source, the Taxpayer Experience Survey, was not administered for tax year 2010.

7 This service covers IRS assistance to taxpayers who are responding to IRS notices.

8 Tax Year 2007 and 2008, includes before and after filing the return.

9 In Tax Year 2007, includes questions about the Economic Stimulus Package.

C. Impact of TAS Services on Taxpayer Compliance

As mentioned above, in recent years cuts to the IRS budget have significantly eroded the quality of taxpayer service. Moreover, the IRS's ability to assist taxpayers has suffered further declines in FY 2014:

- For the first four months of FY 2014, the level of service (LOS) on the phones was 62.5 percent, down from 73.7 percent during the first four months of FY 2013. Among taxpayers who got through, hold time rose from 12.8 minutes to 20.3 minutes.¹⁰
- In an effort to answer more calls, the IRS will not answer any questions that are “more detailed” than “basic” during the filing season.¹¹ In addition, it will not answer any tax-law questions after mid-April, although millions of taxpayers file extensions and prepare their returns later in the year.
- Also, to conserve resources, the IRS announced that it will no longer prepare any tax returns at its walk-in sites, even for low income, elderly, or disabled taxpayers.¹²

The National Taxpayer Advocate believes that quality taxpayer service is a fundamental taxpayer right, and that funding for IRS services should be set at a level that ensures that the IRS will be able to provide quality service to the nation's taxpayers.¹³ However, the measures stakeholders routinely apply to the IRS do not acknowledge the importance of service delivery. Invariably, the focus is on reducing the tax gap through enforcement efforts, or improving efficiency as measured by return on investment (ROI). Because measuring the impact of service on compliance (*i.e.*, the ROI of IRS services) is difficult, the IRS currently cannot provide detailed ROI calculations to support taxpayer service funding requests.

In recent years, TAS Research has studied whether taxpayer service, among other factors, impacts taxpayer compliance behavior.¹⁴ In FY 2015, TAS will conduct additional research to explore the impact of service on compliance.

TAS Research will develop a representative sample of taxpayers who sought help from TAS for collection and examination related issues in FY 2009. We will measure their subsequent filing, payment, and reporting compliance during the next five years, and will compare the resulting compliance rates to those for a control group. TAS will construct the control group from a random sample of taxpayers who have the same compliance issues

10 IRS, Joint Operations Center, *Snapshot Reports: Enterprise Snapshot and Product Line Detail* reports (week ending Feb. 1, 2014). IRS data for the first four months of the fiscal year (October through January) generally does not include the tax-return filing season, which this year started on January 31.

11 IRS, e-News for Tax Professionals – Issue Number 2013-49, Item 4, *Some IRS Assistance and Taxpayer Services Shift to Automated Resources* (Dec. 20, 2013), at <http://www.irs.gov/uac/Some-IRS-Assistance-and-Taxpayer-Services-Shift-to-Automated-Resources>.

12 *Id.*

13 See *Internal Revenue Oversight, Hearing Before the Subcommittee on Financial Services and General Government, H. Comm. on Appropriations*, 113th Cong. (Feb. 26, 2014) (statement of Nina E. Olson, National Taxpayer Advocate). See also, *Progress on the Implementation of the Taxpayer Assistance Blueprint: Five-Year Progress Report: FY 2008–FY 2012* 45-47 (Apr. 22, 2013).

14 See National Taxpayer Advocate 2013 Annual Report to Congress Vol. 2 at 33 (*Small Business Compliance: Further Analysis of Influential Factors*). See also National Taxpayer Advocate 2012 Annual Report to Congress Vol. 2 at 1 (*Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results*).

and who did not use TAS services. We will use the comparison of the two groups' compliance rates to estimate the value of quality services to future taxpayer compliance. Our target to complete this research is the end of June 2015.

D. Analysis of the IRS EITC Audit Strategy

Overall, EITC noncompliance is a relatively small portion of the tax gap.¹⁵ EITC overclaims account for six percent of the gross individual income tax noncompliance while business income underreported by individuals accounts for 51.9 percent.¹⁶ Nevertheless, EITC post-claim compliance costs are high and cannot be ignored.

It is important to understand the sources of error for total (gross) EITC overclaims in order to develop targeted strategies to reduce the overclaim rate. The most recent IRS National Research Program (NRP) EITC results are useful in this regard, because they provide a statistically representative sample from which to draw observations of taxpayer behavior and better understand the sources of EITC noncompliance.¹⁷ Specifically, the IRS Tax Year 2006 – 2008 NRP Compliance Study data show the impact on compliance of the complex eligibility criteria and the characteristics of the EITC beneficiary population. The IRS should use these findings to drive its EITC education, compliance, and enforcement initiatives.¹⁸

15 The tax gap is defined as the amount of tax liability faced by taxpayers that is not paid on time. The tax gap can be divided into three components: non-filing, underreporting and underpayment. See IRS, IR-2012-4, *IRS Releases New Tax Gap Estimates; Compliance Rates Remain Statistically Unchanged from Previous Study* (Jan. 6, 2012).

16 IRS, IR-2012-4, *IRS Releases New Tax Gap Estimates; Compliance Rates Remain Statistically Unchanged from Previous Study* (Jan. 6, 2012). The IRS estimates \$235 billion in individual income tax underreporting for tax year (TY) 2006 with \$122 billion of this amount attributable to business income underreported by individuals as sole proprietors on Schedule C (Profit or Loss from Business), as farmers on Schedule F (Profit or Loss from Farming), or as income from 1120S corporations, partnerships, rent, royalty, etc. on Schedule E (*Supplemental Income and Loss*). The IRS estimates about \$14.1 billion in EITC overclaims from the NRP from TYs 2006-2008. We determined the EITC overclaim amount by multiplying the overclaim rate by the amount of EITC claims (0.285 lower bound EITC overclaim rate multiplied by \$49.3 billion). IRS, RAS, *Compliance Estimates and Sources of Errors for the Earned Income Tax Credit Claimed on 2006-2008 Returns* (Feb. 12, 2014) (unpublished).

17 The IRS created the National Research Program (NRP) in 2000 to “develop and monitor strategic measures of taxpayer compliance.” National Research Program, at [http://www.irs.gov/uac/National-Research-Program-\(NRP\)](http://www.irs.gov/uac/National-Research-Program-(NRP)) (last visited on Feb. 19, 2014). NRP is a comprehensive effort by the IRS to measure payment, filing, and reporting compliance for different types of taxes and various sets of taxpayers and to deliver the data to the Business Operation Divisions to meet a wide range of needs including support for the development of strategic plans and improvements in workload identification. Internal Revenue Manual (IRM) 4.22.1.3 (Apr. 25, 2008).

18 The NRP Compliance Study estimated the total (gross) dollar overclaim percentage at 28.5 percent or \$14.1 billion (Lower Bound Estimate or LBE). IRS, RAS, *Compliance Estimates and Sources of Errors for the Earned Income Tax Credit Claimed on 2006-2008 Returns 7* (Feb. 12, 2014) (unpublished). Lower-bound estimates assume audit non-participants have similar compliance behavior to audit participants with similar characteristics (*i.e.*, in same sampling strata). Upper-bound estimates assume audit non-participants are noncompliant (*i.e.*, exam conclusion is correct). IRS, RAS, *Compliance Estimates and Sources of Errors for the Earned Income Tax Credit Claimed on 2006-2008 Returns 4* (Feb. 12, 2014) (unpublished). TAS research studies suggest the Lower Bound Estimate more accurately reflects the EITC dollar overclaim rate. A 2004 Taxpayer Advocate Service study of a representative sample of the EITC Audit Reconsideration population found that 43 percent of taxpayers who in the original audit did not respond to IRS contacts, or whose response was received after the IRS deadline and thus was not considered in the audit, had favorable outcomes from the audit reconsideration process (meaning they received more EITC from the reconsideration than from the initial audit itself). This percentage is about the same as the favorable outcome rate for *all* taxpayers in the audit reconsideration sample. Moreover, the non- and late-responders received about 96 percent of the total EITC claimed on the original return. “*This suggests that taxpayers who fail to respond to the audit, or who have a late response, may in fact be eligible for the EITC.*” (Emphasis in original.) See National Taxpayer Advocate 2004 Annual Report to Congress, Vol. 2, at 29 (*Earned Income Tax Credit (EITC) Audit Reconsideration Study*). Accordingly, we use the LBE rate throughout this discussion.

Perhaps the most significant finding is that qualifying child errors were the most costly type of error,¹⁹ accounting for between 40 and 50 percent of total overclaim dollars. Among “knowable” qualifying child errors,²⁰ 76 percent were attributable to residency test errors, compared to 20 percent that were attributable to relationship test errors.

Despite the prevalence of qualifying child residency errors, TAS review of the results of a recent study of a representative sample of taxpayers undergoing EITC audits suggests that the IRS is generally selecting returns based on residency only when relationship issues are also present.²¹ The goal of this research is to evaluate whether IRS audit coverage effectively addresses the most significant areas of noncompliance. To conduct the analysis, TAS Research will review and compare IRS audit selection criteria to the NRP results that show the relative magnitudes of the most significant overclaim error types. We anticipate completing this research by the end of December 2014.

E. Impact of Outreach and Education on Tax Compliance

As discussed above in “Impact of Audits on Taxpayer Compliance,” TAS is engaged in a multi-year study exploring the impact of a variety of factors on taxpayer compliance behavior. In the second phase of the study, TAS employed factor analysis and logistic regression to analyze the results of a national survey of taxpayers with sole proprietor income (*i.e.*, Schedule C, Profit or Loss from Business (Sole Proprietorship)).²² TAS found that compliance norms and trust in government were the principal factors that appear to influence taxpayer compliance behavior.

In the current study, TAS will explore whether outreach and education can favorably influence compliance norms and trust in the IRS, resulting in improved taxpayer compliance.²³ In particular, the study will focus on whether taxpayer awareness and perception of their taxpayer rights can influence their trust in the IRS and compliance behavior. TAS

19 The four other most costly error types were:

- Self-employment income misreporting (13-20%);
- Filing status errors (9-16%);
- Income misreporting of investment income and AGI (excluding earned income) (5-7%); and
- Wage income misreporting (2-5%).

20 The NRP Compliance Study distinguishes between “known errors” and “unknown errors.” It estimates that 30 percent of total possible overclaim returns and 41 percent of total possible overclaim dollars stem from unknown errors (*i.e.*, cases where compliance and errors are unknown mostly because of audit non-participation).

21 TAS Research study conducted in collaboration with the Small Business / Self-Employed (SB/SE) and Wage and Investment (W&I) Operating Divisions. To conduct the study, IRS Information Technology (IT) programmed IRS computers to select a representative sample of 900 cases from the W&I and SB/SE EITC correspondence examination inventory and directed the cases to the Atlanta and Philadelphia campuses during the 2011 filing season. The apparent prevalence of relationship as a basis for audit selection was not an objective of this study and is not reported as a study finding. Rather, it was an informal observation based on our review of the sample cases.

22 In the first study phase, a vendor, Russell Research, conducted a telephone survey of a nationally representative sample of sole proprietors in 2012. See National Taxpayer Advocate 2013 Annual Report to Congress Vol. 2 at 33 (*Small Business Compliance: Further Analysis of Influential Factors*). See also National Taxpayer Advocate 2012 Annual Report to Congress Vol. 2 at 1 (*Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results*).

23 The phase 2 study found that all three components of trust in government studied, *i.e.*, trust in the federal government, the tax laws and the IRS appear to influence compliance behavior. We are focusing solely on trust in the IRS, since we believe that IRS can take actions to directly influence this component.

believes this issue to be of high importance, since the National Taxpayer Advocate has long urged the IRS to publish a taxpayer bill of rights, and the IRS has recently acted on that recommendation.¹

TAS will contract with a vendor to design the study, analyze the results, and produce a final report evaluating the results in detail and discussing their implications for tax administration. We anticipate that the study will take two years to complete. In FY 2015, the contractor will complete the study design. In FY 2016, TAS will conduct the study and the contractor will prepare the final report.

F. Low Income Taxpayer Clinic (LITC) User Needs Survey

During the first half of FY 2014, TAS Research worked with a vendor to develop a telephone survey of the population of potential LITC users. The vendor is currently administering this survey to taxpayers. The goal of the survey is to identify the needs of the LITC user population. The survey focuses on their needs with respect to resolution of tax controversies and education covering their rights and responsibilities as U.S. taxpayers.

Survey respondents were drawn from the national population of taxpayers with incomes at or below 250 percent of the federal poverty level. The sample includes 1,000 randomly selected respondents. The sample also includes 200 Spanish speaking respondents who are being interviewed in a separate survey. The vendor is conducting the survey via telephone using a sampling frame that is representative of the population of both land line and cell phone users. TAS anticipates that this research will be completed by the end of December 2014.

¹ See IRS News Release, IR-2014-72, IRS Adopts “Taxpayer Bill of Rights”; 10 Provisions to Be Highlighted on IRS.gov, in Publication 1 (June 10, 2014), available at <http://www.irs.gov/uac/Newsroom/IRS-Adopts-Taxpayer-Bill-of-Rights;-10-Provisions-to-be-Highlighted-on-IRSGov,-in-Publication-1>.