

National Taxpayer Advocate

Annual Report to Congress

*2010 Annual Report to Congress*

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NATIONAL  
TAXPAYER  
ADVOCATE

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2010  
ANNUAL REPORT  
TO CONGRESS

Volume Two:  
TAS Research and  
Related Studies

TAXPAYER  
ADVOCATE  
SERVICE

YOUR VOICE AT THE IRS

December 31, 2010

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National Taxpayer Advocate

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**UNLIMIT INNOCENT SPOUSE  
EQUITABLE RELIEF**

## Unlimit Innocent Spouse Equitable Relief\*

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## EXECUTIVE SUMMARY

### Background

The validity of a Treasury Regulation effectively imposing a two-year statute of limitation on an innocent spouse's request for equitable relief from income tax liability has been denied by the U.S. Tax Court and is pending before multiple circuits of the U.S. Court of Appeals. The two-year regulatory period, which the IRS continues to enforce despite the National Taxpayer Advocate's recommendation for legislative removal and the Tax Court's invalidation, leaves innocent spouses in a quandary. Many requests for equitable relief filed after the two-year period cannot be resolved until the appellate courts rule, and thereafter, there may be divergent rules among circuits.

### Analysis

In developing the applicable legislation, Congress heard testimony from innocent spouses who described circumstances that could delay a request for relief. Congress then affirmatively omitted from the equitable relief provision any statute of limitation (other than the pre-existing one on tax collection), while specifically prescribing a two-year period for traditional or separately allocated relief elsewhere within the same statute. Unlike traditional and separately allocated relief, which covered only understatements of tax, equitable relief covered underpayments as well, thereby affording relief even if there is no deficiency. Accordingly, equitable relief extended the innocent spouse provision into the realm of collection, which already had a statute of limitations (generally ten years). Consequently, the two-year limit on equitable relief under the regulation is not a reasonable interpretation of the statute. It forecloses a class of requests that equitable relief was designed to reach, namely those in which an innocent spouse delayed a request for relief upon being misled or intimidated by a joint filer.

### Recommendation

The National Taxpayer Advocate believes the law should be clarified, whether by administrative, judicial, or legislative means, to confirm the permissibility of equitable relief at any time within the applicable limitation period on collection. As a matter of tax administration, this rule should apply uniformly to taxpayers across the country. In short, a setting aside of the invalidated regulation would allow for effective and consistent implementation of the statutory scheme.



## INTRODUCTION

The validity of a Treasury Regulation that effectively imposes a two-year statute of limitation on a request for equitable relief by an innocent spouse is pending before multiple circuits of the U.S. Court of Appeals, with the putative innocent spouse represented *pro bono* by a Low Income Taxpayer Clinic (LITC) in several cases.<sup>1</sup> Already, the Seventh Circuit has disagreed with a majority of the U.S. Tax Court which, in a court-reviewed opinion, had invalidated the regulation, leaving the innocent spouse subject only to an underlying limitation period for collecting tax under Internal Revenue Code (IRC) § 6502 (generally ten years).<sup>2</sup> For cases subject to review in other circuits, the Tax Court has reiterated its majority opinion invalidating the regulation.<sup>3</sup>

The National Taxpayer Advocate, after monitoring the implementation of the current innocent spouse provisions since they were enacted,<sup>4</sup> observes that equitable relief would be administered most effectively and consistently with the statutory scheme without limitation by the regulation in question.<sup>5</sup> As discussed below, the statutory scheme contemplates cases like those in the appellate courts, when delay in requesting relief – typical of an innocent spouse who has been misled or intimidated by a joint filer – is itself an equitable factor. Accordingly, the National Taxpayer Advocate believes the law should be clarified by administrative, judicial, or legislative means, to conform with the congressional intent implicit in the statutory scheme and confirm the permissibility of equitable relief at any time within the applicable limitation period on collection.<sup>6</sup> Although statutory amendment would be unnecessary absent the IRS regulatory position, which the Tax Court has held invalid, harm to taxpayers from the current uncertainty in the law makes clarification necessary now. In short, a setting aside of the invalidated regulation would allow for effective and consistent implementation of the statutory scheme.

<sup>1</sup> See *Mannella v. Comm’r*, 132 T.C. 196 (2009), appeal docketed No. 10-1308 (3rd Cir. Jan. 25, 2010) (reflecting counsel by Duquesne Univ. School of Law Low Income Tax Practicum); *Buckner v. Comm’r*, T.C. Docket No. 12153-09, appeal docketed No. 10-2056 (6th Cir. Aug. 18, 2010) (reflecting counsel by Mich. State Univ. LITC); *Coulter v. Comm’r*, T.C. Docket No. 1003-09, appeal docketed No. 10-680 (2d Cir.) (reflecting counsel by Cardozo School of Law Tax Clinic and Vt. Legal Aid); *Jones v. Comm’r*, T.C. Docket No. 17359-08, appeal docketed No. 10-1985 (4th Cir. Aug. 30, 2010).

<sup>2</sup> See *Lantz v. Comm’r*, 132 T.C. 131 (2009), *rev’d and remanded by* 607 F.3d 479, 483 (7th Cir. 2010) (reflecting counsel by Valparaiso Univ. Law Clinic and Legal Aid Soc’y of Mid. Tenn. & the Cumberlands) (stating “the 10-year limit in section 6502 is not a constraint on taxpayer action” but rather on IRS collection action).

<sup>3</sup> See *Hall v. Comm’r*, 135 T.C. No. 19 (Sept. 22, 2010).

<sup>4</sup> See National Taxpayer Advocate 2009 Annual Report to Congress 378; National Taxpayer Advocate 2008 Annual Report to Congress 524; National Taxpayer Advocate 2007 Annual Report to Congress 549; National Taxpayer Advocate 2006 Annual Report to Congress 540; National Taxpayer Advocate 2005 Annual Report to Congress 326, 407; National Taxpayer Advocate 2004 Annual Report to Congress 490; National Taxpayer Advocate 2003 Annual Report to Congress 170; National Taxpayer Advocate 2002 Annual Report to Congress 150; National Taxpayer Advocate 2001 Annual Report to Congress 159; National Taxpayer Advocate 2000 Annual Report to Congress 97.

<sup>5</sup> See Treas. Reg. § 1.6015-5(b)(1).

<sup>6</sup> See Legislative Recommendation: *Allow Taxpayers to Request Equitable Relief Under Internal Revenue Code Section 6015(f) or 66(c) at Any Time Before Expiration of the Period of Limitations on Collection and to Raise Innocent Spouse Relief as a Defense in Collection Actions*, *supra*; National Taxpayer Advocate 2006 Annual Report to Congress 540.

### Prior Law Did Not Contain a Statute of Limitations

As enacted in 1971, an innocent spouse provision of the tax law under certain circumstances relieved a married taxpayer who had filed a joint return from liability attributable to her or his spouse's omission of over 25 percent of gross income of which she or he did not know, or have reason to know, and from which she or he did not significantly benefit.<sup>7</sup> Because this provision did not contain a statute of limitations, the effective limitation was the period generally applicable to federal tax collection.<sup>8</sup>

In 1984, Congress believed that the “rules relieving innocent spouses from liability for tax on a joint return are not sufficiently broad to encompass many cases where the innocent spouse deserves relief.”<sup>9</sup> Consequently, the Tax Reform Act of 1984 expanded relief from liability to encompass any substantial understatement (*i.e.*, over \$500) attributable to a spouse's grossly erroneous items (including any omission) of which the taxpayer did not know or have reason to know.<sup>10</sup> There was still no statute of limitations within the provision.

### RRA 98 Limited Expanded Provisions

The IRS Restructuring and Reform Act of 1998 (RRA 98) expanded innocent spouse relief.<sup>11</sup> First, as introduced in the House of Representatives, RRA 98 removed the thresholds for substantial understatement and grossly erroneous items. As long as the innocent spouse did not know or have reason to know of understatements attributable to erroneous items in any amounts, this provision affords “traditional” relief.<sup>12</sup> Second, as modified by a Senate bill, RRA 98 allowed certain separated or divorced taxpayers to segregate tax liability from that of the joint filer, except with respect to items of which she or he actually knew.<sup>13</sup> The Senate provision enacted within RRA 98 stipulated that the innocent spouse must make an election within two years after IRS collection activities began.<sup>14</sup> Under RRA 98, the two-year rule applied to traditional as well as separately allocated relief.<sup>15</sup>

Third, if relief is not available under these two provisions, RRA 98 as modified by conference agreement created equitable relief.<sup>16</sup> Thus, equitable relief is “a safety-valve provision

<sup>7</sup> See Pub. L. No. 91-679 (adding IRC § 6013(e)).

<sup>8</sup> See IRC §§ 6502, 6503 (applying a ten-year period after 1990 but before then a six-year period, which in any case may be suspended for various reasons). IRC § 6511 provides that a taxpayer may file a claim for credit or refund of overpayment within the later of three years from the time the return was filed or two years from the time the tax was paid. IRC § 6511(b) sets forth rules for calculating the amount of credit or refund that can be allowed on a timely filed claim.

<sup>9</sup> H. Rept. No. 98-432, 98th Cong., 2nd Sess. 1502 (1984).

<sup>10</sup> See Pub. L. No. 98-369, Div. A, § 424, 98 Stat. 801 (1984).

<sup>11</sup> See Pub. L. No. 105-206, § 3201 (adding IRC § 6015).

<sup>12</sup> See IRC § 6015(b). Under the House version of the bill, which would have allowed relief “on an apportioned basis,” a taxpayer “must claim innocent spouse status with regard to any assessment not later than two years after the date of such assessment.” H.R. Conf. Rept. No. 105-599, 105th Cong., 2nd Sess. 250-51 (1998).

<sup>13</sup> See IRC § 6015(c).

<sup>14</sup> See H.R. Conf. Rept. No. 105-599, 105th Cong., 2nd Sess. 250-51 (1998); S. Rep. No. 105-174, 105th Cong., 2nd Sess. 55-60 (1998).

<sup>15</sup> See H.R. Conf. Rept. No. 105-599, 105th Cong., 2nd Sess. 254 (1998).

<sup>16</sup> See H.R. Conf. Rept. No. 105-599, 105th Cong., 2nd Sess. 251-55 (1998).

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for innocent spouses who fall through cracks” in the first two provisions.<sup>17</sup> Specifically, relief is available if, under procedures prescribed by the IRS, taking into account all the facts and circumstances, it is inequitable to hold an innocent spouse liable for a joint deficiency or unpaid tax. The statute is silent on any time for requesting equitable relief.<sup>18</sup>

Unlike traditional and separately allocated relief, which covered only understatements of tax, the provision for equitable relief as enacted in the RRA 98 conference agreement covered underpayments as well, thereby affording relief even if there is no deficiency. Accordingly, equitable relief extended the innocent spouse provision into the realm of collection, which already had a statute of limitations (generally ten years).<sup>19</sup>

### Congress Heard Testimony on Post-Hoc Circumstances

In widely publicized hearings leading up to enactment of RRA 98, the Senate Finance Committee had entertained testimony from innocent spouses, among other witnesses. Overall, as a senator put it, “the testimony we heard before the Finance Committee was that it is virtually impossible for the standards of that innocent spouse provision to be met.”<sup>20</sup> Another senator agreed “that the current law innocent spouse provisions are weak at best, and need dramatic change.”<sup>21</sup>

In pertinent part, the testimony described situations in which an innocent spouse might not, under the circumstances, request relief within two years. For example, a witness stated that when the IRS placed a lien on her home, “It was only after I informed my ex-husband of this problem that he confessed that he had, in fact, been receiving mail from the IRS addressed to both of us for years.”<sup>22</sup> Thus, a husband’s deceptive silence was a reason for an innocent spouse’s delay. Another witness asserted that “the IRS continues to send mail to the old marital address to both parties, even though these individuals have been filing separately and unmarried from different addresses for many years.”<sup>23</sup> In other words, circumstances typical of separated or divorced spouses could impede effective communica-

<sup>17</sup> Lantz, 607 F.3d at 484.

<sup>18</sup> See IRC § 6015(f). The legislative history states: “The conferees do not intend to limit the use of the Secretary’s authority to provide equitable relief to situations where tax is shown on a return but not paid. The conferees intend that such authority be used where, taking into account all the facts and circumstances, it is inequitable to hold an individual liable for all or part of any unpaid tax or deficiency arising from a joint return. The conferees intend that relief be available where there is both an understatement and an underpayment of tax.” H.R. Conf. Rept. No. 105-599, 105th Cong., 2nd Sess. 254-55 (1998).

<sup>19</sup> See Bryan T. Camp, *Interpreting Statutory Silence*, Tax Notes 501, 503 (Aug. 2, 2010).

<sup>20</sup> 144 Cong. Rec. (May 7, 1998) S4473-74 (recording statement of Sen. Bob Graham, D-Fla.).

<sup>21</sup> *Id.* at S4474 (recording statement of Sen. Alfonse D’Amato, R-N.Y.).

<sup>22</sup> Sen. Comm. on Finance, *IRS Restructuring Hearings*, 105th Cong., 2nd Sess. 149 (Jan. 28-29; Feb. 5, 11 & 25, 1998).

<sup>23</sup> *Id.* at 147.

tion. In sum, the Committee heard allegations of circumstances that could delay a request for relief. These circumstances were among concerns that RRA 98 addressed.<sup>24</sup>

### IRS Guidance Encompasses Post-Hoc Factors

In 2000, the IRS prescribed applicable procedures for equitable relief under IRC § 6015(f), setting as a threshold condition a request not later than two years after the first IRS collection activity, but encompassing future economic hardship absent relief as a necessary circumstance.<sup>25</sup> Thus, eligibility for equitable relief may turn on facts to occur later than two years after the IRS begins collection activity. In 2002, the IRS issued regulations containing the two-year limit and incorporating the other procedures by reference.<sup>26</sup>

### Appealed Cases Turn on Post-Hoc Facts

The facts of cases in the appellate courts help to illustrate the point that equitable relief is designed to be broader than traditional or separate relief, and that delay due to fear, intimidation, fraud, or ignorance brought on by the foregoing, is itself an equitable factor.<sup>27</sup> In each case summarized below, there was a reason why the innocent spouse did not request relief within the two-year period. Either her husband was taking care of the tax liability, or he told her that he would do so, or he did not tell the innocent spouse about the liability in the first place. In another case, an innocent spouse was intimidated by her husband until they divorced. The point is not just that relief would have been available on the merits but for delay, but that the delay itself was indicative of the spouse's innocence.

### *Ms. Lantz's Husband Had Advised the IRS that She Was an Innocent Spouse*

Cathy Marie Lantz filed a joint return for 1999 with Richard Chentnik, a dentist who, as it turned out, was engaged in Medicare fraud. In 2000, Dr. Chentnik was arrested and subsequently convicted and sent to prison. In 2002, the IRS assessed a deficiency of several hundred thousand dollars on the 1999 joint return due to the fraud. In 2003, the IRS sent letters to the couple that proposed a levy and constituted the first collection activity.<sup>28</sup> From prison, Dr. Chentnik advised Ms. Lantz that he would handle communication with the IRS. In 2004, the IRS issued notices to Dr. Chentnik, who had "characterized petitioner [Ms. Lantz] as 'the innocent spouse,'" indicating that the joint liability "should be moved into currently noncollectible status."<sup>29</sup> Later in 2004, Dr. Chentnik was released to a halfway house

<sup>24</sup> In view of such circumstances, RRA 98 § 3201(d), required the IRS to send a separate notice to each individual spouse filing a joint return. Nevertheless, the Committee was apprised of issues beyond those that separate notices could resolve. For instance, another witness statement was that when collection activity occurred, "I called my former husband about all that had taken place and he assured me that he would take care of the problem. I still trusted him, since he was the one who handled all our finances while we were married." Thus, an innocent spouse's misplaced reliance on her husband was a reason for delay. Sen. Comm. on Finance, *IRS Restructuring Hearings*, 105th Cong., 2nd Sess. 149 (Jan. 28-29; Feb. 5, 11 & 25, 1998).

<sup>25</sup> See Rev. Proc. 2000-15, 2000-1 C.B. 447, *superseded by* Rev. Proc. 2003-61, 2003-2 C.B. 296 (containing parallel provisions).

<sup>26</sup> See Treas. Reg. §§ 1.6015-4(c), -5(b)(1), 67 Fed. Reg. 47,278 (July 18, 2002).

<sup>27</sup> See *Hall*, slip op. at 12 (stating where "a spouse is prevented from acting by fear, intimidation, or fraud, an administrative procedural hurdle would eliminate consideration of relief").

<sup>28</sup> See *Lantz*, 132 T.C. at 132 (stating these "letters conformed with the notice requirements of section 6330").

<sup>29</sup> *Lantz*, 132 T.C. at 132-33.

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where he passed away. In 2005, the IRS applied an overpayment by Ms. Lantz against the 1999 liability. In 2006, Ms. Lantz filed Form 8857, *Request for Innocent Spouse Relief*, which the IRS denied as late.<sup>30</sup>

### *Ms. Mannella's Husband Had Not Shared IRS Notices with Her*

From 1996 through 2000, Denise and Anthony Mannella filed joint returns on which they did not pay the tax. On June 4, 2004, the IRS sent the couple “notice[s] of intent to levy.”<sup>31</sup> Mr. Mannella signed the certified mail receipts but did not share the notices with Ms. Mannella.<sup>32</sup> On November 1, 2006, Ms. Mannella filed Form 8857, but the IRS denied her request as several months late.

### *Ms. Hall's Husband Was Legally Obligated to Pay Their Joint Liability*

In 1998 and 2001, Audrey Marie and Etheridge Hall filed joint returns but did not pay all of their tax. In 2003, they divorced under a decree that obliged Mr. Hall to pay their joint liabilities. On July 6, 2004, the IRS “initiated collection activity . . . by issuing an intent to levy notice.”<sup>33</sup> On August 1, 2008, Ms. Hall requested innocent spouse relief, which the IRS denied as untimely, although the IRS agreed she would be entitled to equitable relief on the merits.<sup>34</sup>

### *Ms. Coulter Was Intimidated by Her Husband*

Heather Coulter (Hoyt) filed a joint return with Kevin Hoyt for 2001. On August 31, 2004, the IRS sent Ms. Coulter a notice of intent to levy to collect unpaid tax on the return.<sup>35</sup> On April 15, 2008, Ms. Coulter requested innocent spouse relief, which the IRS denied as late, but still stipulated that she otherwise would be entitled to equitable relief on the merits.<sup>36</sup> Ms. Coulter said she had not filed a timely request because “I was still married and had I filed an innocent spouse claim at that time it would have made an already volatile living situation much worse for my children.”<sup>37</sup>

<sup>30</sup> See *Lantz*, 132 T.C. at 133.

<sup>31</sup> *Mannella*, 132 T.C. at 197, 199 (stating “issuance of a notice of intent to levy under section 6330 is a collection activity”); see also Treas. Reg. § 1.6015-5(b)(2).

<sup>32</sup> Even though RRA 98, § 3201(d) requires a separate notice to each individual spouse filing a joint return, as a practical matter, a recipient of mail at an address can sign certified mail receipts on behalf of the household. In any case, the Tax Court assumed that Ms. Mannella did not actually receive notice. See *Mannella*, 132 T.C. at 199-200.

<sup>33</sup> *Hall*, slip op. at 3.

<sup>34</sup> While the Tax Court did not specifically set forth factual findings as to whether Mr. Hall failed to satisfy his divorce decree obligation to pay the joint tax liabilities, as a legal matter, a divorce decree obligation is a factor in determining equitable relief. See *Hall v. Comm’r*, 135 T.C. No. 19 (Sept. 22, 2010); see also Rev. Proc. 2003-61, § 4.03(2)(a)(iv), 2003-2 C.B. at 298 (considering whether “the nonrequesting spouse has a legal obligation to pay the outstanding income tax liability pursuant to a divorce decree or agreement”).

<sup>35</sup> The facts stipulated by both parties in *Coulter v. Comm’r*, on which the Tax Court entered a Decision in Docket No. 1003-09, are reflected in Brief for the Appellant 4, No. 10-680 (2d Cir.), which refers to “a notice of intent to levy and of her right to a collection-due-process (CDP) hearing before such levy under § 6330 of the Code with respect to unpaid tax due for 2001.”

<sup>36</sup> See Brief for the Appellant 9.

<sup>37</sup> Petition ¶ 1, T.C. Docket No. 1003-09.

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**RRA 98 Was Not Ambiguous**

When Congress imposed a statute of limitations in two provisions but not in the third provision within the same section, the omission was affirmative.<sup>38</sup> Although precedents uphold regulatory limitation under silent statutes,<sup>39</sup> they are not on point because the relevant section of RRA 98 was not silent on the two-year period. Ever since enactment of the 1971 innocent spouse statute, the effective statute of limitation had been the underlying one for collection of tax.<sup>40</sup> Nevertheless, in the appellate cases, the IRS argues essentially that Congress did not preclude regulatory promulgation of a limit.<sup>41</sup> As a matter of statutory construction, it would be possible to dismiss this argument, but the regulation may fall even on its own merits.

**The Regulatory Period Is Not Reasonable**

As stated above, an affirmative omission, what the Tax Court majority called “audible silence,” does not result in an ambiguous statute.<sup>42</sup> To the extent that the lack of express preclusion of a regulatory limit may be perceived as creating ambiguity, the question is whether the regulation is a reasonable interpretation.<sup>43</sup> Here the regulation is not a reasonable interpretation because it forecloses a class of requests that equitable relief was designed to reach, namely those in which an innocent spouse delayed a request for relief upon being misled or intimidated by a joint filer.<sup>44</sup>

In a case where the tax law authorized the IRS to prescribe the “manner” of a claim, leading to a regulation that contained a time limit, an appellate court has upheld IRS regulatory authority.<sup>45</sup> Here, however, the time-bar exceeded a procedural prescription of time or manner because it precluded a substantive kind of request.<sup>46</sup> Moreover, an innocent spouse equitable request, which may encompass an underpayment as well as an understatement, is more like a defense against federal tax collection than a claim of the type foreclosed by a statute of limitations.<sup>47</sup>

<sup>38</sup> See *General Motors Corp. v. U.S.*, 496 U.S. 530, 538 (1990); *Russello v. U.S.*, 464 U.S. 16, 23 (1983) (stating “where Congress includes particular language in one section of a statute but omits it in another section of the same Act, it is generally presumed that Congress acts intentionally and purposely in the disparate inclusion or exclusion”).

<sup>39</sup> See, e.g., *Withey v. Perales*, 920 F.2d 156, 159 (2d Cir. 1990) (stating that “Congress frequently fails to address the issue of a limitations period”).

<sup>40</sup> *But see Lantz*, 607 F.3d at 482 (stating “the fact that Congress designated a deadline in two provisions of the same statute and not in a third is not a compelling argument that Congress meant to preclude the Treasury Department from imposing a deadline applicable to cases governed by that third provision”).

<sup>41</sup> See *Mannella*, No. 10-1308 (3d Cir.) Brief for the Appellant 36.

<sup>42</sup> *Lantz*, 132 T.C. at 138.

<sup>43</sup> See *Chevron U.S.A., Inc. v. Natural Resources Defense Council*, 467 U.S. 837 (1984).

<sup>44</sup> *Contra Lantz*, 607 F.3d at 481 (upholding administrative position because “regulations issued pursuant to authority delegated by Congress must be upheld unless unreasonable”).

<sup>45</sup> See *Swallows Holding, Ltd. v. Comm’r*, 515 F.2d 162 (3d Cir. 2008), *vacating* 126 T.C. 96 (2006).

<sup>46</sup> See *Hall*, slip op. at 13 (stating that the invalidated regulation “has the substantive effect of making one circumstance, the time of the claim, the only relevant factor”).

<sup>47</sup> See Patrick J. Smith, *Gaps in the Seventh Circuit’s Reasoning in Lantz*, Tax Notes (Aug. 24, 2010).

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By comparison, under a federal statute that authorized an administrative agency to designate placement of certain prisoners considering five factors, a regulation purported to place prisoners in a halfway house for a certain period at the end of their sentences. Appellate courts invalidated this regulation because designation solely based on time served eviscerated consideration of the five prescribed factors.<sup>48</sup>

In the case of an innocent spouse, the Treasury Regulation eviscerated consideration of equitable factors by time-barring all cases after two years. Moreover, a delay may be indicative of fear, intimidation, fraud, or ignorance due to abuse, which even the IRS counts as a factor that should be considered in determining equitable relief.<sup>49</sup>

### **A Statute of Limitations Is Inappropriate to Equitable Relief**

Legislative history, typical fact patterns, and regulatory deference do not support imposition of the two-year period on equitable relief. Additionally, the logic underlying related common-law doctrines and regulatory provisions leads to the conclusion that a statute of limitations should not apply.

In 2006, the National Taxpayer Advocate recommended legislation to clarify the availability of equitable relief beyond the two-year period. A logical basis for the recommendation, by analogy to common law doctrines, was that a taxpayer who has a claim against a third party may obtain relief from tax liability as long as the IRS collection statute remains open.<sup>50</sup> That is, the statutory scheme that was “audibly silent” on the two-year period with respect to equitable relief incorporates the logic of the doctrines of equitable recoupment and setoff, given that an innocent spouse necessarily has a claim against a joint filer.

Another relevant doctrine is equitable tolling.<sup>51</sup> Generally, equity may toll the running of a period of limitations as long as the latter seeks to protect a case-specific interest in timeliness rather than a systemic goal of facilitating the administration of claims.<sup>52</sup> Naturally, equitable relief is case-specific because it proceeds from case-by-case requests from innocent spouses. When the IRS imposed the two-year period arguably to facilitate administration, the regulation exceeded statutory authority. Thus, equitable tolling could apply but for the invalidity of the limitation period. In any case, a purportedly systemic statute of limitations is inapposite to equitable relief.

<sup>48</sup> See *Wedelstedt v. Wiley*, 477 F.3d 1160 (10th Cir. 2007); *Levine v. Apker*, 455 F.3d 71 (2d Cir. 2006); *Fults v. Sanders*, 442 F.3d 1088 (8th Cir. 2006); *Woodall v. Fed. Bureau of Prisons*, 432 F.3d 235 (3d Cir. 2005).

<sup>49</sup> See Rev. Proc. 2003-61, § 4.03(2)(b)(i), 2003-2 C.B. at 299.

<sup>50</sup> See National Taxpayer Advocate 2006 Annual Report to Congress 540.

<sup>51</sup> See *Hall*, slip op. at 20 (Wells, J., concurring).

<sup>52</sup> See *John R. Sand & Gravel Co. v. U.S.*, 552 U.S. 130 (2008).



In fact, the number of equitable cases foreclosed by the two-year rule would be relatively low. Historically, tens of thousands of Forms 8857 are filed annually,<sup>53</sup> yet only hundreds or thousands of equitable requests per year have been precluded by the two-year rule.<sup>54</sup>

Similarly, discretionary extensions of time to make certain tax elections are available under regulations that consider factors such as a taxpayer's good faith, reasonable reliance on professional advice, and any prejudice to the government's interest.<sup>55</sup> Even if these regulations do not specifically provide for innocent spouse requests,<sup>56</sup> they underscore the point that in equitable cases, the IRS should not apply a statute of limitations as such.

## CONCLUSION

Allowance of equitable relief even after the two-year statutory period for traditional or separate relief would complete rather than undermine the legislative scheme.<sup>57</sup> As discussed above, Congress contemplated cases in which an innocent spouse might not lodge a request within two years. At the same time, an exception for equitable relief does not swallow the two-year rule because the substantive provisions are different.

The two-year regulatory period for filing a request for equitable relief, which the IRS continues to enforce despite the National Taxpayer Advocate's recommendation for a legislative amendment that would allow the filing of requests for equitable relief so long as the period for collection remains open and the Tax Court's invalidation, leaves innocent spouses in a quandary. Many requests for equitable relief filed after the two-year period cannot be resolved until the appellate courts rule, and thereafter, there may be divergent rules among circuits.

## RECOMMENDATION

As a matter of law, the availability of equitable relief beyond the two-year period should be clarified by administrative, judicial, or legislative means.<sup>58</sup> As a matter of tax administration, this rule should apply uniformly to taxpayers across the country. In sum, a setting aside of the invalidated regulation would allow for effective and consistent implementation of the statutory scheme.

<sup>53</sup> See National Taxpayer Advocate 2005 Annual Report to Congress 329.

<sup>54</sup> The numbers of IRC § 6015(f) disallowed untimely claims in FY 2004-10 were 1,127, 377, 1,175, 1,752, 2,053, 2,396, and 1,555. E-mail from IRS Wage & Investment Division Compliance function (Dec. 7, 2010) (on file with TAS).

<sup>55</sup> See *Lantz*, 132 T.C. at 150 (Halpern, J., dissenting).

<sup>56</sup> See Treas. Reg. § 301.9100-0 *et seq.*

<sup>57</sup> *Contra Lantz*, 607 F.3d at 484 (stating "if there is no deadline in subsection (f), the two-year deadlines in subsections (b) and (c) will be set largely at naught because the substantive criteria of those sections are virtually the same as those of (f)").

<sup>58</sup> See Legislative Recommendation: *Allow Taxpayers to Request Equitable Relief Under Internal Revenue Code Section 6015(f) or 66(c) at Any Time Before Expiration of the Period of Limitations on Collection and to Raise Innocent Spouse Relief as a Defense in Collection Actions, supra.*



Unlimit Innocent Spouse Equitable Relief

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National Taxpayer Advocate

Annual Report to Congress

2010 Annual Report to Congress

**THE PATIENT PROTECTION AND  
AFFORDABLE CARE ACT:**

**A PRELIMINARY ANALYSIS OF THE  
CHALLENGES FACING THE IRS IN  
IMPLEMENTING HEALTH CARE REFORM**

The Patient Protection and Affordable Care Act: A Preliminary Analysis of the Challenges Facing the IRS in Implementing Health Care Reform

## The Patient Protection and Affordable Care Act: An Initial Analysis of the Implementation Challenges<sup>1</sup>

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## INTRODUCTION

On March 23, 2010, the President signed into law Public Law 111-148, the Patient Protection and Affordable Care Act (known by the short title Affordable Care Act). The new law, later amended by the Health Care and Education Reconciliation Act (HCERA), enacts significant changes to America's health care system. Health care reform will likely be the most extensive social benefit program the IRS has been asked to implement in recent history. Although most Americans do not now interact with the IRS in connection with their health insurance, many provisions of the new law will require IRS involvement at some point in the future.

The majority of the tax-related provisions in the law have delayed effective dates.<sup>2</sup> However, a recent Associated Press poll found more than half of Americans believe the health care law will raise taxes on individuals this year.<sup>3</sup> For example, the new W-2 reporting requirement has raised numerous concerns that reporting the value of health insurance on an employee's W-2 may cause the amount to be taxed.<sup>4</sup> In October, the IRS announced it would delay implementation of the W-2 reporting requirement for a year. An IRS news release explains the delay is designed to give employers more time to prepare and update their systems. However, the release also states: "[T]he IRS continues to stress that the amounts reportable are not taxable."<sup>5</sup>

Given the confusion about the law, the IRS must conduct considerable education and outreach to the affected taxpayers. In addition, the IRS will be the face of health care reform for taxpayers, but in many circumstances it will not be the decision maker. For example, exemptions for the individual penalty and many aspects of the premium tax credit likely will be determined by the state-level exchanges.

The IRS will have to determine the best way to administer decisions made by these other entities in the least burdensome manner for both the taxpayer and itself. The IRS has extensive experience implementing new legislation with very little lead time. But this challenge is bigger. Given the enormously complex task it now faces, the IRS should use its time wisely to conduct research and bring to bear the knowledge it has gained from its administration of the Earned Income Tax Credit (EITC), First-Time Homebuyer Credit (FTHBC), and Making Work Pay Credit to strengthen its health care implementation plans.

<sup>2</sup> For example, the premium tax credit, individual responsibility requirement, and employer requirement are effective January 1, 2014. See Patient Protection and Affordable Care Act of 2009, Pub. L. No. 111-148, §§ 1401, 1501, 1513, as amended by the Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-443.

<sup>3</sup> Ricardo Alonso-Zaldivar and Trevor Tompson, Associated Press, *AP Poll: Health Care Law Making US Muddle-Minded* (Sept. 21, 2010).

<sup>4</sup> See, e.g., Tax Girl, *No Tax on Health Care Benefits for 2010 or 2011 or...*, available at <http://www.taxgirl.com/no-tax-on-health-care-benefits-for-2010-or-2011-or/> (last visited Dec. 14, 2010). Starting in tax year 2011, the Affordable Care Act requires employers to report the value of employer-provided health insurance coverage on employees' annual W-2 forms. This reporting is for informational purposes only. Patient Protection and Affordable Care Act of 2009, Pub. L. No. 111-148, § 9002, as amended by the Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-443.

<sup>5</sup> IRS, IR-2010-103, *IRS Releases Draft W-2 Form for 2011; Announces Relief for Employers*, available at <http://www.irs.gov/newsroom/article/0,,id=228881,00.html> (last visited Oct. 15, 2010).

## The Patient Protection and Affordable Care Act: A Preliminary Analysis of the Challenges Facing the IRS in Implementing Health Care Reform

Although the IRS has been working to implement the major provisions that directly affect taxpayers, it has not publicly discussed the particular challenges it faces. The National Taxpayer Advocate believes a public discussion regarding the scope and design of IRS health care activities will ensure that the agency has the funding and resources it will require to effectively deliver the program. Moreover, early public discussion will help identify areas that could cause problems or confusion for taxpayers. This early discussion will allow the IRS, the National Taxpayer Advocate, and others to propose “fixes” for problem areas – whether administrative or legislative.

For these reasons, the National Taxpayer Advocate would like to begin the dialogue with this discussion about the health tax provisions and related challenges to further the public’s understanding of their complexity and scope. Included in this piece are “process maps” of each of the three major provisions that have yet to be implemented to help describe the administrative challenges the IRS is facing. With proper planning and funding, the IRS is fully capable of implementing health care reform. However, a comprehensive assessment of the potential issues and challenges that lie ahead is a prerequisite for success.

### Background

#### *An Overview of the Four Main Health Tax Provisions*

Although the Patient Protection and Affordable Care Act contains a number of tax-related provisions, this discussion will focus on the four main ones:

- **Small Business Tax Credit** – Beginning in tax year 2010, a tax credit is available to eligible for-profit and tax-exempt small employers with less than 25 full-time employees that pay at least half the cost of single coverage for their employees.<sup>6</sup> The amount is based on the number of full-time employees and their average annual wages. The credit is targeted to small businesses and tax-exempt organizations employing low and moderate income workers.<sup>7</sup>
- **Premium Tax Credit** – Beginning in 2014, the Affordable Care Act creates a refundable tax credit for coverage under a qualified health plan. The credit is available to eligible individuals and families with incomes below a specified threshold (subject to an income phase-out range) and subsidizes the purchase of health insurance through an exchange.<sup>8</sup>
- **Individual Responsibility Requirement** – Beginning in 2014, individuals will be required to maintain minimal essential health care coverage for themselves and their dependents or be subject to an annual penalty. The law makes exceptions for individuals with certain religious objections, those who are not lawfully present in the United States, and incarcerated individuals. The new law provides exemptions from

<sup>6</sup> Single coverage is the cost of covering a single individual under a health insurance plan. This is compared with Family coverage, which is generally the cost of covering two or more individuals under a health insurance plan.

<sup>7</sup> Internal Revenue Code (IRC) § 45R.

<sup>8</sup> IRC § 36B.

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the penalty for persons with a hardship waiver, who cannot afford coverage, who have incomes of less than 100 percent of the federal poverty level, who are members of an Indian tribe, or who are not covered for a period of less than three months.<sup>9</sup>

- Employer Requirement – Beginning in 2014, employers with 50 or more full-time employees that do not offer minimum essential health insurance coverage or offer unaffordable coverage will be liable for an additional tax if one or more employees purchase insurance through an exchange and receive a premium tax credit.<sup>10</sup>

### *IRS Implementation of the Small Business Tax Credit Leaves Unanswered Questions*

The Small Business Tax Credit in IRC § 45R is the first major health care tax provision to take effect. As noted above, the credit is available to employers with less than 25 full-time employees that pay at least half the cost of single coverage.<sup>11</sup> The credit is based on the number of full-time employees and their average annual wages, with the full amount available to employers with less than ten full-time employees and less than \$25,000 in average annual wages.<sup>12</sup>

In mid-April, the IRS began mailing postcards to millions of small businesses providing a brief description of the new tax credit and directing the businesses to visit the IRS website or consult a tax professional to find out if they qualify.<sup>13</sup> In mid-May, the IRS issued Notice 2010-44 with more details and examples of the various requirements of the credit. The IRS also provided a three-step form for employers to determine eligibility, a set of frequently asked questions, and a YouTube video on the credit.<sup>14</sup>

Eligible employers will use new Form 8941, *Credit for Small Employer Health Insurance Premiums*, to claim the small business tax credit, while tax-exempt small employers will use a revised Form 990-T, *Exempt Organization Business Income Tax Return*,<sup>15</sup> which will be available for the 2011 filing season.<sup>16</sup> With respect to for-profit businesses, the credit is claimed as a general business credit against tax and is not refundable.<sup>17</sup>

<sup>9</sup> IRC § 5000A. If an individual does not have qualifying health insurance, the individual will be subject to a penalty of the greater of \$695 per person per year (up to a maximum of \$2,085 per family), or 2.5 percent of household income. The penalty is phased in beginning in 2014 until it reaches the full amount of \$695 per person in 2016.

<sup>10</sup> IRC § 4980H.

<sup>11</sup> The credit is equal to 35 percent (25 percent for tax-exempt small employers) of an employer's premium payments taken into account for purposes of the credit. In tax year 2014, the percentage increases to 50 percent (35 percent for tax-exempt small employers) and the credit is limited to two years, without regard to any years prior to 2014. IRC § 45R(b), (g).

<sup>12</sup> The amount of the credit phases out as the number of full time employees exceeds 10 and the average annual wages exceed \$25,000. The credit is completely phased out once the employer has 25 full time employees or average annual wages of \$50,000 or more. IRC § 45R(c).

<sup>13</sup> IRS, Notice 1397 (Apr. 2010); IRS, IR-2010-48, *IRS Reaches Out to Millions of Employers on Benefits of New Health Care Tax Credit* (Apr. 19, 2010), available at <http://www.irs.gov/newsroom/article/0,,id=221511,00.html>. The IRS mailed the postcard to more than four million small businesses and tax-exempt organizations.

<sup>14</sup> Small Business Health Care Tax Credit for Small Employers, available at <http://www.irs.gov/newsroom/article/0,,id=223666,00.html> (last visited Nov. 9, 2010).

<sup>15</sup> *Id.*

<sup>16</sup> *Id.*

<sup>17</sup> IRC §§ 38(b)(36), 45R. For tax-exempt employers, the credit is a refundable credit not to exceed the employer's payroll taxes during the year. IRC § 45R(f)(1).

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To date, the IRS has only had to deal with outreach to small businesses on the new tax credit. However, the 2011 filing season will be the first opportunity for taxpayers to claim the credit and for the IRS to discover what problems exist with implementation. As previously seen with the First-Time Homebuyer and Making Work Pay credits, new credits create taxpayer problems that the IRS does not always foresee.<sup>18</sup>

The small business credit requires the employer/taxpayer to take a number of steps to determine eligibility and calculate the proper amount. To determine whether it is eligible for the credit and compute the size of the credit under IRC § 45R, an employer must:<sup>19</sup>

1. Determine which employees to take into account for purposes of the credit;
2. Determine the number of hours of service those employees perform;
3. Calculate the number of the employer's Full-Time Equivalents (FTEs);
4. Determine the average annual wages paid per FTE; and
5. Determine the premiums paid by the employer that are taken into account for purposes of the credit.

Because this is the first year to claim the credit, small employers will be struggling through these calculations for the first time. At this point, it is unclear how the IRS Compliance and Criminal Investigation (CI) functions plan to handle claims. The complex calculations leave room for error and the dollars at stake create the potential for fraud. It is also unclear whether, post-filing season, the IRS plans to conduct outreach to small employers who do not claim the credit but the IRS believes might be eligible.

### *IRS Overall Implementation Efforts Are Still in the Initial Stages*

The IRS is in the initial stages of implementing the main provisions of the law that take effect in future years. The IRS has set up a health care program office to lead the implementation efforts, and through the program office, it has established four teams that are

<sup>18</sup> For a discussion of the First-Time Homebuyer and Making Work Pay Credits, see National Taxpayer Advocate Fiscal Year 2011 Report to Congress 1 (*TAS Continues to Believe that the IRS Should Do a Better Job of Meeting Taxpayers Needs and TAS Will Continue to Advocate for Improved Taxpayer Services*).

<sup>19</sup> For example, for the 2010 taxable year, a taxable eligible small employer has 12 FTEs and average annual wages of \$30,000. The employer pays \$96,000 in health insurance premiums for its employees (which does not exceed the average premium for the small group market in the employer's state) and otherwise meets the requirements for the credit. The credit is calculated as follows:

1. Initial amount of credit determined before any reduction:  $(35\% \times \$96,000) = \$33,600$ .
2. Credit reduction for FTEs in excess of 10:  $(\$33,600 \times 2/15) = \$4,480$  (the 2/15 percentage is the average number of FTE in excess of ten over 15). IRC § 45R(c)(1).
3. Credit reduction for average annual wages in excess of \$25,000:  $(\$33,600 \times \$5,000 / \$25,000) = \$6,720$  (the \$5,000/\$25,000 percentage is the average annual wages in excess of \$25,000 over \$25,000). IRC § 45R(c)(2).
4. Total credit reduction:  $(\$4,480 + \$6,720) = \$11,200$ .
5. Total 2010 tax credit equals \$22,400  $(\$33,600 - \$11,200)$ .

IRS, *Small Business Health Care Tax Credit: Frequently Asked Questions, Example 9*, available at <http://www.irs.gov/newsroom/article/0,,id=220839,00.html> (last visited Dec. 14, 2010) (explanations and citations added).

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working on specific issues.<sup>20</sup> The National Taxpayer Advocate has repeatedly asked that TAS be included in these teams and has offered her senior advisors to serve on them. The National Taxpayer Advocate is concerned the IRS declined to include TAS members on the teams, increasing the risk that the IRS will make operational decisions that are best for itself without adequate consideration of taxpayer impact.

The IRS has also established an executive-level team – of which TAS is a member – to discuss implementation of the new provisions at a more general level. The main efforts of the executive team center around a series of process maps TAS developed that outline the main provisions in the new law. TAS designed these process maps, contained in charts 1–6, to help the IRS understand how these provisions will operate as well as what types of interaction the IRS will have with taxpayers, other government agencies, and other entities. Most importantly, the process maps can assist in identifying potential problems for taxpayers and the IRS, as well as areas for IRS outreach and education.

Despite the exclusion of TAS from the IRS's health care implementation teams, TAS is undertaking its own efforts. The National Taxpayer Advocate convened an internal team of TAS executives and other employees who meet bi-weekly to discuss the various provisions and identify potential problems and implications for taxpayers, the IRS, and TAS. In addition to developing the process maps discussed above, TAS is training its own employees and the Low Income Taxpayer Clinics on the provisions in the health care law.<sup>21</sup>

Over the past few months, TAS has developed a course that provides an overview of the new law as well as in-depth training on the small business tax credit. This course was available as an option at TAS's 2010 Symposium (an all-employee technical training event) and was recently provided to TAS's leadership and all of its Local Taxpayer Advocates. TAS has also converted the course into a series of online classes that every TAS employee will take over the next few months. While this is only the beginning of TAS's education efforts regarding health care reform, TAS is proud that its employees are already beginning to think

<sup>20</sup> The four teams are:

- Individual Education and Compliance;
- Employer Education & Compliance;
- Premium Assistant & Tax Credit Reconciliation; and
- Customer Service and Operations.

The teams reported on their activities on December 7, 2010, to the leadership of the IRS Operating Divisions, MITS, Appeals, and Research. The National Taxpayer Advocate was excluded from this meeting and to date has not received a copy of the briefing document.

<sup>21</sup> Low Income Taxpayer Clinics are authorized by IRC § 7526 and represent low income taxpayers before the IRS and assist taxpayers in audits, appeals, and collection disputes. LTCs can also help taxpayers respond to IRS notices and correct account problems. Early in 2010, TAS began providing training to employees on the various health tax provisions in the new law. TAS executives and senior-level employees received in-depth training and TAS staff developed a training course providing an overview of the new law, with a focus on the small business tax credit and the remaining major tax provisions. This training course was offered as an option for TAS employees at the August 2010 Symposium. IRS employees who attended TAS's Symposium were also able to attend the course. Following the success of the course, TAS converted it into a three-part online course. Some portions of the course are included in TAS's annual Filing Season readiness training, which all TAS employees will take in early 2011. The remaining sections of the health care course will be rolled out during 2011 and will be required training for all TAS employees. This is just the first step in TAS's efforts to train its employees on the new law and TAS will be developing additional training courses in 2011 and beyond as the IRS implements the new provisions.



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through the potential impact of the new provisions so it can most effectively advocate for taxpayers who experience difficulties.

### THE IRS FACES EXTENSIVE CHALLENGES IN IMPLEMENTING HEALTH CARE TAX PROVISIONS.

The IRS must deal with a number of new issues as it moves forward with implementing the health care provisions, including:

- Gathering new information;
- Communicating with entities and government agencies (including federal, state-based, public and private groups);
- Creating new form(s) to obtain data from taxpayers;
- Establishing a new definition of income; and
- Addressing privacy concerns.

The health care tax provisions require the IRS to gather a significant amount of new information that it does not currently have. This new information includes:

- Insurance plan information, including who is covered under the plan and the dates of coverage;<sup>22</sup>
- The costs of health insurance plans;<sup>23</sup>
- Whether a taxpayer had an offer of employer-sponsored health insurance;<sup>24</sup>
- The cost of employer-sponsored insurance;<sup>25</sup>
- Whether a taxpayer received a premium tax credit;<sup>26</sup> and
- Whether a taxpayer has an exemption from the individual responsibility requirement.<sup>27</sup>

This is different from the type of information the IRS typically deals with, and some taxpayers may feel uncomfortable about sharing it with the IRS. As a result, some taxpayers could be tempted to not file a tax return or file a return with incorrect or incomplete information, creating problems for both the taxpayer and the IRS.

<sup>22</sup> Information will be used to determine if the individual responsibility requirement is met.

<sup>23</sup> Information will be used to calculate the premium tax credit.

<sup>24</sup> Information will be used to determine eligibility for the premium tax credit and applicability of the employer responsibility requirement.

<sup>25</sup> Information will be used to determine applicability of the employer responsibility requirement.

<sup>26</sup> Information will be used to calculate the premium tax credit and determine applicability of the employer responsibility requirement.

<sup>27</sup> Information will be used to determine if the individual responsibility requirement is met.

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Obtaining this new information will also require the IRS to communicate with entities and government agencies that it may not deal with now, including:

- New insurance exchanges;<sup>28</sup>
- Employers;<sup>29</sup>
- Insurance companies;<sup>30</sup> and
- Government insurance programs.<sup>31</sup>

This new information will likely come to the IRS via new forms or an electronic exchange. This means the IRS will need to either create new systems or update current ones to make them capable of communicating with groups outside the IRS, such as the exchanges. For example, in determining whether an individual is eligible for a premium tax credit and the amount of the credit, the IRS will have to quickly verify the household income information a taxpayer provides to the exchange.<sup>32</sup> The amount of data the IRS will have to exchange with outside groups and the speed with which this will need to be done depend almost entirely on IRS systems, and the challenges the IRS faces because of its systems needs cannot be overstated.

The IRS will likely have to develop a new form or forms to collect health care information from taxpayers, as there is not enough room available on the current Form 1040. Because of the complexity of the new provisions, it is important that any new forms be easy to understand and not add to taxpayer confusion. The IRS should also ensure that, unlike the form for claiming the FTHBC, any new forms can be filed electronically, eliminating the need for large numbers of taxpayers to file paper returns.<sup>33</sup>

The IRS will use the information provided by taxpayers and outside entities to determine whether an individual may be subject to the responsibility requirement penalty or is eligible for a premium tax credit. The prompt delivery of taxpayer refunds will depend on the IRS's ability to quickly process and match this information to prevent refund holds. At the same time, the IRS will have to minimize the payment of refunds to taxpayers it later determines are subject to the responsibility requirement penalty (which would result in improper payments).<sup>34</sup>

<sup>28</sup> The IRS will need to know who purchased health insurance through the exchange and who received the premium tax credit.

<sup>29</sup> The IRS will need insurance information about their employees.

<sup>30</sup> The IRS will need information about who is covered during the year.

<sup>31</sup> The IRS will need information about who is covered during the year.

<sup>32</sup> For a detailed discussion of the mechanics of the premium tax credit, see discussion *infra* and the process maps contained in Charts 1 – 3.

<sup>33</sup> IRS, *First-Time Homebuyer Credit*, available at <http://www.irs.gov/newsroom/article/0,,id=204671,00.html> (last visited Dec. 15, 2010) (noting FTHBC claims must be filed using a paper tax return).

<sup>34</sup> Improper Payments Elimination and Recovery Act of 2010, Pub. L. No. 111-204. An improper payment includes a payment that should not have been made or was made in the wrong amount (including overpayments and underpayments). *Id.* at § 2(f)(2)(A).

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It is likely that the biggest challenge the IRS will face is communicating the new law to taxpayers. Taxpayers will go to the exchange to apply for the premium tax credit or an exemption from the individual responsibility requirement, but the IRS will be the agency left enforcing these provisions at the end of the year.<sup>35</sup> Thus, the IRS will collect from taxpayers if they received too large a premium tax credit, and the IRS will impose a penalty on taxpayers who did not have health insurance and did not qualify under one of the exemptions. So although taxpayers may contact the exchanges during the year for assistance, they will hear from the IRS at the end of the year when their tax accounts are affected.

Because many of the new provisions force the IRS to rely on other government agencies and enforce their potentially controversial decisions, the IRS needs to ensure it owns the messages delivered to the public about these provisions. In its own self-interest, the IRS should educate taxpayers about the importance of updating their premium tax credit eligibility information with the exchanges because the IRS will be the agency that ultimately collects from taxpayers if their credits are too large. Further, the IRS should educate taxpayers about the economic consequences of failing to purchase health insurance because the IRS will be collecting the penalty.

The IRS is the best-equipped agency to explain the complex tax issues in the new health care law. Leaving the messaging up to other agencies increases the risk that taxpayers will run into problems during the filing season as well as the risk that the IRS will have to do additional (unfunded) work to resolve these problems.

In addition to these overarching concerns, the IRS will face additional concerns specific to certain provisions.

### Premium Tax Credit

#### *Background*

The premium tax credit is designed to help low and middle income individuals and families purchase health insurance through the exchange. The tax credit is refundable, payable in advance to the insurer, and available to eligible individuals and families with income from 133 to 400 percent of the federal poverty level (FPL).<sup>36</sup>

<sup>35</sup> For a detailed discussion of the mechanics of the premium tax credit and the individual responsibility requirement, see *infra*.

<sup>36</sup> IRC § 36B(c)(1)(A). The federal poverty level is the official poverty line as defined by the Office of Management and Budget based on the most recent data available from the Bureau of the Census. IRC § 36B(d)(3)(A) (referring to 42 U.S.C. § 1397jj(c)(2)).

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The premium tax credit carries a number of eligibility requirements.<sup>37</sup> The amount is tied to the second lowest cost “silver plan” in the area<sup>38</sup> and is on a sliding scale based on a percentage of household income.<sup>39</sup> Individuals with incomes of up to 133 percent FPL will not be expected to pay more than two percent of their household income for health insurance. This increases to nine and a half percent of household income for individuals between 300 to 400 percent FPL.<sup>40</sup>

To receive the credit, a taxpayer would go to the exchange (either in person or online) and enroll in a health insurance plan.<sup>41</sup> The taxpayer would provide the exchange with his or her most recent tax return, which contains necessary information about family size and household income,<sup>42</sup> and must also provide additional identifying information, including citizenship or immigration status.<sup>43</sup> The exchange then verifies the information<sup>44</sup> and informs the taxpayer whether he or she is eligible for a tax credit and the amount of the credit.<sup>45</sup>

Individuals whose circumstances change during the year (change in income, marriage, birth of a child, etc.) should update their eligibility information with the exchange for recalculation of their tax credit. A reconciliation process takes place at the end of the year when the taxpayer files a return.<sup>46</sup> If the taxpayer received too little of a credit, he or she will

<sup>37</sup> The premium tax credit is only available to U.S. citizens and legal immigrants. IRC § 36B(e). An individual's income and immigration status must both be verified to determine eligibility for the premium tax credit. Legal immigrants who are barred from enrolling in Medicaid during their first five years in the U.S. are eligible for the premium tax credit. IRC § 36B(c)(1)(B)(ii). Taxpayers who are married must file a joint return to be eligible for the credit. Additionally, to be eligible for the credit, a taxpayer cannot be claimed as a dependent on someone else's return. IRC §§ 36B(c)(1)(C), (D). Employees who are offered health insurance by their employer are not eligible for the premium tax credit unless the employer-provided plan does not have an actuarial value of at least 60 percent or if the employee's share of the premium exceeds 9.5 percent of their income. IRC § 36B(c)(2)(C). An actuarial value of at least 60 percent means the health care plan expects to cover 60 percent of a population's expected health care costs.

<sup>38</sup> There are four levels of plans offered through the exchanges – bronze, silver, gold, and platinum. The second lowest cost silver plan is the second lowest cost silver plan in the individual market in the area where the taxpayer lives, which is offered through the exchange. IRC § 36B(b)(3)(B).

<sup>39</sup> Household income is the sum of the taxpayer's modified adjusted gross income (MAGI), plus the aggregated MAGI of all other individuals taken into account in determining the taxpayer's family size. An individual's MAGI is not taken into account if they are not required to file a tax return for the taxable year. MAGI is adjusted gross income plus any § 911 income (exclusion of gross income for citizens or residents living abroad) plus any tax-exempt interest. IRC § 36B(d)(2).

<sup>40</sup> IRC § 36B(b)(3)(A)(i).

<sup>41</sup> The new law calls for the establishment of American Health Benefit Exchanges that are designed, in part, to facilitate the purchase of qualified health insurance plans. Patient Protection and Affordable Care Act of 2009, Pub. L. No. 111-148, § 1311(b).

<sup>42</sup> If an individual did not file a tax return in the previous year, the individual will be able to provide the exchange with alternative documentation in order to establish eligibility. Initial eligibility for the credit is based on an individual's income for the tax year ending two years prior to the enrollment period. For enrollment in 2014, eligibility will be based on income from tax year 2012.

<sup>43</sup> IRC § 36B(e).

<sup>44</sup> The exchange's verification of information is done through Health and Human Services, who sends the information to the appropriate agency. The IRS is responsible for verifying family size and household income. Social Security Administration verifies citizenship status and Homeland Security verifies immigration status. A process will be developed to appeal a determination as a result of the verification process.

<sup>45</sup> The amount of the tax credit reduces what the individual has to pay for his or her health insurance plan. The individual pays his or her portion of the premium directly to the health insurance company. FMS pays the individual's tax credit amount directly to the health insurance company. Individuals who fail to pay the premium amount are given a three-month grace period before the insurance is terminated and FMS discontinues paying the tax credit amount to the insurance company.

<sup>46</sup> IRC § 36B(f).

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receive a refund for the underpayment.<sup>47</sup> If the taxpayer received too much, he or she will be responsible for repaying it, either through a reduction in the refund or as taxes owed. However, the law limits the recapture of any overpayment if the taxpayer's household income is below 500 percent FPL. Individuals below 200 percent FPL will have any overpayment owed capped at \$600. This amount will increase as percentage of FPL increases, until it reaches \$3,500 for individuals between 450 to 500 percent FPL. Taxpayers whose household income is above 500 percent of FPL will be responsible for repaying the entire amount of the overpayment.<sup>48</sup>

*The Advanceable and Refundable Nature of the Premium Tax Credit Will Likely Cause Problems for Both Taxpayers and the IRS.*

In implementing the premium tax credit (hereinafter referred to as "the credit"), the IRS can learn a good deal from its previous experiences with administering refundable credits, particularly the EITC. The target group for the credit will likely overlap significantly with the EITC population, and the credit itself shares numerous characteristics (complicated eligibility calculations, refundability, significant dollars at stake) with the EITC. The IRS's experience with and past research on the EITC and the EITC-eligible population can help inform and improve implementation of the new credit.<sup>49</sup>

The IRS should also examine why the recently repealed Advanced EITC did not work<sup>50</sup> and what lessons it can learn to apply to the premium credit. Many recipients appeared to prefer receiving their EITC in a lump sum at the end of the year, instead of in ratable amounts throughout the year.<sup>51</sup> This issue may be similar to one the IRS will face with the advanceable, refundable premium tax credit, so the IRS may want to consider how to promote the advanced nature of the credit to make it more attractive to taxpayers.

A major challenge in implementing the credit is the new measure of income on which the credit is based, which is household income. Unlike every other current provision of the tax code, the credit is based on the income of *all* individuals in the taxpayer's household, not just the income reported on their return(s). The IRS does not now record or identify household income, and taxpayers are unaccustomed to calculating this information. This

<sup>47</sup> If an individual was eligible for a tax credit but did not claim it during the year, he or she can claim the credit on his or her return and receive a refund for the amount the taxpayer is entitled to (presuming the taxpayer meets the other eligibility requirements).

<sup>48</sup> IRC § 36B(f)(2)(B)(i) (as amended by the Medicare and Medicaid Extenders Act of 2010, Pub. L. No. 111-309). This marks a change to the reconciliation rules as originally passed, which limited the repayment for taxpayers under 400 percent FPL to \$400. The change was the result of concerns of the cliff effect of the repayment provision. The new provision replaces the flat structure with a scaled structure that starts at lower levels for lower income taxpayers.

<sup>49</sup> For example, the EITC Qualifying Child Residency Certification Study was designed to assess the impact of a residency certification requirement on EITC claims. The study offered a sample group of potentially ineligible taxpayers the opportunity to precertify that their qualifying child or children met the residency requirement of the EITC. IRS, *IRS Earned Income Tax Credit (EITC) Initiatives: Report on Qualifying Child Residency Certification, Filing Status, and Automated Underreporter Tests*, available at [http://www.irs.gov/pub/irs-utl/final\\_eitc\\_initiatives\\_report\\_final\\_121708.pdf](http://www.irs.gov/pub/irs-utl/final_eitc_initiatives_report_final_121708.pdf) (last visited Nov. 18, 2010).

<sup>50</sup> The Advance EITC allowed employees who are eligible for the EITC and have one qualifying child to receive their EITC throughout the year in their paycheck. The Advance EITC is repealed, effective December 31, 2010. FAA Air Transportation Modernization and Safety Improvement Act, Pub. L. No. 111-226, § 219.

<sup>51</sup> Government Accountability Office (GAO), GAO-07-11110, *Advance Earned Income Tax Credit: Low Use and Small Dollars Paid Impedes IRS's Efforts to Reduce High Noncompliance* 13 (Aug. 2007).

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change will force the IRS to reprogram its systems to capture this data and educate taxpayers about how to compute it.

Another challenge will likely arise from the IRS's role in verifying the income information taxpayers provide to the exchanges to establish eligibility for the credit. Who will the taxpayer turn to in order to resolve a discrepancy between the information he or she provides and what the IRS has on its records? Although the exchange decides whether an individual is eligible for the credit, many individuals may contact the IRS if they discover discrepancies involving their income information. The IRS will need to train its assistors about how to handle these calls, despite the fact that the exchanges are the decision makers on eligibility. Will the IRS transfer the taxpayer to the appropriate exchange or simply provide the taxpayer with the appropriate contact information?

The reconciliation process of the new credit may be the most difficult aspect for the IRS to administer. Taxpayers who did not update their household information during the year may find they owe a significant amount of money at the end of the year – money they likely do not have. The need for reconciliation arises because eligibility for the credit is based on tax return data that is two years old. In the interim, many taxpayers will have experienced at least some change in circumstances.<sup>52</sup> If taxpayers do not realize the importance of updating their information with the exchange – even after their initial eligibility determination is made – a large number of taxpayers will likely owe at least some money.

The IRS will need to work with outside entities – such as the exchanges, employers, and family service agencies – to continually educate taxpayers about the need to update their information with the exchanges whenever they have a life change such as a change in family size or income. For the IRS, launching a coordinated information campaign on this scale may be unprecedented. This aspect of the premium tax credit is one of the most critical provisions. It is also one area where the IRS's effectiveness can make a tremendous impact on the potential downstream consequences for both taxpayers and the IRS itself.

One thing the IRS can do to help taxpayers navigate the reconciliation process is consider providing taxpayers with pre-filled forms. The IRS should already have information the taxpayer previously provided to the exchange during the application process. The IRS can use this information to partially fill in forms and then ask taxpayers to verify or update the information. These forms may give taxpayers an idea of what information was used to calculate their initial eligibility, since it will have been more than a year since they applied for the credit.

<sup>52</sup> Initial eligibility for the credit is based on an individual's income for the tax year ending two years prior to the enrollment period. For enrollment in 2014, eligibility will be based on income from tax year 2012.

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## Individual Responsibility Requirement

### Background

Beginning in 2014, all U.S. citizens and legal residents will be required to have qualifying health insurance.<sup>53</sup> An individual who does not have qualifying health insurance will be subject to a penalty of the greater of \$695 (per person) per year, up to a maximum of \$2,085 per family, or 2.5 percent of household income.<sup>54</sup>

The law provides exemptions from the responsibility requirement for:

- Religious grounds;<sup>55</sup>
- Individuals who are not U.S. citizens or an alien lawfully present in the U.S.;<sup>56</sup> and
- Individuals who are incarcerated.<sup>57</sup>

The law also provides exemptions from the penalty for:

- Hardship;<sup>58</sup>
- Members of Indian tribes;<sup>59</sup>
- Individuals with incomes below the filing threshold;<sup>60</sup>
- Individuals without insurance for less than three months;<sup>61</sup> and
- Individuals who cannot afford coverage.<sup>62</sup>

Once the responsibility requirement penalty is effective, taxpayers will have to report on their tax returns whether or not they have health insurance.<sup>63</sup> Taxpayers who do not have insurance and do not qualify under an exemption will be subject to the penalty. However, the IRS can only collect this penalty through refund offsets. The new law prohibits the

<sup>53</sup> IRC § 5000A(a). In order to meet the responsibility requirement, the health insurance plan must provide minimum creditable coverage (as defined in PPACA).

<sup>54</sup> The penalty will be phased in according to the following schedule:

- 2014 - \$95 or 1 percent of household income.
- 2015 - \$325 or 2 percent of household income.
- 2016 - \$695 or 2.5 percent of household income.

Beginning in 2017, the penalty amount will be increased annually by the cost of living adjustment. IRC § 5000A(c)(3).

<sup>55</sup> IRC § 5000A(d)(2).

<sup>56</sup> IRC § 5000A(d)(3).

<sup>57</sup> IRC § 5000A(d)(4).

<sup>58</sup> IRC § 5000A(e)(5).

<sup>59</sup> IRC § 5000A(e)(3).

<sup>60</sup> IRC § 5000A(e)(2).

<sup>61</sup> IRC § 5000A(e)(4).

<sup>62</sup> Exemption applies if the taxpayer's required contribution for the coverage month exceeds eight percent of the individual's household income. IRC § 5000A(e)(1).

<sup>63</sup> The IRS will verify health insurance coverage using information from insurance companies and employers.



IRS from filing a lien or levying on any property to collect the responsibility requirement penalty.<sup>64</sup>

*The Unique Nature of the Individual Responsibility Requirement Penalty Will Challenge the IRS's Audit Selection and Collection Processes.*

The individual coverage responsibility requirement and associated penalty will pose a different set of challenges to the IRS. Some taxpayers who do not want to share their health care information with the IRS may not file returns or may file incomplete ones. In some instances, the IRS will receive information from insurance companies that certain individuals have coverage and therefore are not subject to the penalty. Other individuals will not have coverage and some will be lower income individuals who are due tax refunds. Even if these taxpayers file returns and do not have health insurance, the IRS would owe them money after collecting the penalty.

This raises the question of how the IRS will deal with taxpayers who do not file returns. From an economic perspective, it may not make sense for the IRS to go after certain nonfilers because the IRS's available information indicates they are likely owed refunds. In other cases, the IRS will not be aware that taxpayers should be subject to the penalty. Individuals who operate entirely in the cash economy (and for whom the IRS receives no Forms W-2 or Forms 1099), do not purchase health insurance, and do not file tax returns may never attract the attention of the IRS because the IRS will not know who they are.<sup>65</sup>

To get at the underlying goal of the new law – health coverage for the vast majority of Americans – will the IRS audit every taxpayer who does not report having coverage? Or will the IRS establish certain tolerances, as it does with other programs? Unlike the traditional tax penalty, which is designed to enhance voluntary compliance or deter tax evasion, this penalty is designed to enforce a mandate.<sup>66</sup> If the IRS does establish tolerance levels for auditing taxpayers without insurance coverage, this approach may limit the overall effectiveness of the responsibility requirement.

Exemptions from the requirement and the penalty will present different challenges. It appears that exemptions from the coverage requirement will be made at the exchange level. However, there may be cases where the IRS can already identify a taxpayer as being eligible for an exemption, *e.g.*, if the taxpayer is a member of an Indian tribe or is Amish. In those situations, the IRS should be able to use this information to identify cases in which taxpayers have an exemption from the penalty and alert them to go to an exchange within a set period of time before the penalty is applied.

<sup>64</sup> IRC § 5000A(g)(2)(B). However, the IRS may use its full collection authorities to collect amounts due under other provisions of the health care law.

<sup>65</sup> However, some of this same group may end up visiting hospital emergency rooms without health insurance, thereby costing the United States money in the form of uncompensated care and undermining the savings built into the new law. The Health Insurance Portability and Accountability Act (HIPAA) contains specific rules protecting patient confidentiality, specifically the use and disclosure of individuals' health information. Health Insurance Portability and Accountability Act of 1996, Pub. L. No. 104-191.

<sup>66</sup> National Taxpayer Advocate 2008 Annual Report to Congress vol. 2, 2 (*A Framework for Reforming the Penalty Regime*).



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The hardship exemption, for which there are no guidelines at this point, will also create difficulties for the IRS. It appears the exchanges will make the determination, but taxpayers will contact the IRS when they face the penalty and are looking for an exemption. Additionally, taxpayers appealing a hardship exemption determination may turn to the IRS even though the IRS does not make the decisions. In most instances, the IRS is being asked to be the collection face of this provision, but not the decision maker. This puts the IRS, and its employees, in the awkward position of collecting a penalty and potentially being unable to work with taxpayers who claim they don't owe it.

As a result of the potential collection issues, refund offsets will likely present a significant challenge for TAS and the IRS. If a taxpayer owes back taxes (distinct from this penalty), the IRS and TAS may override a current year refund offset and manually refund the full amount if the taxpayer comes in early enough in the process.<sup>67</sup> However, this action can only be taken in instances of economic hardship and is only available for tax debts.<sup>68</sup> Neither the IRS nor TAS has the discretion to stop a refund offset to satisfy a non-tax debt such as past-due child support.<sup>69</sup>

Due to the size of the responsibility requirement penalty and the IRS's role in collecting it, many taxpayers subject to the penalty and suffering an economic hardship may come to TAS seeking an offset bypass refund. It is unclear at this point whether or not debt stemming from the penalty will be considered a tax debt that qualifies for the provisional authority to bypass and issue a refund.<sup>70</sup> Moreover, the IRS definition of hardship is different from the definition contained in the responsibility requirement.<sup>71</sup> The practical result is that taxpayers who do not otherwise qualify for a hardship exemption from the exchange may experience a hardship that qualifies for an offset bypass refund from the IRS.

Once a penalty is assessed, the protection against using liens or levies to collect will require the IRS to isolate the amount from other tax liabilities for which there is no limit on the IRS's collection powers. However, to ensure that it collects the penalty from taxpayers who are owed refunds, the IRS must be able to quickly match information provided by taxpayers and others to determine whether a taxpayer is subject to the penalty. Otherwise, the

<sup>67</sup> IRM 21.4.6.5.12.1, *Offset Bypass Refund (OBR)* (Mar. 2008). Under certain hardship circumstances, the IRS may issue manual refunds of excess credits without first satisfying an IRS outstanding balance. This type of refund is called an Offset Bypass Refund (OBR). An OBR must be issued before the posting date of the original return.

<sup>68</sup> IRM 21.4.6.5.6, *Hardship Refund Request* (Mar. 2008).

<sup>69</sup> IRM 21.4.6.4.2, *Treasury Offset Program (TOP) Offset* (Oct. 2007). The Treasury Offset Program (TOP) is a program designed to intercept IRS refunds and offset them to non-tax debts such as unpaid student loans and child support.

<sup>70</sup> The legislative language of IRC § 5000A does not appear to contain any language that prohibits the issuance of manual offset bypasses relative to the individual responsibility requirement penalty. TAS is also not aware of any IRS Office of Chief Counsel decision on this issue.

<sup>71</sup> Under IRC § 5000A(e)(5), a hardship is determined by the Secretary of Health and Human Services and is related to the availability of affordable qualified health insurance. The IRS and TAS consider hardship refund requests on a case by case basis. Generally, the inability to provide shelter, food, medical needs, and employment related transportation qualifies as a hardship.

IRS will issue refunds to taxpayers who owe a penalty and then may find itself unable to recoup the improper payment.<sup>72</sup>

## Employer Requirement

### *Background*

Under the employer requirement, employers with 50 or fewer employees are not required to offer health insurance coverage and are not subject to any penalty if their employees receive the premium tax credit. However, employers with more than 50 employees that do not offer health insurance and have at least one full-time employee who receives a premium tax credit are subject to a fee of \$2,000 per full-time employee, with the first 30 full-time employees excluded from the assessment.<sup>73</sup> Employers with more than 50 employees that offer health insurance and have at least one full-time employee who receives a premium tax credit are subject to a fee of the lesser of \$3,000 for each employee receiving a premium credit or \$2,000 per full-time employee.<sup>74</sup>

When an exchange determines that an individual is eligible for a premium tax credit because his or her employer does not provide minimum creditable coverage, the employer will need to be notified of the potential liability. However, it is unclear how the assessment and appeals process will work.

### *The Employer Requirement Will Raise Significant Compliance and Privacy Concerns for the IRS.*

The employer requirement also presents a unique set of issues. Because the penalty is tied to the employer having fewer than 50 full-time employees, employers may lay off or fire employees or refrain from hiring in order to avoid the penalty. The implications of hiring additional employees are significant, especially for employers who are close to the threshold of 50. This new penalty may act as a disincentive to hire additional employees based on the potential economic impact. Other employers may simply recharacterize employees as independent contractors to avoid the penalty.

The employer penalty is subject to the standard deficiency procedures in IRC §§ 6211-6261.<sup>75</sup> This means that employers will receive a notice of deficiency under IRC § 6212 if the IRS finds they are subject to the penalty. However, the IRS has yet to determine whether, in the early years of implementation, it will first issue warning notices either before or after assessment. One possibility is to use a soft notice for the first few years to

<sup>72</sup> For a more detailed discussion of the IRS's need to process information reporting documents before filing season, see National Taxpayer Advocate 2009 Annual Report to Congress 338 (Legislative Recommendation: *Direct the Treasury Department to Develop a Plan to Reverse the "Pay Refunds First, Verify Eligibility Later" Approach to Tax Return Processing*).

<sup>73</sup> IRC § 4980H(a).

<sup>74</sup> IRC § 4980H(c). If an employer offers health insurance to its employees and that coverage is deemed unaffordable, the employee can apply to the Exchange for an affordability waiver to be able to purchase insurance through the Exchange. Unaffordable coverage is defined as coverage with a premium that exceeds 9.5 percent of the employee's household income.

<sup>75</sup> IRC § 4980H(e). This is different from how employment tax liabilities are typically assessed

## The Patient Protection and Affordable Care Act: A Preliminary Analysis of the Challenges Facing the IRS in Implementing Health Care Reform

encourage employers to either meet the obligations of the employer requirement or pay the penalty.<sup>76</sup>

Once a penalty is assessed, how the IRS designs the appeal process will affect employers' perception of how fairly the provision is administered. Employers will need enough information to appeal the penalty if appropriate, but the IRS must protect confidential taxpayer information. Whether or not an employer is liable for the penalty is dependent on how many of its employees received the premium tax credit. For an employer that offers qualified health insurance, its employees can receive the premium tax credit only if the insurance offered is unaffordable – a determination based on the employee's household income. An employer knows what it is paying an employee in salary, but most employers do not have or want information about their employees' *household* economic status. It may be difficult to administer the appeal process without sharing at least some of these data.

Moreover, identifying specific employees who chose to go to the exchanges and trigger the penalty for the employer may lead to retaliation. The IRS will have to walk a fine line between providing employers with the information they need to defend against the penalty and protecting individual taxpayers who do not want to share their personal health care and household income information with their employer.

### THE IRS NEEDS TO EVALUATE HOW BEST TO MOVE FORWARD WITH ITS IMPLEMENTATION EFFORTS.

After taking a closer look at the specifics of the main health care tax provisions, it is clear that the IRS's implementation efforts must be far more extensive than those for other new programs and tax credits. While the IRS has formed a program office charged with implementing the new health care law, the unprecedented complexity and scope of this law make clear that the IRS's traditional implementation and enforcement efforts are inadequate to meet this challenge. The IRS will need to do more than set up a program office, write new computer code, and provide training to employees in advance of the filing season. To implement the new program effectively, the IRS must undertake a comprehensive review of how it will administer the new provisions in light of the challenges and potential ramifications taxpayers face.

<sup>76</sup> An IRS Notice of Deficiency informs a taxpayer of the tax the IRS plans to assess and gives the opportunity for the taxpayer to respond prior to assessment. In comparison, a soft notice encourages the taxpayer to voluntarily correct a discrepancy in a tax return. If a taxpayer receives a soft notice and repeats the behavior the following year, the taxpayer's account is flagged. Internal Revenue Service Advisory Committee, *Wage and Investment Subgroup Report* (Nov. 10, 2010), available at <http://www.irs.gov/taxpros/article/0,,id=231501,00.html>; IRS, *Addressing Underreporting – The Soft Notice Approach*, available at [http://www.irs.gov/pub/irs-utl/addressing\\_underreporting\\_-\\_the\\_soft\\_notice\\_approach.pdf](http://www.irs.gov/pub/irs-utl/addressing_underreporting_-_the_soft_notice_approach.pdf) (last visited Dec. 15, 2010).

## CONCLUSION

The new health care law will require a massive undertaking by the IRS – one that will require the IRS to think outside its traditional “revenue collection” box.<sup>77</sup> The IRS faces a daunting task, not only in implementing the health care provisions within its own systems and organization, but in conducting the outreach needed to educate taxpayers about the new law as well.

Because of the far-reaching scope of these provisions, the IRS needs to do more than simply establish a separate program office. It should consider hiring phone employees dedicated solely to health care. These phone employees would have experience with social work and case management, which are critical when dealing with a social program like health care.<sup>78</sup> Additionally, the Commissioner should establish a cross-function Executive Steering Committee to advise the program office. This committee should include representatives from all of the operating divisions as well as TAS, Appeals, Research, CI, MITS, Counsel, and Communications and Liaison.

While the National Taxpayer Advocate believes the IRS is capable of implementing this new law given sufficient funding and staffing, this discussion is designed to identify potential challenges and concerns with how the law may be administered and give Congress and the IRS enough time to address them.

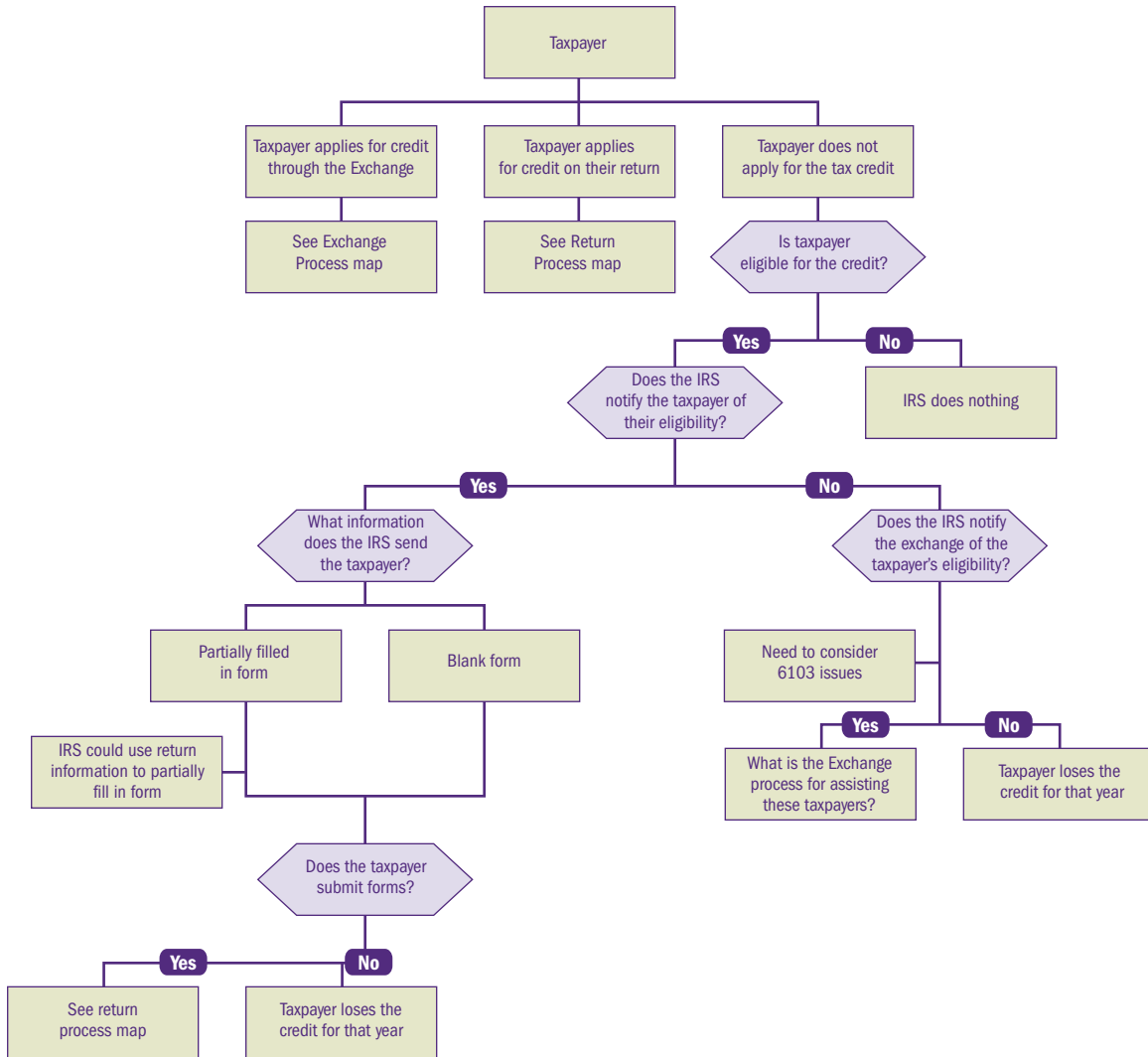
<sup>77</sup> See Most Serious Problem: *The IRS Mission Statement Does Not Reflect the Agency's Increasing Responsibilities for Administering Social Benefits Programs*, *supra*; National Taxpayer Advocate 2009 Annual Report to Congress vol. 2, 75 (*Running Social Program Through the Code*).

<sup>78</sup> *Id.*

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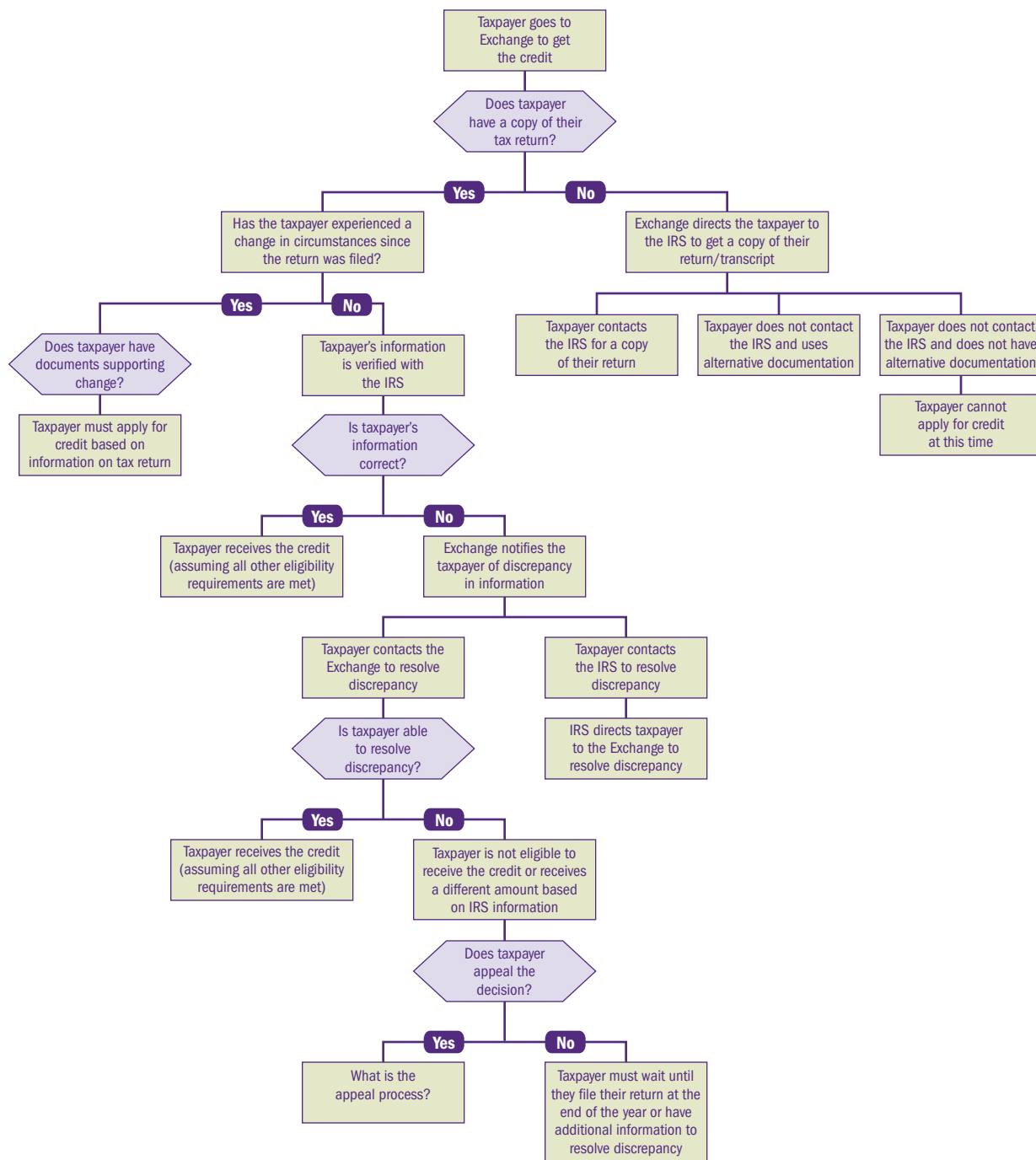
## APPENDICES

CHART 2.2.1, Premium Tax Credit: Overall Process



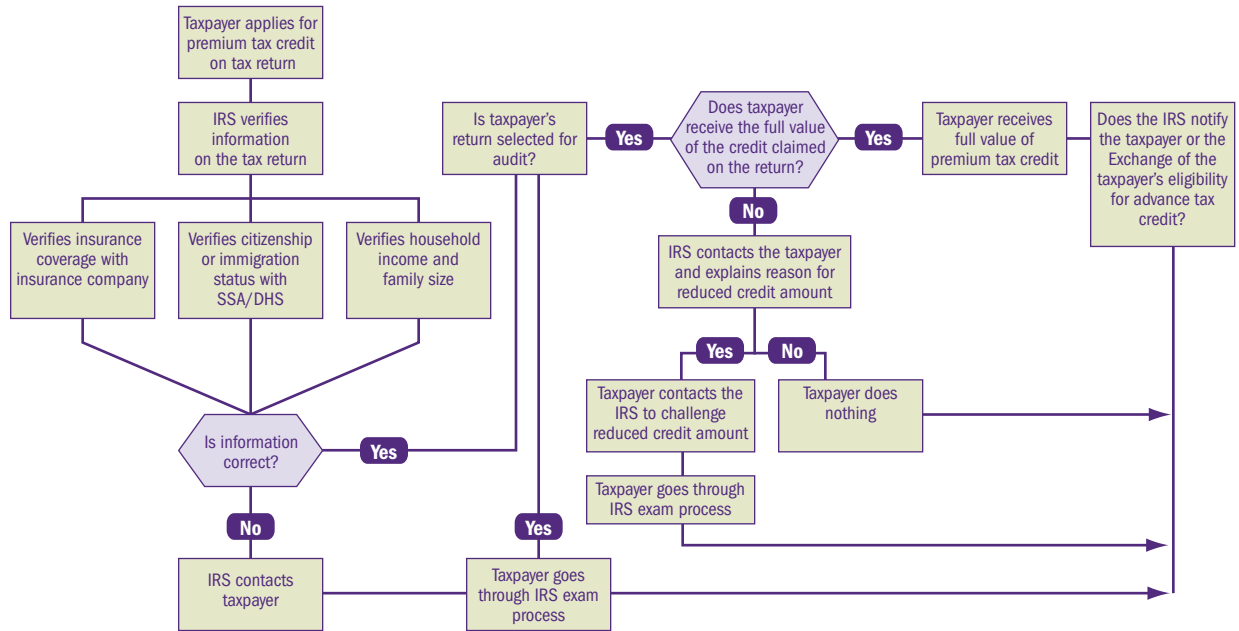
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CHART 2.2.2, Premium Tax Credit: Exchange Process



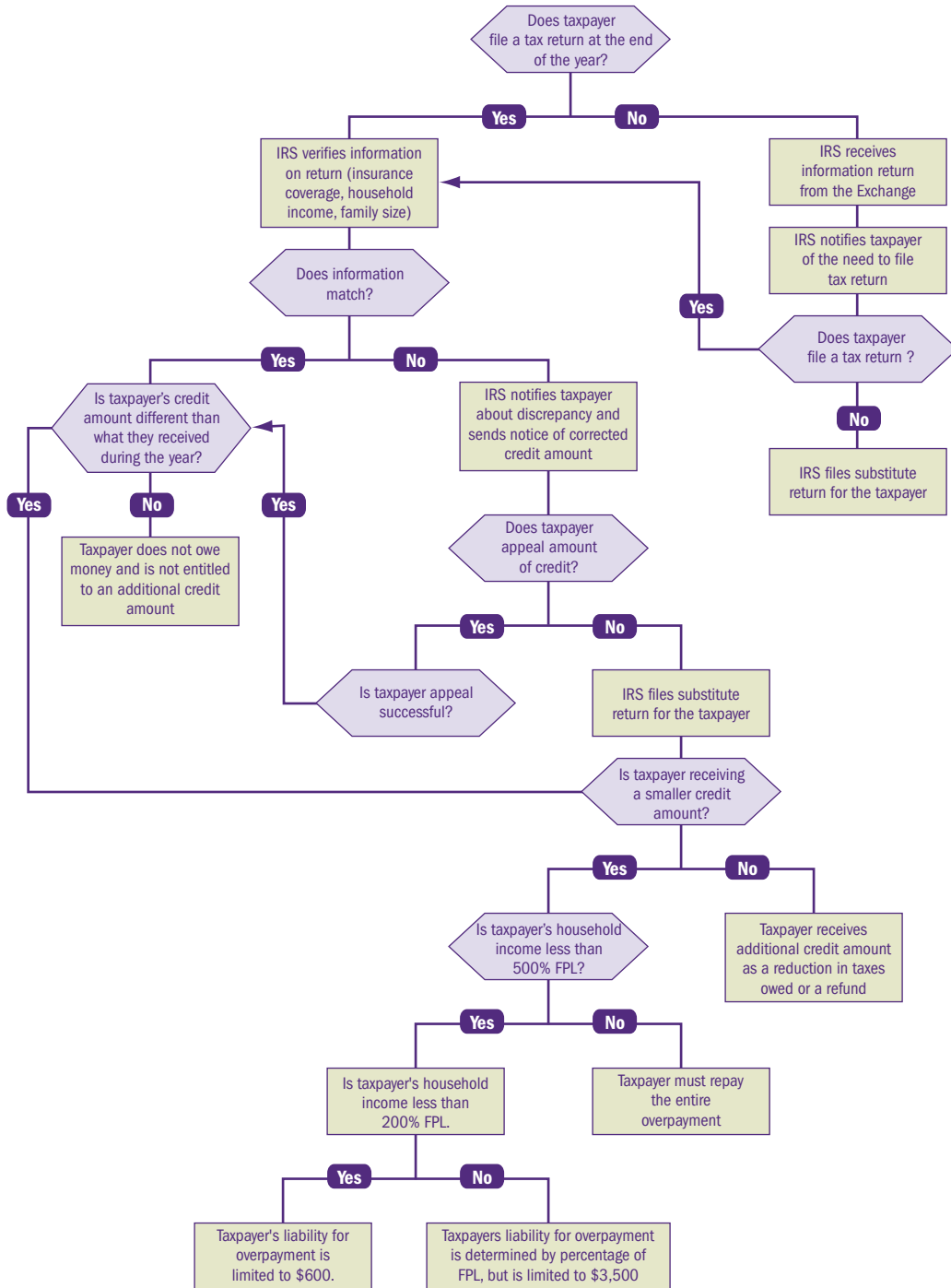
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CHART 2.2.3, Premium Tax Credit: Return Process



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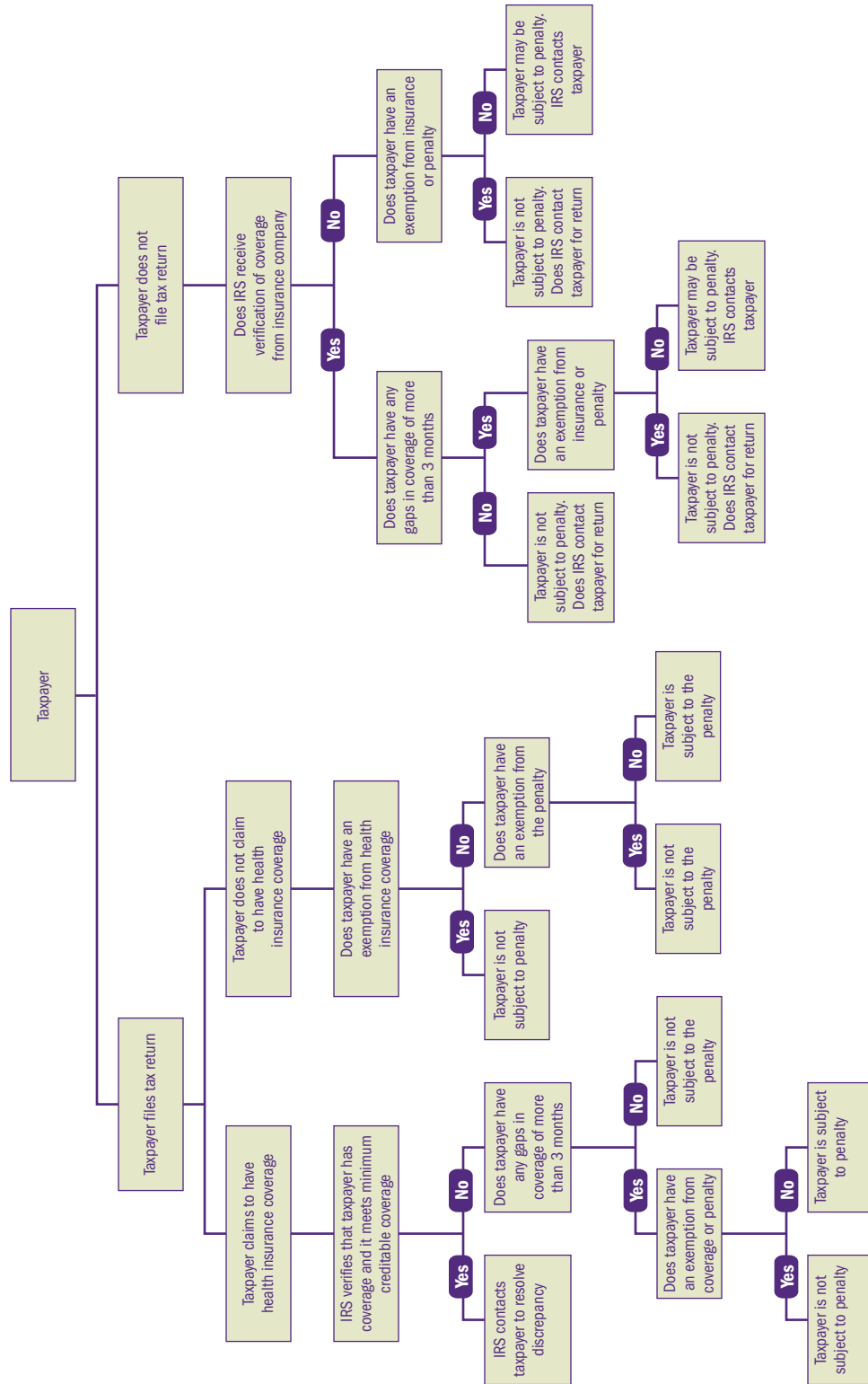
CHART 2.2.4, Premium Tax Credit: Reconciliation Process





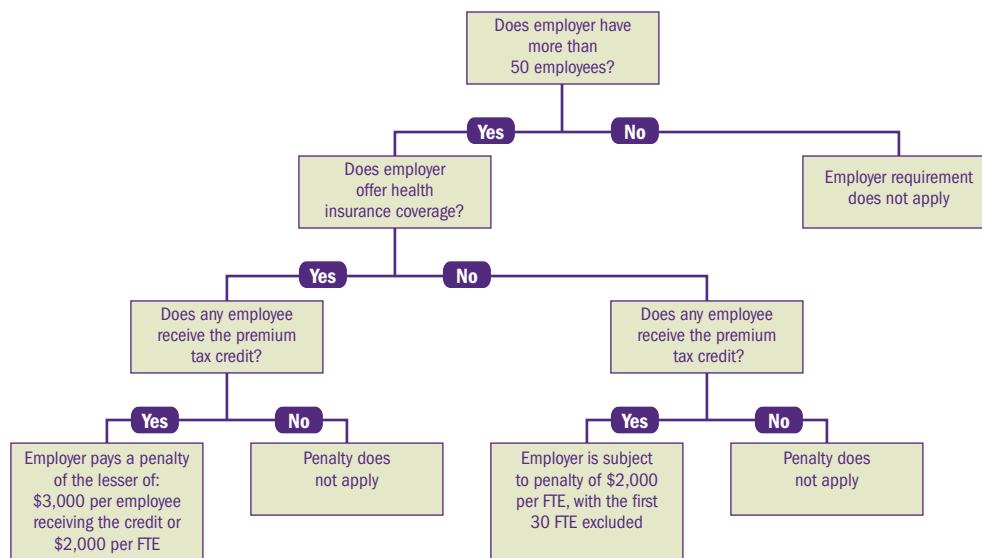
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CHART 2.2.5, Individual Responsibility Requirement



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CHART 2.2.6, Employer Requirement



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National Taxpayer Advocate

Annual Report to Congress

2010 Annual Report to Congress

**AN ANALYSIS OF THE IRS  
COLLECTION STRATEGY:**

**SUGGESTIONS TO INCREASE REVENUE,  
IMPROVE TAXPAYER SERVICE,  
AND FURTHER THE IRS MISSION**

An Analysis of the IRS Collection Strategy: Suggestions to Increase Revenue, Improve Taxpayer Service, and Further the IRS Mission

## An Analysis of the IRS Collection Strategy: Suggestions to Increase Revenue, Improve Taxpayer Service, and Further the IRS Mission<sup>1</sup>

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<sup>1</sup> The principal authors of this study are Michael McDermit, TAS Collection Technical Liaison, and Nina E. Olson, National Taxpayer Advocate.

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## EXECUTIVE SUMMARY

In the 2004 Annual Report to Congress, the National Taxpayer Advocate discussed concerns with the IRS “Collection Strategy,” and questioned the effectiveness of a “one-size-fits-all” approach to servicing accounts of taxpayers with collection-related tax problems.<sup>2</sup> The IRS’s “assembly-line” approach to processing collection accounts has remained essentially unchanged for over 25 years, even while the Collection operation has regularly received substantial criticism from key stakeholders, including highly significant congressional and judicial actions needed to ensure fair and equitable treatment of taxpayers with collection problems.

Program results indicate the IRS collection strategy could be more effective in recovering delinquent revenue and reducing the IRS’s inventory of unpaid assessments:

- The inventory of unpaid assessments has grown from approximately \$270 billion in FY 2006 to \$359 billion in FY 2010 – an increase of 33 percent.<sup>3</sup>
- Dollars reported as “currently not collectible” (CNC) increased from \$16.2 billion in FY 2006 to \$28.9 billion in FY 2010 – an increase of 78 percent.<sup>4</sup>
- The number of taxpayer accounts reported as CNC increased by 73 percent – from 751,012 in FY 2006 to approximately 1.3 million in FY 2010.<sup>5</sup>
- The dollar value of Taxpayer Delinquent Accounts (TDAs) assigned to the Collection Queue at the end of FY 2010 was approximately \$46.2 billion – a 70 percent increase from 2006.<sup>6</sup>
- In FY 2010, the dollars reported as CNC by the Collection Field function (Cff) were approximately 320 percent of the combined total of dollars collected on open Cff TDAs and installment agreements generated by the Cff.<sup>7</sup>

These problems were evident well before the recent downturn in the nation’s economy, and have worsened in spite of the 20 percent increase in the IRS’s enforcement budget since 2006.<sup>8</sup>

The IRS relies heavily on the bulk processing of correspondence and systemically generated enforcement actions to manage its considerable workload of collection accounts.

<sup>2</sup> National Taxpayer Advocate 2004 Annual Report to Congress 226-245.

<sup>3</sup> IRS, *Collection Process Study, Executive Summary 2* (Sept. 30, 2010). The data for the balance of unpaid assessments at the conclusions of fiscal year (FY 2010) was provided by SB/SE in an e-mail message dated Dec. 14, 2010.

<sup>4</sup> IRS, Collection Activity Reports, NO-5000-149, *Recap of Accounts Currently Not Collectible Report* (Oct. 2010).

<sup>5</sup> *Id.*

<sup>6</sup> IRS, Collection Activity Reports NO-5000-2, *Taxpayer Delinquent Account Reports* (Oct. 2010). The Collection Queue is an inventory of TDA accounts that are active, but unassigned to the ACS or Cff functions. See IRM 5.1.20.2 (May 27, 2008).

<sup>7</sup> IRS, Collection Activity Report, NO-5000-2, *Taxpayer Delinquent Account Cumulative Report* (Oct. 2010); IRS, Collection Activity Report, NO-5000-6, *Installment Agreement Cumulative Report* (Oct. 2010).

<sup>8</sup> U.S. Department of the Treasury, *Budget in Brief, Internal Revenue Service*, available at [www.treasury.gov/about/budget-performance/budget-in-brief/Documents/IRS](http://www.treasury.gov/about/budget-performance/budget-in-brief/Documents/IRS). The IRS’s appropriations for “Enforcement – Exam and Collections” for FY 2006 and FY 2010 were approximately \$3.9 billion and \$4.7 billion respectively.

While enforcement tools such as liens and levies are appropriate and necessary to address situations involving taxpayers who refuse to comply with the tax laws, these tools are not well suited to be the foundation of the IRS's contact strategy. More emphasis on prompt, personal contacts, coupled with a goal of providing "one-stop service" could actually result in a more effective use of the IRS's collection resources.

In general, the IRS collection strategy reacts in far too many situations as if delinquent taxpayers have made a conscious decision to not comply with their tax obligations, using the "full force of the law" to correct problems in a manner that may be premature in many cases. The IRS must adjust this mindset and achieve a better balance in the use of enforcement actions with other collection tools, including payment alternatives such as reasonable installment agreements (IAs) and offers in compromise (OICs). Collection treatments should be tailored to the needs of each taxpayer, with the purpose of not only addressing the delinquencies at hand, but also promoting future compliance.

The purpose of this analysis is to examine the actual performance of the IRS collection process, *i.e.*, the "collection strategy," over the past five years, identify trends that reflect results produced by the design of this process, and provide comments regarding the degree to which the IRS collection strategy is actually fulfilling its mission. This study indicates that a more effective IRS collection strategy must include greater emphasis on providing *timely attention* to collection problems as they arise, actually *talking to taxpayers* about their tax problems, and *assisting* taxpayers to regain a "fully compliant" status with *collection treatments that are flexible, considerate, and effective*.

At the conclusion of this analysis, the National Taxpayer Advocate offers the following recommendations for actions the IRS can take to improve its collection strategy:

1. Develop an improved working model of the "will pay," "can't pay," and "won't pay" distinctions in determining the most appropriate collection treatments for taxpayers with collection problems.
2. Provide timely interventions for emerging collection problems.
3. Use more timely *personal contacts* to help taxpayers fully resolve their collection problems.
4. Deliver collection inventory to organizational segments trained and empowered to provide "one-stop service," based on the specialized needs of the taxpayer segment in question.
5. Use all available collection tools, including the full range of collection payment alternatives, *e.g.*, offers in compromise and reasonable installment agreements.
6. Reevaluate the requirements for managerial review of IRS liens and levies.
7. Eliminate the Collection Queue.
8. Measure and evaluate the effectiveness of collection tools and treatments in meeting taxpayer needs and promoting future compliance.



## INTRODUCTION

### **The IRS collection process serves a visible and critical role in tax administration.**

The IRS is authorized by Congress to administer and supervise the execution and application of the nation's tax laws, as detailed in the Internal Revenue Code (IRC).<sup>9</sup> One key element in the administration of these tax laws is the IRS collection process. As a matter of policy, the IRS Internal Revenue Manual (IRM) emphasizes that, "A tax system based on voluntary assessment would not be viable without enforcement programs to ensure compliance. Accordingly, the Service is responsible for taking all appropriate actions provided by law to compel noncompliant taxpayers to file their returns and pay their taxes."<sup>10</sup> The collection process has been designed and implemented as the framework within which the IRS addresses the responsibility to secure delinquent revenue, correct individual incidences of noncompliance, and promote the concept of voluntary compliance within the general population of taxpayers.

The IRC equips the IRS with a variety of powerful collection tools to accomplish these objectives, including the ability to file notices of federal tax lien (NFTL), seize and sell property, and serve levies attaching to financial accounts, wages, and other sources of income. Unlike other creditors, the IRS can initiate these enforcement actions without first going to court to reduce the liabilities to judgments.<sup>11</sup> The IRS is not reticent to use these tools, even during times of significant economic turmoil. In fiscal year (FY) 2010, the IRS filed approximately 1.1 million NFTLs (14 percent more than the previous year) and issued over 3.6 million levies.<sup>12</sup> For millions of taxpayers, the Collection operation is "the face and the voice of the IRS."

### **Stakeholders have been critical of the IRS's longstanding enforcement-oriented approach to collection.**

#### *Congress and the courts have acted to ensure fair and equitable treatment of taxpayers with IRS collection problems.*

However, with great powers also come great responsibilities. Over the years, and on several occasions, Congress and the federal courts have determined that IRS collection practices did not align with the law, violated taxpayer rights, or did not reflect the intent of the law to provide fair and equitable treatment for all taxpayers. The following are particularly noteworthy events that resulted in significant adjustments to IRS collection practices:

- **G.M. Leasing Corp. v. United States (1977)** – The U. S. Supreme Court decision in this case held that the warrantless entry by the IRS onto private property for the purpose of seizing property to satisfy a tax liability may violate the Fourth Amendment to the

<sup>9</sup> IRC §§ 7801 and 7803.

<sup>10</sup> IRM 1.2.14.1.1 (Aug. 18, 1994).

<sup>11</sup> See, e.g., IRC § 6331.

<sup>12</sup> IRS, Collection Activity Report, NO-5000-23, *Collection Workload Indicators* (Oct. 2010). See also Status Update: *The IRS Has Been Slow to Address the Adverse Impact of Its Lien Filing Policies on Taxpayers and Future Tax Compliance*, *supra*.

Constitution.<sup>13</sup> This decision prompted the IRS to make significant procedural changes in collection practices involving the seizure of assets, particularly those involving businesses.

- **Taxpayer Bill of Rights (1988 & 1996)** – This legislation provided for numerous significant adjustments to IRS collection policies and procedures, including expanded notice requirements prior to initiation of collection enforcement actions, increased use of installment agreements (IA), new review and approval requirements for seizures involving principal residences, new criteria for situations mandating the release of levies, and new criteria authorizing the withdrawal of NFTLs.<sup>14</sup>
- **The IRS Restructuring and Reform Act of 1998 (RRA 98)** – This legislation established the Collection Due Process (CDP) appeal option (including judicial review) for taxpayers subject to IRS lien and levy actions, guaranteed IAs in certain situations, provided the basis for expanded use of offers in compromise (OIC), and emphasized that seizures of personal residences and businesses should only be taken after other collection options have been exhausted.<sup>15</sup>
- **American Jobs Creation Act of 2004** – This act included a section that provided the IRS legal authority to enter into an IA that may result in less than full payment of the delinquent tax debt of the taxpayer, *i.e.*, a partial payment installment agreement (PPIA).<sup>16</sup>
- **Vinatieri v. Commissioner (2009)** – The United States Tax Court determined that IRS collection practices violated IRC § 6343 by proposing to proceed with a levy against a taxpayer who was experiencing an economic hardship, because of delinquent tax returns that remained due from the taxpayer.<sup>17</sup>

While these events span several decades, they were generally prompted by:

- 1) Inadequate taxpayer service for collection-related problems;
- 2) Excessive use of “heavy-handed” enforcement; and
- 3) Lack of flexibility in the use of collection payment options, *e.g.*, the IA and OIC.

***The National Taxpayer Advocate has consistently expressed concerns that the IRS collection strategy does not reflect the full scope of the IRS mission.***

The mission of the IRS is to, “Provide America’s taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with

<sup>13</sup> 429 U.S. 338 (1977). See also IRM 5.17.3.5.1 (Dec. 7, 2007).

<sup>14</sup> The Taxpayer Bill of Rights 1 (TBOR 1) was included in the Technical and Miscellaneous Revenue Act of 1988, Pub. L. 100-647 (1988); Taxpayer Bill of Rights 2 (TBOR 2), Pub. L. 104-168 (1996).

<sup>15</sup> Pub. L. 105-206, 112 Stat. 685 (1998).

<sup>16</sup> Pub. L. No. 108-357, § 843 (2004).

<sup>17</sup> 133 T.C. No. 16 (2009), 2009 WL 4980692 (U.S. Tax Ct. Dec. 21, 2009).

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*integrity and fairness to all.*<sup>18</sup> Further, according to IRS policy, all decisions made within the collection process must be guided by the following “collecting principles.”<sup>19</sup>

- **Service and Assistance** – All taxpayers are entitled to courteous, responsive, and effective service and assistance in all their dealings with the Service.
- **Taxpayer Rights** – We will observe taxpayers’ rights, including their rights to privacy and to fair and courteous treatment.
- **Compliance** – The public trust requires us to ensure that all taxpayers promptly file their returns and pay the proper amount of tax, regardless of the amount owed.
- **Case Resolution** – While we will actively assist taxpayers to comply, we will also take appropriate enforcement actions when warranted to resolve the delinquency. To resolve a case, *good judgment* (emphasis added) is needed to make sound decisions on the appropriate action needed.

In the 2004 Annual Report to Congress, the National Taxpayer Advocate discussed concerns with the IRS “Collection Strategy,” and identified problems with the traditional collection process that have contributed to less than satisfactory results in the areas of taxpayer service and compliance.<sup>20</sup> The report noted that “the IRS has failed to develop an effective, comprehensive and consistent collection strategy to counter the two most serious threats to our tax administration system: the ever widening tax gap, and the decline in tax compliance.” The report further states that while the IRS’s approach to collection strategy over the years has been marked by dramatic shifts in emphasis, “These shifts have not sought to harmonize effective collection strategies used in the private sector with strategies designed to address the causes of noncompliance.”

The report suggested that a service-oriented, taxpayer-focused collecting process that emphasizes timely personal contacts, and provides treatments based on an understanding of the taxpayer’s needs, would be more effective in realizing the IRS mission than one based on a regimented generation of collection-oriented activities without regard to outcomes. The report also urged the IRS to use a research-based approach to provide data-driven explanations of why delinquent taxpayers do not comply, identify the collection “touches” that are most effective in resolving collection problems, and provide the IRS with information that supports efforts to reduce the opportunities for payment noncompliance.<sup>21</sup>

Since 2004, the National Taxpayer Advocate has frequently identified the IRS Collection process as a significant contributing factor to the most serious problems facing America’s

<sup>18</sup> IRM 1.1.1.1 (Mar. 1, 2006).

<sup>19</sup> IRM 1.2.14.1.2 (Feb. 17, 2000). The current IRS mission statement was developed after the implementation of RRA 98, and designed to represent an increased emphasis on taxpayer service, and the important role the IRS plays in assisting taxpayers to meet their voluntary compliance obligations. The “collecting principles” were subsequently tailored to complement the new mission statement, and provide more clarity for the manner in which the collection process supports the IRS in meeting these goals.

<sup>20</sup> National Taxpayer Advocate 2004 Annual Report to Congress 226-245.

<sup>21</sup> *Id.*

taxpayers, and on numerous occasions has identified aspects of the process that do not reflect the values presented in its “collecting principles.”<sup>22</sup> The IRS has generally responded to these concerns, as well as those of other key stakeholders, by making relatively minor adjustments to Collection’s policies and procedures, *i.e.*, “tweaking the system.” However, the basic collection strategy used by the IRS has not significantly changed.

## DISCUSSION

### The IRS collection strategy could be more effective in recovering delinquent revenue and reducing the IRS’s inventory of unpaid assessments.

An objective analysis of IRS program data raises serious questions about the effectiveness of the traditional IRS collection strategy. Consider the following facts that have emerged over the past five fiscal years (2006 thru 2010):

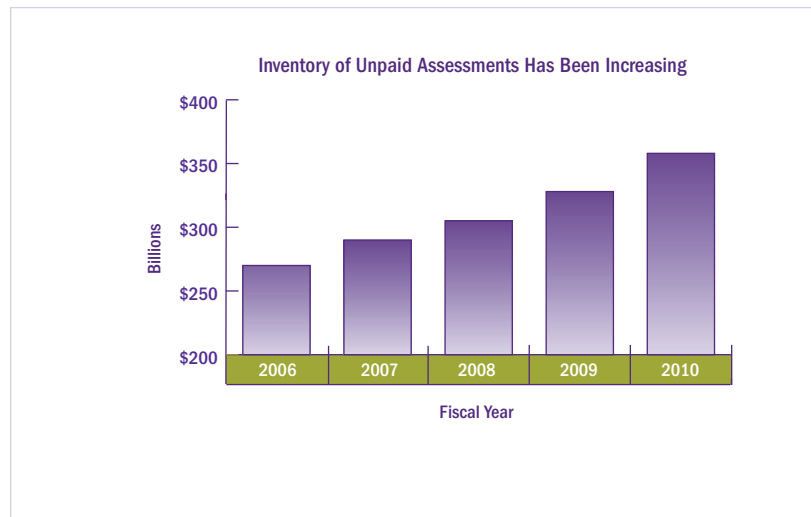
- The inventory of unpaid assessments has grown from approximately \$270 billion in FY 2006 to \$359 billion in FY 2010 – an increase of 33 percent.<sup>23</sup>

<sup>22</sup> See National Taxpayer Advocate 2005 Annual Report to Congress 123-135 (Most Serious Problem: *Levies on Social Security Payments*); National Taxpayer Advocate 2005 Annual Report to Congress 209-221 (Most Serious Problem: *Automated Collection System Levy Releases*); National Taxpayer Advocate 2005 Annual Report to Congress 270-291 (Most Serious Problem: *Allowable Expense Standards for Collection Decisions*); National Taxpayer Advocate 2005 Annual Report to Congress 345-356 (Most Serious Problem: *Limitations of Collection Account Databases*); National Taxpayer Advocate 2005 Annual Report to Congress 447-463 (Key Legislative Recommendation: *Restructuring and Reform of Collection Due Process Provisions*); National Taxpayer Advocate 2005 Annual Report to Congress 466-467 (Additional Legislative Recommendation: *Social Security Levies*); National Taxpayer Advocate 2006 Annual Report to Congress 62-82 (Most Serious Problem: *Early Intervention in IRS Collection Cases*); National Taxpayer Advocate 2006 Annual Report to Congress 83-109 (Most Serious Problem: *IRS Collection Payment Alternatives*); National Taxpayer Advocate 2006 Annual Report to Congress 110-129 (Most Serious Problem: *Levies*); National Taxpayer Advocate 2006 Annual Report to Congress 130-140 (Most Serious Problem: *Centralized Lien Procedures*); National Taxpayer Advocate 2006 Annual Report to Congress 141-156 (Most Serious Problem: *Collection Issues of Low Income Taxpayers*); National Taxpayer Advocate 2006 Annual Report to Congress 157-171 (Most Serious Problem: *Excess Collections*); National Taxpayer Advocate 2006 Annual Report to Congress 507-519 (Key Legislative Recommendation: *Improve Offer in Compromise Program Accessibility*); National Taxpayer Advocate 2006 Annual Report to Congress 520-526 (Key Legislative Recommendation: *Elimination of Lengthy Collection Statute of Limitation Extensions*); National Taxpayer Advocate 2006 Annual Report to Congress 527-530 (Key Legislative Recommendation: *Levies on Fixed and Determinable Assets*); National Taxpayer Advocate 2006 Annual Report to Congress 551-552 (Additional Legislative Recommendation: *Collection Due Process*); National Taxpayer Advocate 2007 Annual Report to Congress 324-336 (Most Serious Problem: *FPLP Levies on Social Security Payments*); National Taxpayer Advocate 2007 Annual Report to Congress 374-387 (Most Serious Problem: *Offer in Compromise*); National Taxpayer Advocate 2007 Annual Report to Congress 388-394 (Most Serious Problem: *Inadequate Training and Communication Regarding Effective Tax Administration Offers*); National Taxpayer Advocate 2007 Annual Report to Congress 395-410 (Most Serious Problem: *Assessment and Processing of the Trust Fund Recovery Penalty*); National Taxpayer Advocate 2008 Annual Report to Congress (Status Update: *IRS Collection Strategy*); National Taxpayer Advocate 2007 Annual Report to Congress 549-550 (Additional Legislative Recommendation: *Allow Taxpayers to Raise Relief Under Internal Revenue Code Sections 6015 and 66 as a Defense in Collection Actions*); National Taxpayer Advocate 2008 Annual Report to Congress 15-38 (Most Serious Problem: *The IRS Needs to More Fully Consider the Impact of Collection Enforcement Actions on Taxpayers Experiencing Economic Difficulties*); National Taxpayer Advocate 2008 Annual Report to Congress 158-175 (Most Serious Problem: *Customer Service Within Compliance*); National Taxpayer Advocate 2008 Annual Report to Congress 193-212 (Most Serious Problem: *Customer Service Issues in the IRS’s Automated Collection System*); National Taxpayer Advocate 2009 Annual Report to Congress 17-40 (Most Serious Problem: *One-Size-Fits-All Lien Filing Policies Circumvent the Spirit of the Law, Fail to Promote Future Tax Compliance, and Unnecessarily Harm Taxpayers*); National Taxpayer Advocate 2009 Annual Report to Congress 196-216 (Most Serious Problem: *The Steady Decline of the IRS Offer in Compromise Program Is Leading to Lost Opportunities for Taxpayers and the IRS Alike*); National Taxpayer Advocate 2009 Annual Report to Congress 357-364 (Key Legislative Recommendation: *Strengthen Taxpayer Protections in the Filing and Reporting of Federal Tax Liens*); National Taxpayer Advocate 2009 Annual Report to Congress, vol. 2, 1-18 (Research Study: *The IRS’s Use of Notices of Federal Tax Lien*).

<sup>23</sup> IRS, *Collection Process Study, Executive Summary 2* (Sept. 30, 2010). The data for the balance of unpaid assessments at the conclusions of FY 2010 was provided by SB/SE in an e-mail message dated Dec. 14, 2010.

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**FIGURE 2.3.1, Growth in Unpaid Assessments, FY 2006-2010**



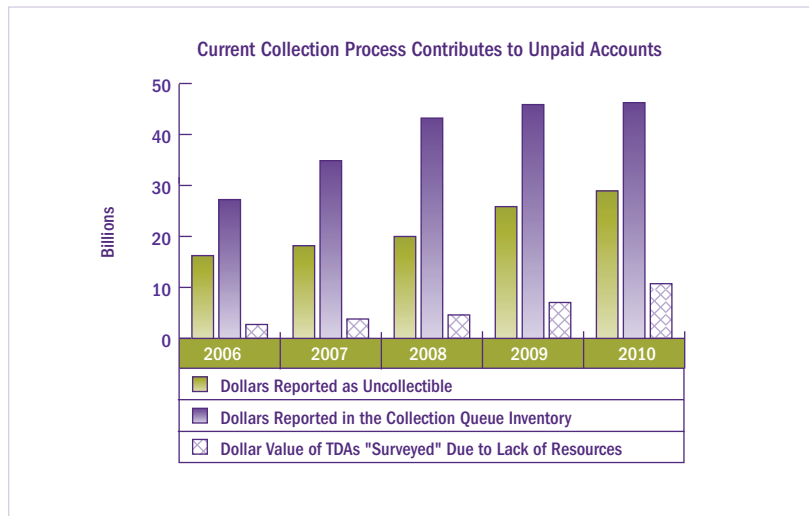
- Dollars reported as “currently not collectible” increased from \$16.2 billion in FY 2006 to \$28.9 billion in FY 2010 – an increase of 78 percent.<sup>24</sup>
- The number of taxpayer accounts reported as CNC increased by 73 percent – from 751,012 in FY 2006 to approximately 1.3 million in FY 2010.<sup>25</sup>
- The amount of TDA dollars reported as “surveyed” by the IRS almost tripled during this period – from approximately \$2.7 billion to \$10.7 billion.<sup>26</sup>
- The dollar value of TDA accounts assigned to the Collection Queue at the conclusion of FY 2010 was approximately \$46.2 billion – a 70 percent increase from 2006.<sup>27</sup>

<sup>24</sup> IRS, Collection Activity Reports, NO-5000-149, *Recap of Accounts Currently Not Collectible Report* (Oct. 2010).

<sup>25</sup> *Id.*

<sup>26</sup> *Id.* Accounts reported as CNC – “surveyed” represent situations where the IRS has chosen not to pursue collection, even though the collection statute remains open. Usually, these decisions are driven by the availability of IRS collection resources.

<sup>27</sup> IRS, Collection Activity Reports NO-5000-2, *Taxpayer Delinquent Account Reports* (Oct. 2010). The Collection Queue is an inventory of TDA accounts that are active, but unassigned to the ACS or Cff functions. See IRM 5.1.20.2 (May 27, 2008).

**FIGURE 2.3.2, Unresolved Collection Accounts, FY 2006 – FY 2010**

It is significant that the negative trends in these indicators increased each year during this period, and cannot be attributed solely to the recent downturn in the economy.<sup>28</sup> It should also be noted that the IRS budget appropriations for “enforcement programs” (which include the Collection operation) increased by 20 percent from FY 2006 to FY 2010.<sup>29</sup>

**Despite unfavorable performance trends, as well as concerns raised by key stakeholders, the IRS collection process has remained essentially unchanged for decades.**

As outlined in the *IRS Collection Strategy* in the 2004 Annual Report to Congress, the basic three-stage collection process employed by the IRS today has been in place for decades.<sup>30</sup> The process begins with a series of written notices sent to taxpayers over a period of several months, *i.e.*, the “notice stream,” followed by assignment to the Automated Collection System (ACS), where the IRS attempts to establish contact with taxpayers telephonically – usually prompted by systemically-generated letters and levies. Cases that are not resolved in the notice stream or the ACS are ultimately assigned to the Collection Field function. Despite the substantial criticism the IRS’s collection practices have received over the years, this basic model continues to provide the framework for the majority of IRS collection actions.

The IRS’s steadfast reluctance to materially change this approach appears to involve a key operating assumption that taxpayers who do not come forward and correct their tax delinquencies during the notice process are, essentially, “won’t pay” taxpayers, *i.e.*, those

<sup>28</sup> National Bureau of Economic Research, *U.S. Business Cycle Expansions and Contractions*, [www.nber.org/cycles/cyclesmain.html](http://www.nber.org/cycles/cyclesmain.html). The recent recession began in December 2007; however, most indicators of its impact did not surface until mid to late 2008. The effect of the recession on IRS collection inventories was not clearly evident until 2009, the year most tax returns for tax year 2008 became due.

<sup>29</sup> U.S. Department of the Treasury, *Budget in Brief, Internal Revenue Service*, [www.treasury.gov/about/budget-performance/budget-in-brief/Documents/IRS](http://www.treasury.gov/about/budget-performance/budget-in-brief/Documents/IRS). The IRS’s appropriations for “Enforcement – Exam and Collections” for FY 2006 and FY 2010 were approximately \$3.9 billion and \$4.7 billion respectively.

<sup>30</sup> National Taxpayer Advocate 2004 Annual Report to Congress 226-245.



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who deliberately choose not to comply with the tax laws.<sup>31</sup> In these cases, the IRS collecting process operates as though timely personal contacts, discussions of available payment alternatives, and even the matter of sending correspondence to a correct address are pointless, when the taxpayers are intentionally trying to avoid the tax collector. Consequently, only IRS enforcement actions, *e.g.*, levies and liens, will likely get the taxpayer's attention in an effective manner, and these actions are only accomplished through the ACS and the Cff. Therefore, the framework for treatments of collection cases not resolved through collection notices, which are classified as TDAs, places heavy emphasis on these enforcement actions. In recent years, the IRS responses to concerns raised in the Annual Reports to Congress confirm this mindset about the basic nature of taxpayers who incur tax debts.<sup>32</sup>

*IRS collection notices are effective in resolving many low-dollar accounts, i.e. the "low-hanging fruit."*

The initial phase of the IRS collecting process is commonly known as the "notice stream." Generally, all "balance due" collection accounts receive the initial notice required by law to formally notify the taxpayer of the unpaid tax debt. If the matter is not resolved with the first notice, the taxpayer may receive one to three additional collection notices, depending on the characteristics of the case. For example, most cases involving individual income taxes reported on Form 1040, *U.S. Individual Income Tax Return*, usually receive up to three collection notices; however, delinquencies involving employment taxes reported on Form 941, *Employer's Quarterly Federal Tax Return*, will usually receive no more than two. The "notice stream" phase of the collecting process can take approximately five months to complete.<sup>33</sup>

The "notice stream" helps the IRS to resolve many collection accounts and collect a substantial amount of revenue. In FY 2010, the IRS collected approximately \$28.4 billion through the notice stream, representing approximately 64 percent of the total yield on collection accounts.<sup>34</sup> Approximately 6.9 million collection notice accounts were full paid during this stage of the process.<sup>35</sup> The IRS expends a relatively small portion of its collection resources

<sup>31</sup> IRM 5.10.1.6 (July 3, 2009). This section details the factors that characterize a "won't pay" taxpayer.

<sup>32</sup> National Taxpayer Advocate 2004 Annual Report to Congress 243 (Most Serious Problem: *IRS Collection Strategy*). The IRS response to this report included the following:

Once an assessment is made, the IRS attempts to collect the amount due in the most efficient manner. The IRS contacts taxpayers through notices and phone calls before utilizing enforcement treatments. If the taxpayer chooses not to interact with IRS, enforcement may be pursued. Given certain legal notification requirements, coupled with limited IRS collection resources, it is not economically feasible to attempt face-to-face contact as an early treatment. Although early personal contact would be ideal for identifying the reasons for the delinquency at hand and going beyond that to foster future compliance, we must use our limited resources to address the most egregious cases, which are usually those who do not respond to the early phone calls.

See also, IRS, *Future Field Collection Design* (Nov. 10, 2005). This study emphasized the observation that "Cff personnel, and particularly ROs (Revenue Officers), recognize their role as the IRS's "final stop" for collecting delinquent taxes and tax returns and take pride in their enforcement role."

<sup>33</sup> IRS, *Taxpayer Communications Taskgroup (TACT): Collection Team VSM Decision* (July 8, 2009).

<sup>34</sup> IRS, *Delinquent Accounts Receivable Yield Report, Fiscal Year Comparison Cum Thru FY 2010 September*; IRS, *Collection Activity Report, NO-5000-6, Installment Agreement Cumulative Report* (Oct. 2010); IRS, *Collection Activity Report, NO-5000-242, Taxpayer Delinquent Account Cumulative Report, Part 2 - Accounts Receivable Notices* (Oct. 2010). In FY 2010, the IRS collected approximately \$18 billion on the initial collection notice, \$5.7 billion on the second thru final notices, and \$4.7 billion from installment agreements issued by Accounts Management (AM) and Compliance Services Collection Operations (CSCO), totaling \$28.4 billion. Total collection yield for FY 2010 was reported to be approximately \$44.1 billion. Payments related to a notice account that were included in IAs established through the ACS or Cff operations were not included in this total.

<sup>35</sup> IRS, *Collection Activity Report, NO-5000-242, Taxpayer Delinquent Account Cumulative Report, Part 2 - Accounts Receivable Notices* (Oct. 2010).

in the notice stream: consequently, this initial phase of the collecting process is considered highly efficient.<sup>36</sup>

However, a closer analysis of the notice stream results indicates that notices may be most effective with taxpayers who owe relatively small amounts. Although the IRS collects substantial amounts of delinquent revenue in this phase of the collecting process, the payments are typically small, *e.g.*, the average of all payments received from individual taxpayers (Individual Master File or IMF) in response to a notice in FY 2010 was \$519.<sup>37</sup> IRS data also indicate that IAs issued on notice accounts tend to provide payment solutions primarily in situations with small balances due.<sup>38</sup> The data reveal that in FY 2010, 77 percent of the dollar value of the IMF first notices issued was not collected in the notice stream, and approximately 3.8 million IMF delinquencies ultimately progressed to the next phase of the collection process as TDAs.<sup>39</sup> Intuitively, these results make sense. Taxpayers who are simply “late payers” or those who are a “little behind” in their financial obligations can resolve relatively small tax debts within a few months of filing their returns, and promptly respond to an IRS collection notice. However, many of those with more serious financial problems may not be able to do so. The IRS does little to proactively reach out to these taxpayers and attempt to resolve their tax debt problems at this early stage of the delinquencies.

***More proactive attention to taxpayer needs could yield significantly greater results in the collection notice stream.***

In general, IRS collection notices are not presented in a manner that *encourages* taxpayers who do not have the means to full pay to come forward, discuss their financial difficulties with the IRS, and explore payment options. The installment agreement option is only briefly addressed in the IRS collection notices, and other alternatives such as the OIC or partial payment installment agreement are not mentioned at all.<sup>40</sup> Surprisingly few business taxpayers are successful in securing IAs through the notice stream.<sup>41</sup> The majority of collection notice-related calls are routed through the Accounts Management (AM)

<sup>36</sup> IRS, *Improving the Collection Process* (May 2010). In FY 2009, the IRS spent approximately 22 percent of its dedicated Collection staff resources on notice-related work, and approximately 65 percent of Collection revenue was generated through the notice stream.

<sup>37</sup> IRS, Collection Activity Report, NO-5000-8, *IMF Collection Yield Report FY 2010*. The IRS received approximately \$9.3 billion from individual taxpayers (IMF) through 17,849,975 payment transactions. A recent IRS study concluded that the median amount of an IMF account resolved in the notice stream was \$650, while the median amount for unresolved modules was over \$3,000. IRS, *TACT: Collection Team VSM Decision 4* (July 8, 2009).

<sup>38</sup> IRS, Collection Activity Report, NO-5000-6, *Installment Agreement Cumulative Report* (Oct. 2010). In FY 10, the average tax balance due for IAs established by AM and CSCO was approximately \$3,910.

<sup>39</sup> IRS, Collection Activity Report, NO-5000-242, *Taxpayer Delinquent Account Cumulative Report, Part 2 – Accounts Receivable Notices* (Oct. 2010).

<sup>40</sup> See IRS collection notices CP 501 and CP 504.

<sup>41</sup> IRS, Collection Activity Report, NO-5000-6, *Installment Agreement Cumulative Report* (Oct. 2010). In FY 2010, the AM Toll-Free and CSCO operations issued only 36,951 IAs on Business Master File (BMF) accounts, although approximately 8.5 million BMF collection notices were issued during the FY. This figure represents 1.6 percent of the total IAs issued by these operations, which have primary responsibility to service collection notices.



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operation, which does not offer specialized handling of collection calls.<sup>42</sup> As a result, the IRS employee who answers the taxpayer's call may not know how to determine if a taxpayer is eligible for an IA or an offer that requires an analysis of the taxpayer's financial situation. Outbound call attempts on accounts in the notice stream are rare.<sup>43</sup> Customer satisfaction ratings from taxpayers regarding the IRS collection notice process are relatively low, particularly concerning the ability to contact the IRS by phone at this point in the process, as well as reported difficulties with resolving problems through the IRS written correspondence process.<sup>44</sup>

**The Automated Collection System emphasizes the use of automated enforcement actions as the foundation of its strategy to contact delinquent taxpayers.**

The ACS, a group of automated telephone call centers, was fully implemented by the IRS in 1984.<sup>45</sup> As stated above, most collection accounts not resolved in the notice stream are classified as TDAs and assigned initially to the ACS for resolution. Designed to serve as a call center for IRS collection accounts, the ACS quickly adopted an inbound call posture, relying primarily on the mass issuance of systemically generated levies to drive taxpayers into paying their tax debts or contacting the IRS to arrange for resolution of their accounts. Historically, the ACS has been perceived by the IRS as a highly efficient and effective component of the collection process.

In FY 2010, the ACS received approximately 3.7 million taxpayer cases, and issued over 2.9 million levies.<sup>46</sup> The use of the systemically generated levy has been the primary ACS contact strategy almost from its inception, and in recent years, from FYs 2006 through 2010, the ACS has averaged approximately 3.4 million levies per year.<sup>47</sup> For 2008 through 2010, while the global recession was taking hold, the ratio of levies to taxpayer case receipts

<sup>42</sup> IRS, *Collection Process Study, Appendix F 4* (Sept. 30, 2010). In general, IRS collection notices provide a telephone number for taxpayers to use to respond. These numbers are handled by the Accounts Management operations, which can answer questions regarding the taxpayers' accounts, and provide limited collection payment options, such as payoff amounts, short-term extensions of time to pay, and streamlined installment agreements. Collection cases with balances due that exceed AM's authorities, or involve issues that require detailed analysis of the taxpayers' financial statements, are usually assigned to the ACS for resolution.

<sup>43</sup> IRS, *Collection Process Study, Final Report 20* (Sept. 30, 2010). In a comparison with best practices employed by private sector collection operations, this study noted that in the first six months of a delinquency, a debtor typically receives about 400 telephone calls from a typical bank. While the National Taxpayer Advocate is not suggesting the IRS should call taxpayers at this frequency, she notes that outbound call attempts are not designed into the IRS collection process until the account reaches TDA status.

<sup>44</sup> IRS, Customer Satisfaction Survey, CSCO Small Business/Self-Employed Division (SB/SE) National Report (Oct. 2010). See also IRS, Customer Satisfaction Survey, CSCO Wage and Investment (W&I) Division National Report (Dec. 2010). The average overall customer satisfaction ratings were 3.88 for W&I and 3.32 for SB/SE (on a scale of 1 to 5). These surveys identified "length of time to get through by phone," "length of time to resolve issue," and "correspondence from CSCO addressing all issues" as improvement priorities for taxpayers responding to IRS collection notices. Reports involving small businesses and self-employed taxpayers reflected higher levels of dissatisfaction than those obtained from wage earners.

<sup>45</sup> IRS, IRS Historical Studies, *IRS Historical Fact Book: A Chronology* (1993).

<sup>46</sup> IRS, Collection Activity Reports NO-5000-2, *Taxpayer Delinquent Account Reports* (Oct. 2010); NO-5000-23, *Collection Workload Indicators* (Oct. 2010).

<sup>47</sup> IRS, Collection Activity Report NO-5000-23, *Collection Workload Indicators* (Oct. 2010).

in ACS was 86 percent.<sup>48</sup> In practice, the matter of levy issuance is “job one” in the ACS, leaving little room for alternative forms of contact or treatment.<sup>49</sup>

The IRS now generates a majority of its liens through the ACS.<sup>50</sup> The number of liens issued by ACS has increased by approximately *97 percent* from fiscal years 2006 to 2010.<sup>51</sup> Most ACS liens are issued systemically, *i.e.*, the lien-filing determinations are driven by IRS “business rules” and procedural requirements, with little or no employee involvement or judgment in the decision-making process.<sup>52</sup> The ACS frequently issues liens in situations where no personal contact has been made with the taxpayers. The IRS’s procedural guidance acknowledges, “We make many of our lien determinations without successfully contacting the taxpayer.”<sup>53</sup> In these situations, the ACS generates liens with no review of the taxpayers’ financial circumstances. The ACS does not determine the impact of the liens on the affected taxpayers, or whether they own any assets requiring a lien to protect the government’s interests.

***The ACS’s strategic emphasis on levies and liens has not been as successful as the IRS would like to believe.***

While on the surface, systemically generated levies appear highly efficient, a close analysis of IRS data raises legitimate questions about the effectiveness and efficiency of the results obtained by the wholesale use of levies. A recent IRS study estimated that levies issued by the ACS lead to full payment or IAs in approximately 24 to 34 percent of the cases in which they are issued.<sup>54</sup> In other words, it appears that the emphasis on ACS levies does not yield productive dispositions of TDAs in at least two-thirds of the cases in which they are employed.<sup>55</sup> Further, IRS data indicate that revenue receipts directly related to individual

<sup>48</sup> IRS, Collection Activity Report NO-5000-2, *Taxpayer Delinquent Account Reports* (Oct. 2010); IRS, Collection Activity Report NO-5000-23, *Collection Workload Indicators* (Oct. 2010).

<sup>49</sup> IRS, *Collection Process Study 98* (Sept. 30, 2010). The current ACS staff spends approximately 70 percent of its time taking inbound calls, so outbound contact attempts are often de-prioritized. Treasury Inspector General for Tax Administration (TIGTA), Ref. No. 2010-30-046, *More Management Information Is Needed to Improve Oversight of Automated Collection System Outbound Calls 6* (Apr. 28, 2010). TIGTA reports that only two to three percent of ACS direct time is spent making outbound calls.

<sup>50</sup> IRS, Collection Activity Report NO-5000-23, *Collection Workload Indicators* (Oct. 2010). In FY 2010, the IRS issued 1,096,376 NFTLs. Of these, 51 percent (554,331) were issued by ACS.

<sup>51</sup> IRS, Collection Activity Report NO-5000-23, *Collection Workload Indicators* (Oct. 2010). In FY 2006, 280,925 notices of federal tax lien were issued by ACS. In fiscal year 2010, ACS issued 554,331 liens.

<sup>52</sup> IRM 5.19.4.5.2 (Aug. 4, 2009). This IRM section details the situations where liens are required to be filed. In most instances, the key driver of the lien determination is the dollar amount of the taxpayer’s aggregate assessed balance of the taxpayer’s tax debt. See National Taxpayer Advocate 2009 Annual Report to Congress 17-40 (Most Serious Problem: *One-Size-Fits-All Lien Filing Policies Circumvent the Spirit of the Law, Fail to Promote Future Tax Compliance, and Unnecessarily Harm Taxpayers*), 357-364 (Key Legislative Recommendation: *Strengthen Taxpayer Protection in the Filing and Reporting of Federal Tax Liens*) for additional discussion of these issues. See also Status Update: *The IRS Has Been Slow to Address the Adverse Impact of Its Lien Filing Policies on Taxpayers and Future Tax Compliance, supra*.

<sup>53</sup> IRM 5.19.4.6.4 (Mar. 8, 2010).

<sup>54</sup> IRS, *IRS Collection Process Study Final Report 96-98* (Sept. 30, 2010). Per the CPS study report, taxpayers typically respond to ACS levies in approximately 40 percent of the levies issued. The IRS estimates that “60-85 percent” of these levy responses result in either full paid accounts or installment agreements.

<sup>55</sup> While the ACS has the ability to report TDA accounts as uncollectible due to economic hardship, these determinations are not made frequently. In FY 2010, less than four percent of the TDAs processed through the ACS were reported as CNC with hardship-related closing codes. IRS, Collection Activity Report, NO-5000-2, *Taxpayer Delinquent Account Cumulative Report* (Oct. 2010).

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levies are not particularly substantial. Although the IRS has averaged 3.4 million levies per year since FY 2006, the *average* dollar yield from this activity has been only \$636 per levy.<sup>56</sup> The low yield suggests that many levies are unproductive, *i.e.*, the taxpayers no longer maintain relationships with the employers or financial institutions on which the levies were served. The low yield also indicates that levy action alone will not resolve most TDA accounts, without further contact with the taxpayers. Yet, the emphasis on levies and levy-related actions remains the primary driver of ACS activity. Essentially, the ACS phase of the collecting process relies on a more forceful use of automation to resolve collection accounts that represent “lower-hanging fruit” at the conclusion of the notice process – with very little effort devoted to more proactive, but less-severe contact attempts.

*More emphasis on personal contacts by the ACS could eliminate substantial amounts of “re-work” – improving service to taxpayers and reducing demands on collection resources.*

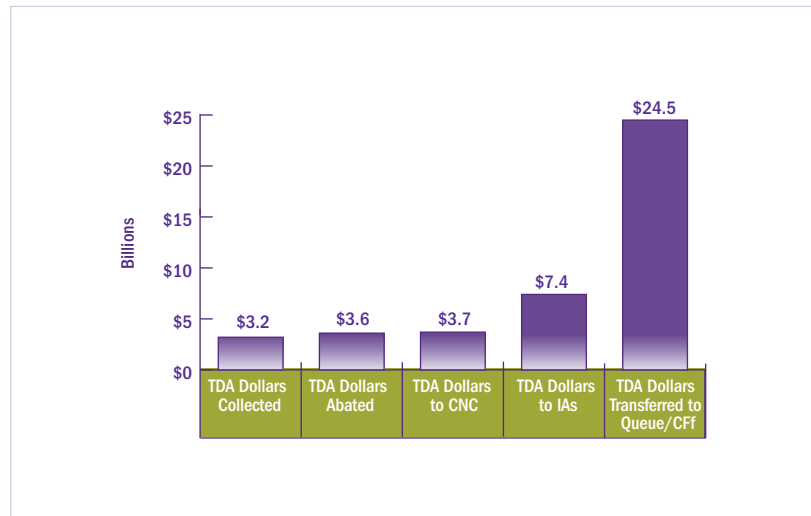
In situations where systemically generated levies fail to collect delinquent taxes, or do not generate taxpayer contacts that lead to case resolutions, very little additional time and effort are expended in the ACS segment of the collecting process.<sup>57</sup> Consequently, only a relatively small portion of the TDA dollar inventory processed through the ACS is actually collected – in FY 2010, while the ACS collected approximately \$3.2 billion and established IAs on another \$7.4 billion of delinquent accounts, \$24.5 billion in TDAs passed on to the Collection Queue and Field inventories.<sup>58</sup> Additionally, approximately \$3.7 billion was reported as uncollectible – with \$655 million of the CNC amount representing cases that were “surveyed.”<sup>59</sup>

<sup>56</sup> IRS, Collection Activity Report NO-5000-23, *Collection Workload Indicators* (Oct. 2010). IRS, Collection Activity Report, NO-5000-7, *BMF Collection Yield Report* (Oct. 2010); IRS, Collection Activity Report, NO-5000-8, *IMF Collection Yield Report* (Oct. 2010).

<sup>57</sup> TIGTA, Ref. No. 2010-30-046, *More Management Information Is Needed to Improve Oversight of Automated Collection System Outbound Calls* (Apr. 28, 2010). In making outbound calls to taxpayers, the ACS operations use predictive dialers. This TIGTA audit reported that there is insufficient management information available about whether the IRS’s use of predictive dialers is effective in contacting taxpayers with delinquent accounts. However, the report notes that only two to three percent of ACS direct time is devoted to outbound calls on collection cases.

<sup>58</sup> IRS, Collection Activity Report, NO-5000-2, *Taxpayer Delinquent Account Cumulative Report* (Oct. 2010).

<sup>59</sup> *Id.*

**FIGURE 2.3.3, Disposition of TDA Dollars in ACS – FY 2010**

The lack of emphasis on personal contacts (including outbound calls) in the IRS collecting process generates a substantial amount of unnecessary re-working of accounts, and considerable waste of collection resources. In FY 2010, approximately 40 percent of “new” TDAs assigned to the ACS involved accounts reissued from the Collection Queue or installment agreement accounts that had been “defaulted” and reactivated as TDAs.<sup>60</sup> Specifically, in FY 2010, approximately 1.7 million TDAs issued to ACS were reactivated IA accounts, which the IRS considered in default.<sup>61</sup> In addition, approximately 1.4 million TDAs were issued to the ACS from the Queue inventory, usually because of new delinquent modules generated by the taxpayers.<sup>62</sup> Neither of these conditions is flagged as a situation that warrants or could benefit from a personal contact. In the case of defaulted IAs, the use of follow-up telephone contacts would allow the IRS to more efficiently use the information it has already obtained from the taxpayer to establish the original agreements. However, the IRS rarely utilizes personal contacts in the process of “defaulting” IAs.<sup>63</sup>

**The Collection Field function represents a significant “bottleneck” in the IRS collecting process, which contributes to lengthy delays in case processing and large backlogs of unassigned cases.**

In theory, cases assigned to the CFf are high-risk, complex collection accounts that require revenue officer involvement for resolution. Some cases may bypass the ACS process, but in practice, the vast majority of CFf assignments involve taxpayer accounts that have previously been through the notice stream and ACS.<sup>64</sup> As a result, cases assigned to the CFf

<sup>60</sup> IRS, Collection Activity Report, NO-5000-2, *Taxpayer Delinquent Account Cumulative Report* (Oct. 2010).

<sup>61</sup> *Id.*

<sup>62</sup> *Id.*

<sup>63</sup> See IRM 5.19.1.5.5, *Installment Agreements* (Dec. 4, 2009) for more details on the procedures the IRS uses to default installment agreements.

<sup>64</sup> IRM 5.1.20.2.3, *Collection Inventory Management – Rules* (May 27, 2008).

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usually involve delinquencies that letters and systemically generated enforcement actions have failed to resolve. Because the IRS collecting process produces many such cases, the Cff has become a classic “bottleneck,” *i.e.*, the function receives many more cases than it can expeditiously handle with its available resources. This condition fosters substantial backlogs and the aging of collection accounts.

By design, the backlog of Cff inventory is assigned to an inventory known as the Collection Queue. In theory, the assignment of a case to the Queue is a temporary condition; cases reside in the Queue until Cff resources are available to work them. At the conclusion of FY 2010, approximately 3.3 million TDAs were assigned to the Queue inventory, representing \$46.2 billion in delinquent tax debts.<sup>65</sup> From 2006 through 2010, the Queue TDA inventory has grown by 36 percent, and the dollar value of accounts assigned to the Queue has increased by 70 percent.<sup>66</sup> In practice, the Queue is not a “temporary” backlog; rather, the backlog has become an institutionalized segment of the IRS collecting process.

An unfortunate by-product of this condition is the aging of accounts assigned to the Cff – before they are ever brought to the attention of an RO. The IRS collection strategy places very little importance on the impact of aging on the ability to collect delinquent accounts receivable. However, even studies conducted by the IRS recognize the “collectibility curve” that becomes apparent as delinquent accounts age. This “curve” indicates that after three years of becoming overdue, these accounts produce minimal collections.<sup>67</sup> Further, an analysis by the Chief Financial Officer of the IRS revealed that 83 percent of IRS collections occur within *two years* of assessment.<sup>68</sup> Yet IRS data reveal that at the end of FY 2010, *80 percent of the inventory of all open TDA accounts represented delinquencies involving tax years 2007 and prior*, and 56 percent had assessment dates over two years old.<sup>69</sup>

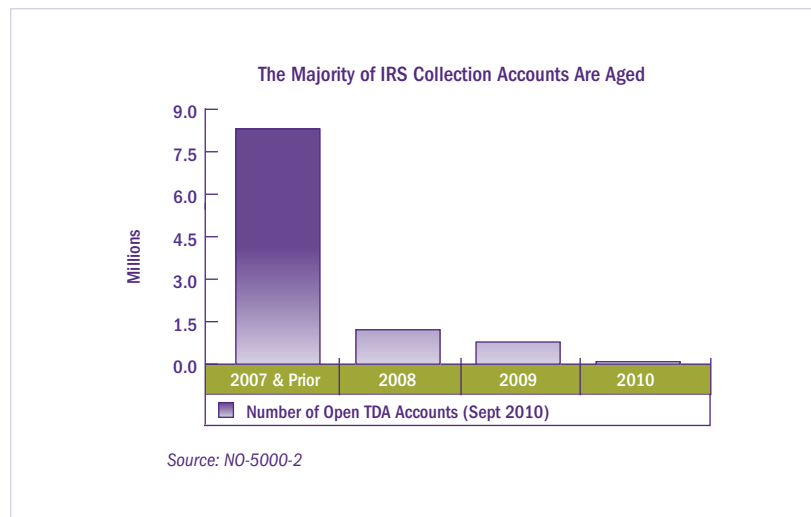
<sup>65</sup> IRS, Collection Activity Report, NO-5000-2, *Taxpayer Delinquent Account Cumulative Report* (Oct. 2010).

<sup>66</sup> *Id.*

<sup>67</sup> IRS, *TACT: Collection Team VSM Decision Paper I* (July 8, 2009).

<sup>68</sup> IRS, *Improving the Collection Process* (May 5, 2010).

<sup>69</sup> IRS, Collection Activity Report, NO-5000-2, *Taxpayer Delinquent Account Cumulative Report* (Oct. 2010).

**FIGURE 2.3.4, Age of IRS Collection Accounts**

IRS program measures that track the performance of the collection processes do not place much emphasis on the actual age of the accounts receivable. Instead, IRS collection measures tend to emphasize “cycle times,” *i.e.*, how quickly collection accounts are moved through the various stages of the collecting process.<sup>70</sup> However, the results of this approach should be a matter of concern for the IRS. In FY 2010, the CFF collected just over \$3.1 billion in TDA accounts, which was approximately seven percent of the TDA dollars assigned to the CFF that year.<sup>71</sup> On the other hand, the CFF reported approximately \$14.1 billion in TDAs as uncollectible.<sup>72</sup> These results, combined with the high volumes of delinquent tax dollars in the Collection Queue and CNC inventories, indicate the traditional use of the CFF is neither efficient nor effective.

*Both the IRS and its stakeholders have recognized the need to reevaluate the role of the CFF.*

The collection results described above have influenced some within the IRS to raise questions about the value of the CFF within the overall collecting process. A recent IRS study concluded the IRS needs to identify “specific cases that require Revenue Officer (RO) skills,” and “determine the optimal size of the CFF to resolve cases requiring RO action.”<sup>73</sup> The study does not, however, provide much insight into the type of assignments best suited for ROs, other than an underlying assumption that RO work is “complex.” Traditionally, the IRS views case complexity as a condition determined by the types of case actions that *may*

<sup>70</sup> For an in-depth discussion of IRS performance measures, see Most Serious Problem: *IRS Performance Measures Provide Incentives That May Undermine the IRS Mission*, *supra*.

<sup>71</sup> IRS, Collection Activity Report, NO-5000-2, *Taxpayer Delinquent Account Cumulative Report* (Oct. 2010).

<sup>72</sup> *Id.* See also IRS, Collection Activity Report, NO-5000-6, *Installment Agreement Cumulative Report* (Oct. 2010). In FY 2010, the dollars reported as CNC by the CFF were approximately 320 percent of the combined total of dollars collected on open CFF TDAs and IAs generated by the CFF.

<sup>73</sup> IRS, *Collection Process Study Final Report* (Sept. 30, 2010).

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be needed that require the RO skill set, *e.g.*, seizures, suit recommendations, and trust fund recovery penalties (TFRP).

A key component of RRA 98 was a requirement for the IRS to revise its organizational structure into units serving particular groups of taxpayers with similar needs.<sup>74</sup> In considering the potential value of the Cff, a more useful approach may be to focus on the needs and characteristics of “particular groups of taxpayers” who could benefit greatly from face-to-face contacts with skilled collectors, specifically trained to address their problems in the manner envisioned in RRA 98. Particularly in addressing problems involving small businesses, the local perspective enables ROs to accurately evaluate the true cause of the tax problems and determine the proper cures, which in turn may make a significant difference in the taxpayer’s long-term compliance. The current state of the Cff illustrates the negative outcomes associated with viewing all taxpayers with tax delinquencies as one “Collection” inventory, as opposed to diverse groups of taxpayers, with very differing needs, who are experiencing collection-related problems.

*The Cff’s renewed focus on enforcement at the expense of taxpayer service is not particularly effective in collecting delinquencies, especially for many small businesses.*

Focus group participants have indicated that the main reason small business taxpayers do not pay their payroll taxes is because “they do not see the immediate consequences of noncompliance.”<sup>75</sup> The participants also stated the IRS “is not very flexible in working with taxpayers to become compliant,” and needs to show more leniency and flexibility in working with taxpayers. Unfortunately, the IRS approach to educating taxpayers of the “consequences of noncompliance,” especially in recent years, has been through enforcement actions, with particular emphasis on levies, liens, and the Trust Fund Recovery Penalty (TFRP).<sup>76</sup> Moreover, from FYs 2006 to 2010, the Cff’s issuance of NFTLs increased by 55 percent, and levy issuances rose 172 percent.<sup>77</sup>

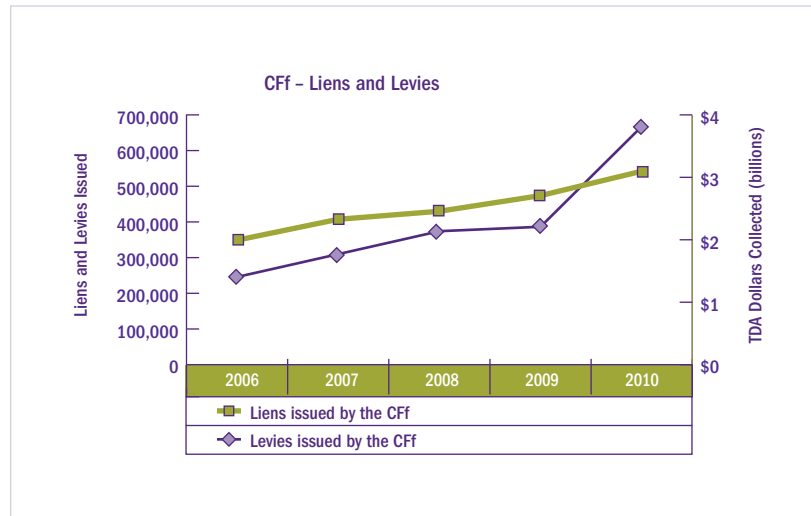
<sup>74</sup> Pub L. No. 105-206, 112 Stat. 685 (1998). For more information on the background of RRA 98, see Most Serious Problem: *The Wage and Investment Division Is Tasked with Supporting Multiple Agency-Wide Operations, Impeding its Ability to Serve its Core Base of Individual Taxpayers Effectively*, *supra*.

<sup>75</sup> IRS, SB/SE Research, *Your Clients and the Economy – How Can the IRS Help* 4 (Jan. 2010).

<sup>76</sup> IRM 5.7.3.1, *Introduction (to TFRP)* (Nov. 12, 2010). IRC § 6672 authorizes the IRS to impose a penalty against any person required to collect, account for, and pay over taxes held in trust who willfully fails to perform any of these activities. The penalty is equal to the total amount of tax evaded, not collected, or not accounted for and paid over.

<sup>77</sup> IRS, Collection Activity Report NO-5000-23, *Collection Workload Indicators* (Oct. 2010). In FY 2006, the IRS Cff issued 245,757 levies and 348,888 NFTLs. These numbers have increased each year through FY 2010, when 542,045 NFTLs were filed and 667,322 levies were issued by the Cff.



**FIGURE 2.3.5, Cff Lien And Levy Increases, FY 2006 - FY 2010**

Additionally, TFRP assessments issued as TDA accounts increased by 52 percent during this five-year period.<sup>78</sup> In fact, the Cff has recently reemphasized the use of liens and TFRPs as “two core and extremely important Collection basics . . . at the foundation of (the Cff) work.”<sup>79</sup> The basis for this emphasis is the perception that the number of small business taxpayers who repeatedly accrue tax delinquencies is a major compliance problem and one of the most significant issues facing the IRS.<sup>80</sup> IRS policy makes little distinction between “repeaters” who are chronically delinquent, *i.e.*, truly “won’t pay” taxpayers, and those that have multiple delinquent tax periods related to one episode of financial difficulty. Moreover, the IRS considers many business taxpayers as “repeaters” despite delays that are virtually built into the processing of BMF accounts, and the role IRS inaction plays in facilitating ongoing delinquencies. The impact of the NFTL can be devastating to businesses that rely on credit to fund operations. Yet, IRS policy promotes filing NFTLs as early as possible in the collecting process, even when the IRS has had no personal contact with the taxpayers.<sup>81</sup>

While the TFRP can be a useful tool in certain situations, the increased emphasis to routinely make TFRP determinations early in the Cff process is a classic example of “too little, too late.” The TFRP does not appear to be efficient or effective as a routine treatment for employment tax deficiencies. From FY 2006 to FY 2010, the dollar value of new TFRP TDAs has increased by 30 percent, but dollars collected (including refund offsets) on TFRP

<sup>78</sup> IRS, Collection Activity Report, NO-5000-2, *Taxpayer Delinquent Account Cumulative Report* (Oct. 2010).

<sup>79</sup> IRS, SB/SE Director of Collection, *Focusing on the Basics*, <http://SB/SE.web.irs.gov/c12/sl/ivt/csk/Collection/0358/transcript.htm>.

<sup>80</sup> *Id.*

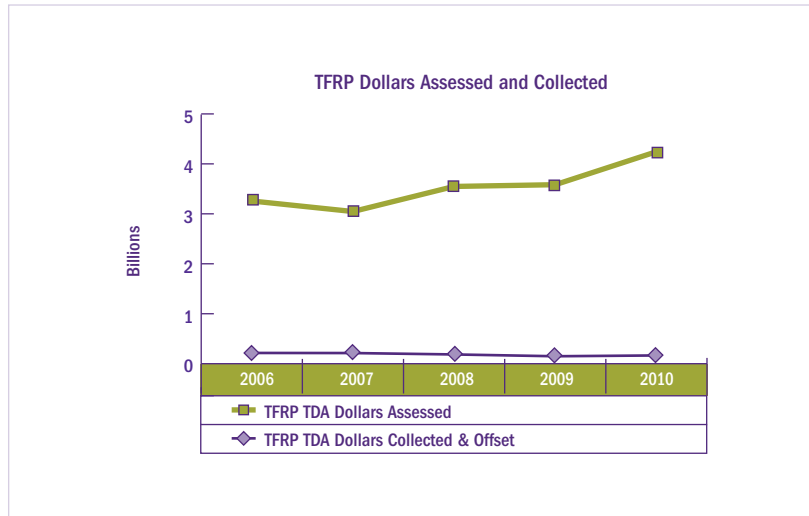
<sup>81</sup> IRM 5.12.2.4 (Oct. 30, 2009). The lien determination is due ten days from the initial attempted contact or initial actual contact date, whichever date is earlier.



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TDAAs have *declined by 23 percent*.<sup>82</sup> Routinely, the IRS collects very few of the dollars assessed through TFRPs.<sup>83</sup>

**FIGURE 2.3.6, Trust Fund Recovery Penalties, FY 2006 – FY 2010**



The CFf is uniquely positioned to provide local service and attention to small business taxpayers. The IRS invests approximately 50 percent of its Collection staffing resources into the CFf.<sup>84</sup> By placing more emphasis on service, personal communication, and treatments designed to actually help small business taxpayers comply with the tax laws while contributing to the nation’s economy, the IRS could use these resources much more effectively.

**Providing timely assistance to taxpayers with emerging collection problems could increase revenue, customer satisfaction and prevent escalating compliance problems.**

The current collecting process may be efficient in resolving collection problems of taxpayers who are willing to do the right thing with minimal prompting (*e.g.*, notices), or those able to respond to routine IRS enforcement actions in a positive manner (*e.g.*, ACS levies). However, the IRS’s aversion to personal contact establishes an environment that may act as a barrier for others to contact the IRS and work out reasonable arrangements to resolve their tax debts.

While the IRS generally assumes taxpayers who do not, or cannot, resolve their problems with the IRS during the notice stream are “won’t pay” problem cases, the IRS collection strategy does not acknowledge that many delinquent taxpayers do not respond to notices

<sup>82</sup> IRS, Collection Activity Report, NO-5000-2, *Taxpayer Delinquent Account Cumulative Report* (Oct. 2010). Excluding refund offsets, dollars collected on TFRP TDAs have declined by 45 percent from FY 2006 to FY 2010.

<sup>83</sup> IRS, Collection Activity Report, NO-5000-2, *Taxpayer Delinquent Account Cumulative Report* (Oct. 2010).

<sup>84</sup> IRS, *Improving the Collection Process* (May 2010).

because they may be paralyzed by fear and uncertainty. A focus group conducted with tax professionals by the IRS in 2009 recognized that many delinquent taxpayers experiencing financial difficulties are greatly influenced by “fear and panic” regarding their situations, and “are scared of the IRS and do not know how to resolve the issues.”<sup>85</sup> Further, in a situation where the collection notice contributed to the “fear and panic,” the impact of a systemically generated levy or lien may be devastating to the taxpayer who is unable to full pay, and cannot see the proverbial light at the end of the tunnel.<sup>86</sup>

Without a meaningful personal contact, the delinquent taxpayer may continue to fall further behind on tax obligations. A TAS research study completed in 2009 concluded that taxpayers who were placed in the Queue continued to accrue additional tax liabilities at very high rates.<sup>87</sup> Yet, the current collection process will likely not provide a personal contact until the debtor’s situation has become much more difficult to resolve. For the taxpayer, this situation can mean failure of a business, bankruptcy, and a huge tax problem that seems impossible to fix. For the IRS, this scenario frequently means uncollectible debts and an escalating inventory of unpaid assessments. This situation demonstrates that an inflexible, enforcement-oriented IRS is something to avoid.

When a recent focus group was asked to identify actions the IRS could take to help small business taxpayers, the number one strategy recommended by participants was “the need for the IRS to react faster.”<sup>88</sup> Participants stated, “The main problem is that many taxpayers are buried too deep by the time the IRS gets involved.”<sup>89</sup> Unfortunately, “reacting faster” from the taxpayer’s perspective is not a key component of the IRS collection strategy. The collecting process places very little emphasis on pre-delinquency education and intervention. The use of Federal Tax Deposit (FTD) Alerts and other field contacts on relatively small balance-due employment tax accounts is rare.<sup>90</sup> In FY 2010, BMF case assignments averaged 2.3 TDAs per taxpayer in ACS, 4.4 TDAs per taxpayer in the Queue, and 5.6 TDAs per taxpayer for the Cff.<sup>91</sup> Considering that most of these cases would involve at least one additional module in notice status, along with unpaid FTDs in the current quarter, it appears that the typical BMF case that the IRS believes warrants a field contact has already accumulated two years of employment tax delinquencies before a face-to-face contact is

<sup>85</sup> IRS, SB/SE Research, *Your Clients and the Economy – How Can the IRS Help* 4 (Jan. 2010).

<sup>86</sup> ACS customer satisfaction surveys routinely identify the “tone of IRS notice, bill, or letter” as an area of significant dissatisfaction with the ACS process, and a key improvement opportunity. IRS, Customer Satisfaction Survey, *Automated Collection System (ACS) SB/SE and W&I National Reports* (Aug. 2010).

<sup>87</sup> National Taxpayer Advocate 2009 Annual Report to Congress, vol. 2, 28 (*Subsequent Compliance Behavior of Delinquent Taxpayers: A Compliance Challenge Facing the IRS*). This study found that of taxpayers who incurred an initial delinquency in 2002, and were subsequently placed in the Collection Queue, 76 percent had at least one subsequent payment delinquency or unfiled return, and 46 percent had at least three such delinquencies.

<sup>88</sup> IRS, SB/SE Research, *Your Clients and the Economy – How Can the IRS Help* 4 (Jan. 2010).

<sup>89</sup> *Id.*

<sup>90</sup> IRM 5.7.1.1 (July 18, 2008). The FTD Alert process identifies, at an early stage (*i.e.*, before the return is due), taxpayers who have fallen behind in their deposits. FTD Alerts determine an employer’s compliance with employment tax deposit requirements for the quarter of Alert issuance, and for subsequent quarters until the taxpayer is brought into full compliance.

<sup>91</sup> IRS, Collection Activity Report, NO-5000-2, *Taxpayer Delinquent Account Cumulative Report* (Oct. 2010).

even attempted.<sup>92</sup> At this time, unfortunately, many of these small business taxpayers are “buried too deep.”

**The IRS has recently completed a study of the collection process to identify improvement opportunities.**

In March 2010, the IRS initiated the Collection Process Study (CPS), an intense, high-level “brainstorming” project to identify improvement opportunities for the treatment of taxpayers with collection problems. The CPS produced 53 recommendations designed to address every stage of the Collection process, from pre-delinquency through collection notice and TDA processing. Due to the nature of the initiative, the CPS recommendations are generally broad in scope, and provide little in implementation detail, although most are supported by data analysis.

With meaningful implementation, several of the CPS recommendations could have a positive impact on the IRS collection process:

- Increased emphasis on *pre-delinquency* and *early intervention* to address collection-related problems before they become unmanageable, *e.g.*, more emphasis on underutilized programs like Withholding Compliance and FTD Alerts.
- Initiating open discussions and increasing the availability of *payment alternatives* much earlier in the collecting process, *e.g.*, more emphasis on the availability of installment agreements in the collection notice process, and more “self-correction” options available on the IRS website.
- Significant improvements in IRS *collection financial analysis* techniques, *e.g.*, factors considered in determining reasonable collection potential (RCP) and allowable living expenses (ALE).
- More flexibility in the use of *lien withdrawals*, which may provide incentives for taxpayers to correct delinquency problems and remain in compliance.
- Increased availability of payment alternatives, such as *OICs* and *Partial Payment Installment Agreements*, as case resolutions for taxpayers who would otherwise be “can’t pay” situations.
- Creation of a *National Research Program for Collection* to provide an ongoing analysis of downstream benefits and costs of various collection treatments, as well as the impact of these treatments on future compliance.

Over the past five years, the National Taxpayer Advocate has supported these concepts on many occasions, and made recommendations through the Annual Reports to Congress that align with those made by the CPS.

<sup>92</sup> Of the BMF Trust Fund notices that were not resolved in the notice stream during FY 2010, approximately 23 percent were “closed” as “deferred” accounts, *i.e.*, due to the relatively small dollar amounts of the delinquencies, the IRS systemically determined to not pursue the delinquencies as TDAs. IRS, Collection Activity Report, NO-5000-242, *Taxpayer Delinquent Account Cumulative Report, Part 2 – Accounts Receivable Notices* (Oct. 2010).

Other CPS recommendations, however, appear to increase emphasis on problematic elements of the Collection operation that are already embedded in the current strategy:

- Increased use of and reliance on *systemically generated levies* as the primary tool to establish taxpayer contacts.
- Continued use of *Notices of Federal Tax Lien*, many systemically generated, without consideration of the facts and circumstances of individual cases.
- Routing more cases through an already heavily burdened *Automated Collection System*, thereby increasing the reliance on systemically generated levies as the “IRS calling card.”
- Increased emphasis on improving *ACS “efficiency,”* e.g., reductions in ACS call-handling times, and more focus on systemic levies rather than outbound calls.

The CPS report provides no reason to believe these recommendations will deliver new or better results than the IRS is already producing on Collection accounts, *i.e.*, “more of the same.” These recommendations can be “implemented” with very little actual change, but require the investment of even more Collection resources into the existing processes, thereby reducing the ability to devote sufficient resources to what we believe are the more beneficial CPS change recommendations.

***A proposal to centralize the IRS Collection operation could prevent meaningful changes.***

The IRS’s recent announcement of the formation of a new office responsible for service-wide collection strategy, policy, and governance raises certain concerns. Although such an office might be helpful in facilitating meaningful changes to the IRS Collection Strategy, placing that office within the SB/SE operating division vitiates RRA 98’s mandate that each organizational unit focus on the particular needs of its taxpayer base. Imposing an SB/SE approach to setting collection policy on the W&I taxpayer base may prove to be ineffective, and could turn W&I collection employees into mere functionaries. This move will separate policy decisions impacting W&I taxpayers from the knowledge base of those within the W&I organization who understand the needs of those taxpayers. However, these concerns could be mitigated, and the effectiveness of the new policy office enhanced, by having it report directly to the Deputy Commissioner, Services and Enforcement.

In addition to the new policy office, the CPS also recommended that the IRS “establish a unified Collection organization to provide “one collection voice” governing policies and procedures applied to the handling of cases involving taxpayers with collection problems. The National Taxpayer Advocate firmly believes this recommendation contradicts the intent, if not the letter, of Section 1001 of RRA 98, which required the IRS to revise its structure into “organizational units serving particular groups of taxpayers with similar needs.”<sup>93</sup> The recommendations made by the CPS will result in an organization that closely resembles

<sup>93</sup> Pub. L. No. 105-206, § 1001(a), 112 Stat. 685 (1998) (codified at IRC § 7801(note)).

the pre-RRA 98 IRS, *i.e.* functionally based units of operation, focused on “Compliance” and “Customer Service.”

The IRS will not resolve its significant collection-related problems by taking a major step backward. In fact, many of the problems identified and addressed in the CPS reflect similar conditions that created the need for the RRA 98 legislation. The IRS has continued to view and treat taxpayers with tax delinquency problems as a “particular group of taxpayers with similar needs,” *i.e.*, “Collection types.” In reality, the issues leading to tax delinquencies for wage earners can be very different from those affecting self-employed taxpayers, larger corporations, or non-profit organizations. The treatments required to best resolve these problems also differ. The proposal to establish a “unified collection organization” will not improve the operation of the IRS, nor the service provided to U.S. taxpayers. On the contrary, another reorganization of Collection could divert attention from actually correcting the significant problems in the handling of cases.

### **The current economic climate makes a change in the IRS collection philosophy more urgent.**

While economists may debate the technical issue of when the recent economic recession ended, it remains a fact that in the year 2010, millions of American taxpayers continued to struggle to make financial ends meet:

- As of November 2010, the nation’s unemployment rate was 9.8 percent, representing 15.1 million Americans.<sup>94</sup>
- Another nine million Americans were reported as being employed part-time for economic reasons, *e.g.*, employment hours were cut, or they were unable to find a full-time job.<sup>95</sup>
- As of June 2010, approximately 14 percent of home mortgages in the United States (or one in every seven loans) were either in foreclosure, or delinquent on scheduled payments.<sup>96</sup> Foreclosure activity increased in 75 percent of the nation’s top metro areas, and nationwide 1.65 million properties received foreclosure filings in the first half of 2010.<sup>97</sup>
- According to experts in the real estate industry, as of June 2010, approximately 21.5 percent of all single-family homes with mortgages had negative equity, *i.e.*, the estimated market values of the homes were less than the amounts owed on the mortgages.<sup>98</sup> However, in some parts of the country, this condition was much more prevalent, *e.g.*, Phoenix, Arizona (67 percent); Riverside, California (49 percent); and Miami, Florida (44 percent).<sup>99</sup>

<sup>94</sup> Bureau of Labor Statistics, *Labor Force Statistics from the Current Population Survey* (Dec. 3, 2010), available at [www.bls.gov/cps](http://www.bls.gov/cps).

<sup>95</sup> *Id.*

<sup>96</sup> Mortgage Bankers Association, [www.mortgagebankers.org](http://www.mortgagebankers.org) (Oct. 12, 2010).

<sup>97</sup> Realty Trac, [www.realtytrac.com](http://www.realtytrac.com) (July 14, 2010, and July 29, 2010).

<sup>98</sup> Zillow.com, *Real Estate Market Reports*, <http://zillow.mediaroom.com/index.php?s=169> (Oct. 12, 2010).

<sup>99</sup> *Id.*

- Bankruptcy filings rose 20 percent in the 12-month period ending June 30, 2010 – approximately 1.6 million cases.<sup>100</sup> The number of businesses filing for bankruptcy protection during this period was 250 percent higher than for the same period in 2007, while non-business filings increased by 208 percent.<sup>101</sup>
- According to the United States Census Bureau, 43.6 million people lived in poverty at the end of calendar year 2009, representing 14.3 percent of the population (or one of every seven Americans). This was the third consecutive annual increase in the number of people in poverty, and the 2009 figure is the largest in the 51 years for which poverty estimates have been published.<sup>102</sup>

For many, the hard economic realities of the recent recession appear to be far from over. For some, the struggle to deal with loss of employment, reductions in income, the loss (or potential loss) of a home, and the sudden evaporation of savings accounts could lead to the additional burdens of unexpected, and unintended, tax problems. The IRS has publicly communicated intentions to take a more helpful, flexible approach to work with taxpayers affected by the downturn.<sup>103</sup> However, there has been little noticeable change in the IRS collection strategy, the treatments provided to taxpayers with collection-related problems, or the reported outcomes of collection cases to support these good intentions.

Of even greater concern, however, is the probability that the IRS has yet to see the full impact of the recession on its inventory of collection accounts. For most individual taxpayers with income tax debts related to a Form 1040 for tax year 2009, accounts not resolved in the collection notice process have only become TDAs in the fourth quarter of FY 2010. Most of the tax problems stemming from financial difficulties taxpayers have encountered in 2010 have yet to be identified. It is quite likely that the IRS has only just begun to scratch the surface of a substantial volume of collection cases related to the recent economic recession.

None of the problems covered in this discussion of the IRS's collection strategy were created by the recession. The National Taxpayer Advocate identified many of the concerns addressed in this report, as well as the negative trends in the IRS performance results, in the 2004 to 2006 Annual Reports to Congress – well before the downturn in the economy. However, unless the IRS makes meaningful changes to its collection strategy in the very near future, it is likely that these problems will become much more apparent, and will harm a much greater number of taxpayers.

<sup>100</sup> Department of Justice, United States Trustee Program, *Bankruptcy Filings Up 20 Percent in June*, available at [www.justice.gov/ust](http://www.justice.gov/ust) (Aug. 17, 2010).

<sup>101</sup> *Id.*

<sup>102</sup> United States Census Bureau at [www.census.gov/hhes/www/poverty/poverty.html](http://www.census.gov/hhes/www/poverty/poverty.html) (Oct. 12, 2010).

<sup>103</sup> IRS, IR 2009-2, *IRS Begins Tax Season 2009 with Steps to Help Financially Distressed Taxpayers; Promotes Credits, e-File Options* (Jan. 6, 2009).

## CONCLUSION

Once again, the IRS appears to be at a crossroads in making decisions that will drive the manner in which the U.S. government interacts with American taxpayers who have developed collection problems. However, significant improvements in performance can only evolve through meaningful changes to a collecting process that has proven to be extremely resistant to such change. Enduring change will require a shift in the manner in which the IRS perceives taxpayers involved in the collecting process, *i.e.*, reevaluating the “won’t pay,” “will pay,” and “can’t pay” distinctions, and implementing a new model for service delivery and tax compliance.

In this year’s Annual Report to Congress, the National Taxpayer Advocate discusses an alternative tax compliance model based on understanding the needs of differing taxpayer segments. In this model, the tax administrator evaluates factors such as the reasons for noncompliance, along with the current level of cooperation from the taxpayer, in determining the proper response, or treatment.<sup>104</sup> Compliance treatments will then vary, based on the needs and characteristics of each taxpayer. For taxpayers who are willing and trying to comply, the tax administrator will emphasize education, self-correction, and assistance. In cases where the taxpayers have decided not to comply, treatments employing the “full force of the law” may be necessary.

The National Taxpayer Advocate acknowledges that some taxpayers have opted not to comply with the tax laws. In those situations, the use of collection enforcement tools, such as liens, levies and seizures is not only appropriate, but necessary to ensure that those taxpayers are not permitted to intentionally avoid paying their tax debts. The integrity of our tax system is based upon all taxpayers contributing their fair share toward payment of the nation’s expenses.

In general, the IRS collection strategy reacts in far too many situations as if delinquent taxpayers have made a conscious decision to not comply with their tax obligations, using the “full force of the law” to correct problems in a manner that may be premature, unnecessary, and even counter-productive in many cases. The IRS needs to adjust this mindset and achieve a better balance in the use of enforcement actions with other collection tools, including payment alternatives such as reasonable installment agreements and offers in compromise. It is imperative – now, more than ever – that the IRS proactively models within its Collection operations the principles embedded in the IRS Mission Statement. A more effective IRS collection strategy must include greater emphasis on providing *timely attention* to collection problems as they arise, actually *talking to taxpayers* about their tax problems, and *assisting* taxpayers to regain a “fully compliant” status with *collection treatments that are flexible, considerate, and effective*.

<sup>104</sup> For an additional discussion of this topic, see *Researching the Causes of Noncompliance: An Overview of Upcoming Studies*, *supra*.



## RECOMMENDATIONS

### 1. **Develop an improved working model of the “will pay,” “can’t pay,” and “won’t pay” distinctions in determining the most appropriate collection treatments for taxpayers with collection problems.**

Meaningful changes in the IRS collection strategy will require fundamental adjustments to the manner in which the IRS views taxpayers with collection-related problems. The “enforcement” mindset that assumes those taxpayers who do not fully resolve their problems during the collection notice process are intentionally avoiding the IRS, *i.e.*, “won’t pay,” needs to be replaced with a more service-oriented model that assumes the majority of these taxpayers are in financial trouble, and need *assistance* from the IRS to fully comply with their tax obligations. This type of culture change will require the review and revision of IRS collection training materials, policies, and procedures. It will require frequent and consistent messages from IRS leaders, and careful *follow-up* to ensure that a *service-based* compliance culture is driving decisions regarding the treatment of American taxpayers with IRS collection problems.

### 2. **Provide timely interventions for emerging collection problems.**

The IRS must recognize that the true age of a delinquent collection account relates to the due date of the tax return, and revise the methods used to prioritize and assign collection cases to fully account for the impact of elapsed time on collectibility and taxpayer burden. Delays built into the current IRS collection strategy all too frequently evolve into “lose-lose” situations. Top priority should be placed on initiating *personal* contacts on *current, self-reported accounts, i.e.*, tax delinquencies on recent tax periods involving taxpayers who have not resolved their tax debts through the collection notice process. Additionally, more emphasis on pre-delinquency interventions, *e.g.*, FTD Alerts, and more proactive outreach in the collection notice process could yield significantly improved results, while preventing collection accounts from reaching TDA status.

### 3. **Use more timely *personal* contacts to help taxpayers fully resolve their collection problems.**

In particular, collection cases that have not self-corrected during the notice process are indications of taxpayers dealing with financial distress, which warrant personal contacts to ensure the collection-related tax problems are *fully* resolved. The degree to which the IRS provides service consistent with the collecting principle that calls for “courteous, responsive and effective service and assistance” is most evident in the manner in which the IRS communicates with taxpayers whose accounts have become TDAs. Systemically generated levies and liens do not appear to be effective “conversation starters” for many of these taxpayers. The high volumes of reworked and unresolved accounts that are produced by the current collection strategy are strong indicators that more emphasis on personal contacts, made early in the delinquency cycle, is a key component to long-term improvements in service, business results, and compliance.



**4. Deliver collection inventory to organizational segments trained and empowered to provide “one-stop service,” based on the specialized needs of the taxpayer segment in question.**

Abandon the “assembly-line” collecting process in favor of one that provides collection treatments that are based on an understanding of the differing needs of “particular groups of taxpayers,” as envisioned in RRA 98. The operational “hand-offs” embedded in the current IRS collection strategy are inefficient and frequently ineffective. TDA accounts should only be assigned to organizational units that can fully address the differing needs and characteristics of the taxpayers involved. These units should be empowered to provide the full range of services and case actions needed to resolve the cases assigned to them.

**5. Use all available collection tools, including the full range of collection payment alternatives, e.g., offers in compromise and reasonable installment agreements.**

At the conclusion of FY 2010, the IRS reported approximately 1.3 million taxpayer accounts as uncollectible, and the dollar value of the CNC inventory was about \$66 billion.<sup>105</sup> Approximately 3.3 million TDA accounts remained assigned to the Collection Queue, which had a dollar value of about \$46 billion.<sup>106</sup> Approximately 80 percent of the inventory of open TDAs involved tax periods from the years 2007 and prior.<sup>107</sup> Yet, in the midst of one of the greatest economic downturns in American history, the IRS only accepted 13,866 offers in compromise and issued 40,461 partial payment installment agreements.<sup>108</sup> Including notice accounts and TDAs, only approximately 95,000 IAs were issued on BMF accounts, generally involving small business taxpayers.<sup>109</sup> Less than four percent of the TDAs handled by ACS were reported as uncollectible due to economic hardship.<sup>110</sup>

The IRS must recognize that liens and levies are not the only tools available to resolve collection accounts. While the more forceful enforcement tools may be necessary to address true “won’t pay” situations, IRS collection program results clearly indicate these actions aren’t the solutions for the majority of collection accounts. The IRS should take a much more *reasonable* and *proactive* approach to the use of collection payment alternatives, such as OICs and PPIAs, as important components of its collection strategy.

<sup>105</sup> IRS, Collection Activity Reports, NO-5000-149, *Recap of Accounts Currently Not Collectible Report* (Oct. 2010).

<sup>106</sup> IRS, Collection Activity Report, NO-5000-2, *Taxpayer Delinquent Account Cumulative Report* (Oct. 2010).

<sup>107</sup> *Id.*

<sup>108</sup> IRS, Collection Activity Report, NO-5000-6, *Installment Agreement Cumulative Report* (Oct. 2010).

<sup>109</sup> *Id.*

<sup>110</sup> IRS, Collection Activity Report, NO-5000-2, *Taxpayer Delinquent Account Cumulative Report* (Oct. 2010).

**6. Reevaluate requirements for managerial review of IRS liens and levies.**

Section 3421 of RRA 98 directed the IRS to implement procedures under which determinations to file liens and levies would require supervisory approval “where appropriate.” In hindsight, the IRS response to this directive was more “reaction” than “reflection.” As a result, the impact of this legislative directive was negligible – the IRS determined that managerial review requirements in most situations involving liens and levies were already “appropriate.”

In recent years, the IRS has ramped up the use of liens and levies to pre-RRA 98 levels, with the majority of these actions issued without human judgment, *i.e.*, systemically generated. The business results stemming from this strategy have been questionable, at best. However, the National Taxpayer Advocate has consistently cautioned the IRS to be more concerned with the negative, unintended consequences these actions can have on the affected taxpayers.<sup>111</sup> The intent of the RRA 98 directive is as valid in 2010 as it was in 1998. The IRS should revisit its policy in this area, and take appropriate steps to ensure that IRS enforcement actions are only employed in situations where they are warranted and necessary.

**7. Eliminate the Collection Queue.**

The existence of the Collection Queue has created a “numbing effect” by masking the ineffectiveness of the current IRS collection strategy. Rather than serving as a temporary stop on the “assembly line” for cases requiring assignment to the CFf, the Queue has become an institutionalized repository for cases the IRS collecting process has failed to resolve. Further, the use of the Queue appears to have heavily contributed to the indifference of the IRS to the aging of collection accounts, and the negative outcomes the delays in case processing have for taxpayers and the IRS’s business results.

The IRS perceives the use of the Queue as a necessity to manage its excessively large collection workload. However, the existence of the Queue mitigates the need for the IRS to routinely evaluate and address the *manner in which it manages* its workload. Elimination of the Queue would force the IRS to place much more emphasis on timely, effective contacts on self-reported tax delinquencies, design treatments that emphasize “one-stop service” in most collection contacts, and use so-called compliance assessments, *e.g.*, the TFRP much more judiciously.

**8. Measure and evaluate the effectiveness of collection tools and treatments in meeting taxpayer needs and promoting future compliance.**

The IRS must be more concerned and aware of the impact of its collection treatments on *taxpayer compliance*. The objective of the IRS to help taxpayers understand and

<sup>111</sup> See Status Update: *The IRS Has Been Slow to Address the Adverse Impact of its Lien Filing Policies On Taxpayers and Future Tax Compliance*, *supra*; National Taxpayer Advocate 2009 Annual Report to Congress 17-40 (Most Serious Problem: *One-Size-Fits-All Lien Filing Policies Circumvent the Spirit of the Law, Fail to Promote Future Tax Compliance, and Unnecessarily Harm Taxpayers*).

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meet their tax responsibilities extends beyond collecting the tax bill at hand.<sup>112</sup> The manner in which the IRS engages the taxpayer in the collection of the tax debt should promote future voluntary compliance.

Further, the IRS needs to develop a deeper understanding of the various factors that can lead to the noncompliant behavior that produced the delinquent collection cases, and use this information in determining treatment options that help prevent problems from repeating in the future. IRS enforcement actions certainly provide an element of “deterrence” for those situations where a taxpayer has chosen, or is considering, non-compliance with the law. However, the deterrence model is too narrow to address the issues contributing to the noncompliant behavior of many of the “can’t pay now” taxpayers in the inventory of IRS collection cases.<sup>113</sup>

The IRS has done very little research into the impact of various collection treatments on future compliance, and does not include any measures of future compliance in its Business Performance Reviews or other highly visible reports. The IRS should conduct additional studies to identify opportunities to expedite personal contacts on collection cases, where it is evident such actions are needed for mutually successful resolutions. Are there common characteristics for taxpayers who do not self-correct during the collection notice process? Are collection and compliance issues in cases involving small business taxpayers and non-profit organizations being handled effectively? Does the “assembly-line” process even make sense for addressing taxpayers who have had prior delinquencies assigned to ACS or the Collection Field operation? Does the IRS have an accurate method to identify chronic delinquents, and intervene accordingly? The IRS needs to ask and answer such questions to ensure that collection treatments and resources are used in the most efficient and effective manner. This information is critical to support meaningful changes to the IRS collection strategy.

<sup>112</sup> In FY 2009, dollars collected on open TDAs accounted for only 0.3 percent of total IRS revenue receipts. IRS, 2009 Data Book; IRS, Collection Activity Report, NO-5000-2, *Taxpayer Delinquent Account Cumulative Report* (Oct. 2010).

<sup>113</sup> For further discussion on this topic, see *Researching the Causes of Noncompliance: An Overview of Upcoming Studies, infra*.

National Taxpayer Advocate

Annual Report to Congress

2010 Annual Report to Congress

RESEARCHING THE CAUSES  
OF NONCOMPLIANCE:  
AN OVERVIEW OF UPCOMING STUDIES

## Researching the Causes of Noncompliance: An Overview of Upcoming Studies

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## EXECUTIVE SUMMARY

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

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

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

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

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

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

<sup>2</sup> See, e.g., National Taxpayer Advocate 2009 Annual Report to Congress 300.

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

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

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

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

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

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

## INTRODUCTION

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

Most people timely and voluntarily comply with the requirement to file and pay taxes. Out of \$2.112 trillion in taxes due in 2001 (the latest year for which IRS estimates are available), taxpayers timely and voluntarily reported and paid \$1.767 trillion – 83.7 percent.<sup>7</sup> The remaining 16.3 percent or \$345 billion not timely and voluntarily reported and paid represents the “tax gap.”<sup>8</sup> Unreported business income, mostly from the cash economy (*i.e.*, income not subject to information reporting), is responsible for the largest portion of the tax gap – more than \$100 billion in 2001.<sup>9</sup>

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

Recognizing the importance of voluntary compliance, the IRS’s goal is to narrow the tax gap by raising the voluntary compliance rate by 2.3 points – from 83.7 percent in tax year 2001 to 86 percent by tax year 2009.<sup>10</sup> Based on the latest IRS estimates for FY 2001, a 2.3 point increase in voluntary compliance could have generated another \$48.8 billion that year<sup>11</sup> – significantly more than the \$33.8 billion the IRS brought in directly through all enforcement activities in 2001.<sup>12</sup> The IRS would need to increase direct enforcement revenue by 144 percent (\$48.8 billion / \$33.8 billion) to match gains from a mere 2.3 point increase in voluntary compliance. Thus, increasing voluntary compliance is the only practical way for the IRS to significantly reduce the tax gap.

### Deterrence promotes voluntary compliance by some.

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

<sup>7</sup> IRS, *Tax Gap Map for Year 2001* (Feb. 2007), [http://www.irs.gov/pub/irs-utl/tax\\_gap\\_update\\_070212.pdf](http://www.irs.gov/pub/irs-utl/tax_gap_update_070212.pdf).

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

<sup>9</sup> See *id.*

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

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

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

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



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

**Deterrence is not the only factor driving voluntary compliance.**

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

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

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

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

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

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

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

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

### Why research noncompliance by participants in the cash economy?

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

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

## DISCUSSION

### Besides deterrence, why do taxpayers voluntarily comply?

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

#### *Compliance norms.*

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

<sup>18</sup> This is so even after accounting for the fact that some people incorrectly compute the probability of detection and others are averse to risk. See, e.g., Richard Lavoie, *Flying Above the Law and Below the Radar: Instilling a Taxpaying Ethos in those Playing by their Own Rules*, 29 Pace L. Rev. 637, 640-642 (2009) (summarizing studies). For further discussion of taxpayer beliefs regarding audit probability, see Sarah B. Lawsky, *Probably? Understanding Tax Law’s Uncertainty*, 157 U. Pa. L. Rev. 1017, 1023 (2009).

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

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

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

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

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

*Trust in government and the tax administration process.*

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

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

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

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

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

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

*Complexity and the convenience of compliance.*

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

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

*Reliance on tax preparers.*

Tax preparers may have a significant effect on tax compliance.<sup>32</sup> About 60 percent of all individual income tax filers used paid tax return preparers in 2008.<sup>33</sup> Taxpayers may use preparers because they perceive the rules as too complex, to save time, or to avoid paying more than required.<sup>34</sup> Some research suggests preparers meet these expectations by enhancing compliance with unambiguous rules, but reducing it with respect to ambiguous ones.<sup>35</sup> Other research suggests that preparers neither enhance compliance with unambiguous rules nor prevent taxpayers from paying too much, at least with respect to issues facing

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

<sup>29</sup> *Id.* at 128-129.

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

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

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

<sup>33</sup> IRS, CDW Tax Year 2008 (Dec. 6, 2010).

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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



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

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

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

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

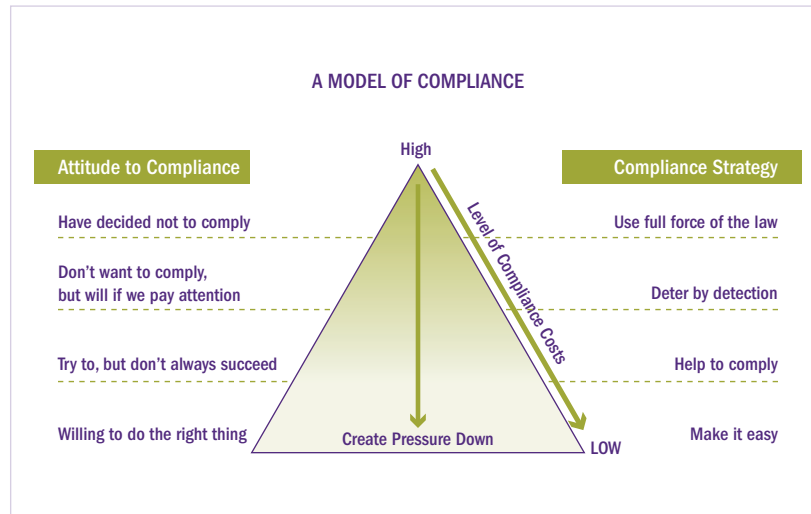
<sup>40</sup> See OECD, Forum on Tax Administration Compliance Sub-group, *Managing and Improving Tax Compliance*, 47 (Oct. 2004), <http://www.oecd.org/dataoecd/44/19/33818656.pdf>. See also Valerie Braithwaite and Jenny Job, *The Theoretical Base for The ATO Compliance Model*, Centre for Tax System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

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



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CHART 2.4.3, Responsive Regulation Compliance Model



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

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

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

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

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

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

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

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

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

#### How will TAS design its research?

##### *How will TAS tie attitudes to objective measures of compliance?*

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

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

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

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

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

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

## Researching the Causes of Noncompliance: An Overview of Upcoming Studies

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

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

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

#### *How will TAS study local differences in attitudes?*

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

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

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

<sup>49</sup> The IRS selects some returns for examination using the Discriminant Index Function (DIF) computer scoring system. IRM 4.1.1.2.6 (Oct. 24, 2006); IRM 4.1.24.1 (Mar. 23, 2010). It develops DIF score algorithms based on information obtained and periodically updated from NRP examinations. Returns with high DIF scores generally have a higher probability of being adjusted on audit than other returns of the same type. IRM Exhibit 4.1.7-1(12) (May 19, 1999).

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

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

### *How will TAS develop the survey?*

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

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

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

## Researching the Causes of Noncompliance: An Overview of Upcoming Studies

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

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

## CONCLUSION

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

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

National Taxpayer Advocate

Annual Report to Congress

*2010 Annual Report to Congress*

**ESTIMATING THE IMPACT  
OF LIENS ON TAXPAYER  
COMPLIANCE BEHAVIOR:  
AN ONGOING RESEARCH INITIATIVE**

## Estimating the Impact of Liens on Taxpayer Compliance Behavior: An Ongoing Research Initiative<sup>1</sup>

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<sup>1</sup> The principal authors of this study are Terry Ashley and Jeff Wilson, Senior Research Analysts for the Taxpayer Advocate Service.

## INTRODUCTION

The National Taxpayer Advocate has requested that Taxpayer Advocate Service (TAS) Research & Analysis investigate the impact of Notices of Federal Tax Lien (NFTL) on the compliance behavior of delinquent taxpayers. The results of this analysis will help the National Taxpayer Advocate and the Internal Revenue Service (IRS) better understand the effectiveness of NFTLs. The purpose of this report is to provide an overview of this ongoing research initiative.

Previous IRS research studies indicate that NFTLs exhibit a positive impact on the collection of tax liabilities from delinquent taxpayers.<sup>2</sup> However, these studies also raise additional questions. For example, one study actually showed an inverse relationship between the filing of an NFTL and the dollars collected on delinquent liabilities, until instrumental variables were added in an attempt to explain why liens were filed in certain circumstances, but not in others.<sup>3</sup> Also, the studies do not thoroughly explore the impact of lien filing on taxpayer compliance in subsequent periods. A study by TAS in last year's Annual Report to Congress found that relatively few subsequent payments were attributable to the NFTL. Therefore, the National Taxpayer Advocate commissioned this study to better understand the relationship between lien filings and subsequent taxpayer payment behavior. This research project will also explore the impact of lien filings on taxpayers' future payment compliance, their future filing compliance, and their ability to earn income.

To accomplish these objectives, TAS Research will analyze a cohort of delinquent individual tax return filers who had new unpaid tax liabilities in tax year (TY) 2002. The study will focus on the payment activities and subsequent compliance behavior of these taxpayers. Particularly, this analysis will compare payment activity and compliance behavior for taxpayers with and without an NFTL. TAS Research will examine payment compliance and the overall compliance behavior of these taxpayers from 2002 through 2009.

TAS Research will employ a two-stage regression analysis. The first stage will determine the likelihood that the IRS will file a lien by examining various case factors and applying the lien filing criteria specified by the Internal Revenue Manual (IRM). This first stage will result in the selection of "matched" pairs of cases with relatively equal chances of having an NFTL filed. Each pair will consist of one case where a lien was filed and another case where a lien was not filed. The matched cases will be very similar, however, with respect to the characteristics the IRS uses to make a lien filing determination.

<sup>2</sup> IRS Small Business/Self-Employed division (SB/SE) Research – St. Paul, Project 13.14, *Estimating the Impact of Federal Tax Lien Filing on Accounts Receivable Resolution* (Dec. 2002); IRS SB/SE Research – St. Paul, Project STP0001, *Impact of the Federal Tax Lien on Cases Shelved by the Currently Not Collectible Filter* (June 2006); IRS SB/SE Research – St. Paul, Project STP0007, *Optimizing the Revenue Collection Impact of Lien Refiling* (Mar. 2007).

<sup>3</sup> An instrumental variable can be used in lieu of an independent variable in a regression model to address bias that arises when the dependent variable (*i.e.*, the variable the model is attempting to estimate) causally influences the independent variable (*i.e.*, this causal relationship means that the independent variable is not truly independent). The instrumental variable must be correlated with the dependent variable in the same way that the independent variable is, but must not be causally influenced by the dependent variable.



We will use the matched pairs in the second stage of the analysis. This will allow us to fairly compare the lien and non-lien groups. During the second stage, we will use regression analysis to determine what factors, including the NFTL itself, significantly impact the outcomes we are investigating (*e.g.*, dollars collected or future filing compliance), and the extent to which they influence these outcomes.

## BACKGROUND

A federal tax lien (FTL) arises when the IRS assesses a tax liability and sends the taxpayer notice and demand for payment, and the taxpayer does not fully pay the debt within ten days.<sup>4</sup> An FTL is effective as of the date of assessment and attaches to all of the taxpayer's property and rights to property, whether real or personal, including rights or property acquired after that date.<sup>5</sup> This lien remains in effect against the taxpayer's property until the liability has been fully paid or becomes legally unenforceable.<sup>6</sup> To put third parties on notice and establish the priority of the government's interest in a taxpayer's property against subsequent purchasers, secured creditors, and junior lien holders, the IRS must file an NFTL in the appropriate location, such as a county register of deeds.<sup>7</sup>

After NFTL filings dropped to an all-time low following the passage of the Restructuring and Reform Act of 1998, the IRS has been increasing the number of filings, with the volume rising precipitously since 2005. In fact, the 2010 volume of lien filings is about six times as large as in 1999. The following chart depicts the trends in lien filings and dollars collected since 1999:

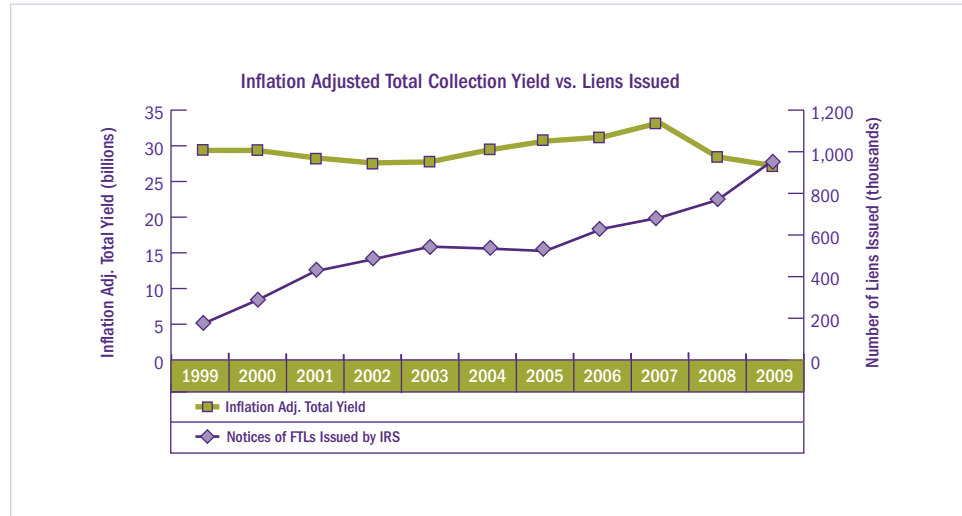
<sup>4</sup> Internal Revenue Code (IRC) §§ 6321 and 6322. IRC § 6201 authorizes the IRS to assess all taxes owed. IRC § 6303 provides that within 60 days of the assessment the IRS must provide notice and demand for payment to any taxpayer liable for an unpaid tax.

<sup>5</sup> See IRC § 6321; Internal Revenue Manual (IRM) 5.12.2.2 (May 20, 2005).

<sup>6</sup> IRC § 6322.

<sup>7</sup> IRC § 6323(f); Treas. Reg. § 301.6323(f)-1; IRM 5.12.2.8 (Oct. 30, 2009).

## Estimating the Impact of Liens on Taxpayer Compliance Behavior: An Ongoing Research Initiative

**FIGURE 2.5.1, Inflation Adjusted Total Collection Yield vs. Liens Issued<sup>8</sup>**

Interestingly, inflation-adjusted collection yield has begun to decline even despite the increase in lien filings. While other economic conditions surely play a part in the total collection yield, the fact that increased lien filings do not necessarily lead to increased collections makes the practice of filing an NFTL questionable in various situations.

A lien filing determination is required for all unpaid assessed delinquencies.<sup>9</sup> The IRM specifies various criteria for lien filings depending on the nature of the delinquency. The IRS is supposed to file an NFTL even for most cases reported as currently not collectible (CNC), if the unpaid balance is at least \$5,000.<sup>10</sup> Streamlined installment agreements (IAs) do not usually require the filing of an NFTL.

Unfortunately, the IRS systemically files many NFTLs without the benefit of a trained collection employee's personal judgment regarding the facts and circumstances of a particular case. The Automated Collection System (ACS) files over half of NFTLs, and over two-thirds of these liens are filed systemically without any significant IRS employee review of the case.<sup>11</sup> The National Taxpayer Advocate does not believe the IRS should be precluded from filing NFTLs, but rather that this powerful collection tool should be used judiciously.

<sup>8</sup> The total collection yield is any revenue collected attributable to IRS collection activities, such as levies, liens, and seizures. Total collection yield in a fiscal year includes tax, interest, and penalties from multiple tax years.

<sup>9</sup> IRM 5.12.2.4 (June 11, 2010).

<sup>10</sup> IRM 5.12.4.1 (June 11, 2010).

<sup>11</sup> For a detailed discussion of the National Taxpayer Advocate's concerns about IRS lien filing policies, see National Taxpayer Advocate 2009 Annual Report to Congress 4-40 (Most Serious Problem: *One-Size-Fits-All Lien Filing Policies Circumvent the Spirit of the Law, Fail to Promote Future Tax Compliance, and Unnecessarily Harm Taxpayers*); National Taxpayer Advocate 2009 Annual Report to Congress 357-364 (Legislative Recommendation: *Strengthen Taxpayer Protections in the Filing and Reporting of Federal Tax Liens*); National Taxpayer Advocate FY 2011 Objectives Report to Congress 13-17 (Area of Emphasis: *The National Taxpayer Advocate Remains Concerned About IRS Collection Practices that Do Not Promote Future Voluntary Compliance and Can Unnecessarily Harm Taxpayers*); Status Update: *The IRS Has Been Slow to Address the Adverse Impact of Its Lien Filing Policies on Taxpayers and Future Tax Compliance, supra*.

Moreover, she believes more research is needed to determine the best criteria for filing an NFTL.

## OBJECTIVES

We intend to explore the effect of the NFTL on:

- Current payment behavior;
- Future payment behavior;
- Future filing behavior; and
- Future income potential.

We also intend to conduct a sensitivity analysis to better understand when NFTLs are likely to be an effective collection tool. TAS does not envision that NFTLs would never be effective, but they may not work for certain taxpayers or in certain situations, such as when taxpayers have low incomes or their liabilities have been reported as CNC.

## METHODOLOGY

TAS Research intends to use a two-stage regression method for our analysis. The first stage, which estimates the probability of a tax lien filing for taxpayers, is also described as generating propensity scores for the taxpayers. We intend to use a logistic regression equation to estimate a propensity score for each taxpayer. The score estimates the likelihood of a tax lien being filed on the taxpayer's liability. This estimation method addresses the selection bias inherent in the tax lien filing process. Selection bias exists because case criteria generally determine which cases will receive an NFTL. We will use propensity scores and a matching algorithm to generate matched pairs of lien taxpayers and non-lien taxpayers, who are very similar with respect to the characteristics the IRS uses to make a lien filing determination. The result will be a sample of taxpayers that approximates a random sample of equivalent pairs of taxpayers for use in the second stage. The two-stage regression model is described in more detail hereafter.

The tax lien model investigates the likelihood that a taxpayer will have a tax lien filed against his or her delinquent tax modules. As mentioned previously, IRS lien filings are not random events. IRM 5.12.2.4 establishes the criteria that determine when they should occur. These criteria introduce selection bias that must be addressed, or the estimation of the tax lien impact in the second stage (using a tax lien indicator) will produce biased results. To overcome this selection bias, we will use a class of probability equations to estimate the dependent variable, *i.e.*, tax lien filing. We intend to use a logistic equation for this purpose.

To overcome the problem of non-randomization in our observational data, we will conduct a matching of taxpayers based on the set of observed covariates (*i.e.*, the taxpayer characteristics used by the IRS in the lien filing determination). When the propensity scores

(conditionally assigned based on the covariates) are equivalent for lien and non-lien taxpayers, the difference in the lien and non-lien outcome measures is an unbiased estimator of the lien effect.

### Stage One of the Regression Analysis

Our first step estimates the propensity score for each taxpayer, *i.e.*, the conditional probability of the taxpayer having a tax lien filed. We use a logistic regression where the dependent variable is a binary variable (one indicates a tax lien has been filed and zero indicates that a lien has not been filed).

The independent variables are the covariates that capture the underlying conditions for tax lien filing. These conditions are identified in the provisions of the IRM section or the systemic behavior of the IRS collection personnel.

Model # 1 specifies the relationship for generating the propensity scores:

$$P(Y_L | Y_{L_1} = 1) = f(X_{AAT}, X_{CR}, X_{CNC}, X_{IA^A}, X_{IA-Def}, X_{Bank}, X_{Rpr}),$$

$P(Y_L)$  is probability of a tax lien filing, propensity score;

$Y_{L_1}$  is an indicator of a tax lien filing;

$X_{AAT}$  is an indicator of aggregate assessed tax greater than \$5,000;

$X_{CR}$  is an indicator of collection at risk;<sup>12</sup>

$X_{CNC}$  is an indicator of taxpayer having CNC modules;

$X_{IA^A}$  is an indicator of taxpayer having an installment agreement;

$X_{IA-Def}$  is an indicator of taxpayer having a defaulted installment agreement;

$X_{Bank}$  is an indicator of taxpayer having a bankruptcy filing; and

$X_{Rpr}$  is an indicator of taxpayer is repeater.

The second step in the propensity score matching technique involves using the estimated propensity scores to create matched pairs of tax lien taxpayers with non-tax lien taxpayers. Several matching methods are available, but we will likely use the nearest available neighbor method. The matched pairs allow the two groups (tax lien taxpayers and non-tax lien taxpayers) to be relatively identical over set covariates (observable characteristics). This condition in the sample allows the estimate of the event effect (*i.e.*, tax lien filing) to be a more unbiased estimator.

In the nearest available neighbor matching method, both lien and non-lien groups are first randomly sorted. Then the first lien unit is selected to find its closest non-lien unit match based on the absolute value of the difference between the propensity score of the selected lien unit and that of the non-lien unit under consideration. The closest non-lien unit is

<sup>12</sup> Sufficient data are not likely available on the Master File to make this determination.

selected as a match. This procedure is repeated for all the lien units. A possible hazard in the analysis is that we will not have sufficient numbers of cases in the lien and non-lien groups to create a matched sample. However, preliminary results indicate that this will not be a problem. The second stage of the regression analysis estimates the actual effect of the NFTL.

### Stage Two of the Regression Analysis

As discussed above, in stage two we will use the dataset that results from the stage one propensity scoring and matching process. This dataset will allow us to make a better estimate of the impact of lien filing on the outcome variables of interest, because the dataset has been adjusted to address the selection bias inherent in the population of taxpayers against whom liens have been filed. Following is an overview of the regression models we will use to estimate each of the outcome variables we are exploring.

#### Current Tax Payment Behavior

Model #2 investigates the tax lien's impact on the probability of the taxpayer making payments on the TY 2002 liability. The dependent variable is a binary variable, where one indicates that a reduction has occurred in the balance due for this liability. The reductions in the balance due exclude any offsets or abatement. The lien variable is the critical variable in this model. Other independent variables are taxpayer condition variables and IRS status variables. The taxpayer condition variables characterize information about the taxpayer's past payment activities, family status, income conditions, and personal conditions (*e.g.*, health issues or other personal issues that influence the taxpayers financial status) while IRS status variables characterize information about lien filing behavior and audit activity. The model analyzes several forms of the dependent variable,  $Y_{CP}$  for payments. The initial dependent variable is change in payments,  $\Delta Y_{CP(1-0)}$ . Other forms of the dependent variable are the probability of payment,  $P(Y_{CP})$ , and amount of the payment,  $Y_{CPi}$ .

The model #2 specification is:

$$Y_{CP} = f(X_{PTP}, X_{FS}, X_{IC}, X_{PC}, X_P, X_A, X_{Lien}),$$

Dependent Variables:

$\Delta Y_{CP(1-0)}$  is the change in payments for 0th and 1st periods,

$P(Y_{CP})$  is the probability of the taxpayer making a payment,

where  $Y_{CP} = 1$ ; and

$Y_{CPi}$  is the taxpayer payment.

Independent Variables:

$Y_{CP1}$  is payments in period 1;

$Y_{CP0}$  is payments in period 0;

$X_{PTP}$  is a vector of past payment variables;

$X_{FS}$  is a vector of family status variables;  
 $X_{IC}$  is a vector of income condition variables;  
 $X_{PC}$  is a vector of personal condition variables;  
 $X_F$  is a vector of IRS filing activity variables;  
 $X_A$  is a vector of IRS audit activity variables; and  
 $X_{Lien}$  is an indicator of NFTL.

### *Timely Future Filing Behavior*

Model #3 in the analysis investigates the impact of a lien on the taxpayer's timely filing behavior for future tax obligations. The dependent variable in this relationship is the timely tax filing indicator for future tax returns. This is a binary variable where one signifies that all tax forms for all relevant future years were filed timely and zero signifies that all forms were not filed timely (*i.e.*, at least one return was not timely). The critical variable in this model is the lien indicator variable. Other independent variables are taxpayer condition variables and IRS status variables. The taxpayer condition variables are the type of primary return filer variable, the number of forms variable (not counting schedules), and the indicator of prior timely tax filing behavior. The IRS status variables are a prior IRS audit variable and an IRS audit outcome variable. [These variables are still to be established.]

The model #3 specification is:

$$P(Y_F | Y_{F1} = 1) = f(X_T, X_{NF}, X_{PTF}, X_A, X_{AO}, X_{Lien}),$$

$Y_F$  is probability of future timely tax filing;  
 $Y_{F1}$  is an indicator of timely tax filing for 1st period variable;  
 $X_T$  is a type of primary tax filer variable;  
 $X_{NF}$  is a number of tax forms variable, not counting schedules;  
 $X_{PTF}$  is an indicator of prior period timely tax filing variable;  
 $X_A$  is an indicator of IRS audit in prior period variable;  
 $X_{AO}$  is an IRS audit outcome for prior audit variable; and  
 $X_{Lien}$  is an indicator of NFTL.

### *Timely Future Payment Behavior*

Model #4 in the analysis investigates the impact of the lien on the taxpayer's timely payment behavior for future obligations. The dependent variable in this relationship is the timely tax payment indicator for future returns. This is a binary variable where one signifies that all tax obligations for all relevant future years were paid timely and zero signifies that all obligations were not paid timely (*i.e.*, at least one payment was not timely). The critical variable in this model is the lien indicator variable. Other independent variables are taxpayer condition

## Estimating the Impact of Liens on Taxpayer Compliance Behavior: An Ongoing Research Initiative

variables and IRS status variables. The taxpayer condition variables are the type of primary return filer variable, the number of forms variable (not counting schedules), and the indicator of prior timely tax paid behavior. The IRS status variables are a prior IRS audit variable and an IRS audit outcome variable. [These variables are still to be established.]

The model #4 specification is:

$$P(Y_p|Y=1) = F(X_T, X_{NF}, X_{PTP}, X_A, X_{AO}, X_{Lien}),$$

$Y_p$  is probability of future timely tax paid;

$X_T$  is a type of primary tax filer variable;

$X_{NF}$  is a number of tax forms variable, not counting schedules;

$X_{PTP}$  is an indicator of prior period timely tax paid variable;

$X_A$  is an indicator of IRS audit in prior period variable;

$X_{AO}$  is an IRS audit outcome for prior audit variable; and

$X_{Lien}$  is an indicator of NFTL.

### Future Income Outcome

Model #5 in the analysis investigates the impact of the lien on the taxpayer's future income. The dependent variable in this relationship is the change in future income as measured by a change in gross income. The change in gross income will act as a proxy for a change in economic financial potential, which is a concept that permits economic hardship to be examined indirectly. Economic hardship will impose a negative impact on economic financial potential. Lower economic financial potential implies that less gross income will be generated. The critical variable in this model is the lien indicator variable. Other independent variables are economic condition variables, which are employment condition variables, gross domestic product variables, and the location variable. [These variables are still to be established.]

The model #5 specification is:

$$\Delta Y_{Inc(1-0)} = Y_{Inc 1} - Y_{Inc 0} = f(X_{Emp}, X_{GDP}, X_L, X_{Lien}),$$

$\Delta Y_{Inc(1-0)}$  is the change in income for 0th and 1st periods,

$Y_{Inc 1}$  is income in period 1;

$Y_{Inc 0}$  is income in period 0;

$X_{Emp}$  is a vector of employment type variables;

$X_{GDP}$  is a vector of gross domestic product type variables;

$X_L$  is a vector of location variables; and

$X_{Lien}$  is an indicator of NFTL.

These models will use the cohort data on the delinquent taxpayers. Estimation of these models will also include procedures to account for the time series cross section nature of the data.

### CONCLUSION

This research project will attempt to quantify the value of a lien in collecting payment delinquencies. TAS Research will also examine the lien's effect on future filing and payment compliance and its effect on the taxpayer's ability to earn future income. We anticipate completing our research by the end of fiscal year 2011.

The lien's effect will be measured under various circumstances (*e.g.*, is its value different for CNC liabilities or for taxpayers with different levels of income) to determine how the impact of lien filing changes with changing circumstances and to help identify when lien filing is most effective. This information will enable the National Taxpayer Advocate to better advocate for modifications in IRS lien filing policies so the IRS will not unnecessarily harm taxpayers or impact their future compliance with the tax laws.



Estimating the Impact of Liens on Taxpayer Compliance Behavior: An Ongoing Research Initiative

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National Taxpayer Advocate

Annual Report to Congress

*2010 Annual Report to Congress*

EVALUATE THE  
ADMINISTRATION OF  
TAX EXPENDITURES

## Evaluate the Administration of Tax Expenditures<sup>1</sup>

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<sup>1</sup> The principal author of this study is Eric A. San Juan, Senior Attorney-Advisor to the National Taxpayer Advocate.

## EXECUTIVE SUMMARY

### Background

The National Taxpayer Advocate has identified legal complexity as a most serious problem of tax administration, particularly with respect to social benefits delivered through the tax law. Complexity arises in large part from tax expenditures, or government spending structured through the revenue system, which continue to proliferate, although measures of their effectiveness are lacking. Whatever the nature of a particular tax expenditure, implementation falls to the IRS as a matter of tax administration.

### Analysis

To the extent that any tax expenditure has a purpose other than modulating revenue collection, policy-makers should know if that purpose has been achieved. Like pure spending, such tax expenditures should be subject to evaluation. This evaluation should account for the effectiveness of the IRS as administrator of a particular tax expenditure.

With respect to social benefit programs, the National Taxpayer Advocate previously has observed that the fundamental design question is whether a program would be better suited to the tax system or to a pure spending program. Further, a social tax expenditure should incorporate effectiveness measures. If effectiveness measures would exceed IRS constraints, such as those on paperwork burden, then the program would not be suited to the tax system.

Assuming a tax expenditure is under consideration, evaluation could take place both before and after enactment of a tax expenditure. During consideration of legislation, evaluation would focus on design implications with projected costs and benefits. After enactment, actual administrative data would become available.

### Recommendation

The National Taxpayer Advocate recommends adoption of a process to evaluate whether a tax expenditure presents an administrative challenge, and if so, the extent to which it achieves its intended purpose. Specifically, tax expenditures would be sorted into two categories. First, those which require minimal administration would not be assessed or evaluated for administrative purposes. Second, tax expenditures that involve expertise beyond the institutional competence of a revenue collector would be subject to further research. Tax expenditures should be subject to evaluation with respect to their programmatic intent. The efficacy of the IRS as the institutional host, or resources required to transform the IRS into an effective administrator of a particular tax expenditure, also should be assessed. Although the National Taxpayer Advocate's recommendation is limited to administration of tax expenditures, research also could evaluate the policy performance of tax expenditures. While some tax expenditures may turn out to be efficiently administered by the IRS, others may add confounding complexity to the tax system.

## INTRODUCTION

The National Taxpayer Advocate is charged in part with identifying problems of tax administration and recommending legislative amendments to mitigate those problems.<sup>2</sup> Toward that end, she has identified complexity as an administrative problem to be reformed by simplification of the tax law.<sup>3</sup> In particular, the National Taxpayer Advocate has focused on the problem of delivering social benefits through the tax system, which complicates the mission of the IRS, resulting in a dual mission of welfare administration as well as revenue collection.<sup>4</sup> Social benefit programs in particular and tax complexity in general arise in large part from tax expenditures, or government spending structured through the revenue system. To address the complexity and other implications of tax expenditures, the National Taxpayer Advocate recommends adoption of a process to evaluate whether a tax expenditure presents an administrative challenge, and if so, the extent to which it achieves its intended purpose.

Tax expenditures continue to proliferate, yet measures of their effectiveness are lacking. Approximately one quarter of government spending consists of tax expenditures.<sup>5</sup> Various conceptualizations, tax expenditures may range from time-honored capital cost recovery allowances such as accelerated depreciation of machinery and equipment (\$1.2 billion) to the recently enacted Making Work Pay credit (\$14.2 billion).<sup>6</sup> The largest tax expenditure is the exclusion of employer contributions for medical insurance premiums and medical care (\$177.0 billion).<sup>7</sup> Whatever the nature of a tax expenditure, implementation falls to the IRS as a matter of tax administration.

Classification of tax expenditures is inherently controversial inasmuch as it marks deviation from an accepted tax base (*i.e.*, the amount on which tax is imposed) regardless of particular rationale. Some tax expenditures may have come into being as economically justified adjustments to the tax base rather than as government spending *per se*. Other tax expenditures may have been conceived as spending mechanisms. For example, the tax law allows a credit that is now refundable even in excess of tax due (as well as an exclusion of employer assistance) for expenses of adopting a child (\$460 million).<sup>8</sup> It is difficult to view

<sup>2</sup> See Internal Revenue Code (IRC) § 7803(c)(2)(A).

<sup>3</sup> See Most Serious Problem: *The Time for Tax Reform Is Now*, *supra*; National Taxpayer Advocate 2008 Annual Report to Congress 3 (Most Serious Problem: *The Complexity of the Tax Code*); National Taxpayer Advocate 2004 Annual Report to Congress 2 (Most Serious Problem: *The Confounding Complexity of the Tax Code*).

<sup>4</sup> See Most Serious Problem: *The IRS's Mission Statement Does Not Reflect Its Increasing Responsibilities for Administering Social Benefits*, *supra*; National Taxpayer Advocate 2009 Annual Report to Congress vol. 2, 75 (*Running Social Programs Through the Tax System*).

<sup>5</sup> See Thomas L. Hungerford, *Tax Expenditures and the Federal Budget*, Cong. Res. Serv., RL34622 (Aug. 19, 2008) 17.

<sup>6</sup> See Ofc. of Mgmt. & Budget, *Budget of the United States Government FY 2011*, Analytical Perspectives (hereinafter *USG Budget*), Ch. 16 (Tax Expenditures), Table 16-1, lines 76 & 130 at 210-11 (relating to 2011).

<sup>7</sup> See *USG Budget*, Table 16-3 at 220 (relating to 2011).

<sup>8</sup> See IRC §§ 36C (reflecting amendment by the Patient Protection and Affordable Care Act of 2010, Pub. L. No. 111-148); *USG Budget*, Table 16-1, line 119 at 211 (including adoption credit and exclusion for 2011). The Tax Reform Act of 1986, Pub. L. No. 99-514, repealed a 1981 itemized deduction of expenses for adopting children with special needs in part because of a belief that assistance payments could best be made by agencies with expertise in the placement of special needs children. See Cong. Res. Serv., *Tax Expenditures: Compendium of Background Material on Individual Provisions*, S. Print 110-667, 110th Cong., 2nd Sess., Comm. on the Budget 709 (Dec. 2008).

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this provision as other than a government spending mechanism to subsidize adoption.<sup>9</sup> As long as a tax expenditure is a spending mechanism, the administrative question is what capabilities does the mechanism require? With respect to adoption assistance, compare the IRS (a revenue collection agency) with an agency that may have pre-existing subject-matter expertise (here child welfare).

In the case of spending formally structured as a budgetary appropriation, various measures of efficiency apply.<sup>10</sup> To the extent that any tax expenditure has a purpose other than modulating revenue collection, policy-makers presumably would want to know if that purpose has been achieved. Like pure spending, such a tax expenditure should be subject to evaluation. This evaluation should account for the effectiveness of the IRS as administrator of a particular tax expenditure.

## BACKGROUND

Tax expenditures may be conceptualized through academic or legislative definitions. Either way, the definition can have political ramifications by highlighting exceptions from integral provisions of tax law.

### **A tax expenditure may be characterized as a deviation from a base**

Classically, an academic concept of a tax expenditure proceeded from the proposition that an economic measure of income should be the tax base in an income tax system. That is, tax should be proportionate to consumption and saving (and, therefore, ability to pay). Manipulation of the scope of the base could result in a tax expenditure, akin to government spending, but introduced by the congressional tax-writing committees and administered by the IRS. Such manipulation thereby introduces government spending policy into what otherwise would be an exercise in economic measurement. An underlying premise of this academic conceptualization may have been that tax expenditures represented a deviation from the tax base, introduced complexity into the tax law, and imposed a spending function on an agency best suited to revenue collection. At the same time, tax expenditures could be perceived as tax cuts while reducing the amount reported as spending in the government budget. Consequently, this concept of a tax expenditure fit within a particular view of what taxation should be. In particular, tax expenditure analysts may have contemplated a comprehensive base of all income, divorced from spending, which would be a separate function in another part of government.<sup>11</sup>

<sup>9</sup> A parity argument could be made to the extent that obstetrical expenses are deductible under a pre-existing tax expenditure. See Treas. Reg. § 1.213-1(e)(1)(ii).

<sup>10</sup> See, e.g., Government Performance and Results Act of 1993, Pub. L. No. 103-62.

<sup>11</sup> A primary proponent of the term “tax expenditure” was Stanley Surrey, a Harvard Law professor who served in the Kennedy and Johnson Administrations as Treasury Assistant Secretary for Tax Policy and previously during the Roosevelt and Truman Administrations as Tax Legislative Counsel. See Stanley S. Surrey & Paul R. McDaniel, *Tax Expenditures* (Cambridge, Mass.: Harv. Univ. Press, 1985); Surrey, *Pathways to Tax Reform* (Cambridge, Mass.: Harv. Univ. Press, 1973); Surrey, *The Federal Tax System – Current Activities and Future Possibilities* (speech before Boston Economic Club, May 15, 1968) and *The U.S. Income Tax System – The Need for a Full Accounting* (speech before Money Marketeers, Nov. 15, 1967) in ANNUAL REPORT OF THE SECRETARY OF THE TREASURY ON THE STATE OF THE FINANCES FYE June 30, 1968, 313, 322 (Washington, DC: Gov’t Printing Ofc., 1969).

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At the same time, some scholars noted that policy judgment is implicit in the income tax base. The first question is: what is income? As long as there are theoretical variations on the scope of the base, the “lack of an agreed conceptual model makes it impossible to say whether a large number of structural features of the existing federal income tax laws are, or are not, ‘tax expenditures.’”<sup>12</sup> Thus, any classification of tax expenditures proceeds from policy premises.

**“Tax expenditure” has a budgetary definition**

Subsequent to the introduction of the academic term “tax expenditure,” an official definition was adopted into law for budgetary purposes. The Congressional Budget Act of 1974 (1974 Act) defined tax expenditures as:

those revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability; and the term “tax expenditure budget” means an enumeration of such tax expenditures.<sup>13</sup>

This definition suggests there should be a listing of government expenditures in the federal tax laws parallel to the appropriated budget.

Historically, a motivation for listing tax expenditures may have been a desire to eliminate them as an administrative burden beyond the mission of the IRS. Nevertheless, case-by-case analysis may reveal justification for a tax expenditure.<sup>14</sup> For example, federal tax law allows a deduction of certain state tax.<sup>15</sup> This deduction has been classified as a \$70.2 billion tax expenditure that may act as an incentive to pay state tax, indirectly subsidizing states.<sup>16</sup> At the same time, review of legislative history summarized by the Congressional Research Service (CRS) for purposes of tax expenditure analysis reveals that in originally enacting the deduction, a rationale of Congress was that state tax is a mandatory reduction in disposable income that should be deductible because it reduces a taxpayer’s ability to pay federal tax.<sup>17</sup> As an administrative matter, a deduction for state tax may be processed like any other monetary adjustment to gross income, verifiable by a third party, even though this particular deduction is a tax expenditure.

<sup>12</sup> Boris I. Bittker, *Accounting for Federal “Tax Subsidies” in the National Budget*, 22 Nat'l Tax J. 244, 258 (1969).

<sup>13</sup> Pub. L. No. 93-344, § 3(3).

<sup>14</sup> See Michael J. McIntyre, *A Solution to the Problem of Defining a Tax Expenditure*, 14 U.C. DAVIS L. REV. 78, 86 (1980) (suggesting a “need to examine individually the myriad purposes for distinguishing tax expenditures from normal tax rules”); but see Bittker, 22 NAT'L TAX J. at 252 (stating “one would either have to accept the formal statements by the President or the Congressional committees as conclusive, or engage a staff of political scientists and psychoanalysts to ascertain the ‘real’ purpose of the statutory change”).

<sup>15</sup> See IRC § 164.

<sup>16</sup> See *USG Budget*, Table 16-1 at 212 (summing deductibility of property taxes on owner-occupied homes with other non-business state and local taxes for 2011).

<sup>17</sup> See CRS, *Tax Expenditures* at 918. Another consideration is that deduction of state tax may be the inverse of imputing state benefits. Calling state tax deductions an expenditure “rests on the view that disallowing them would be a good enough proxy for directly including the value of the benefits.” See Daniel N. Shaviro, *Rethinking Tax Expenditures and Fiscal Language*, 57 TAX L. REV. 187, 224 (2004).

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As it happened, a great reduction in tax expenditures was a by-product of the Tax Reform Act of 1986, which reduced total tax expenditures by \$190 billion.<sup>18</sup> Forty percent of this cut in monetary value was due to base broadening, or repeal of special provisions such as the investment tax credit, and 60 percent was due to rate reduction.<sup>19</sup> Tax reform, rather than identification of tax expenditures as such, was an historical reason for their reduction.

After enactment of the 1974 Act, congressional and executive agencies annually tabulated tax expenditures. Currently, tabulations are published by the Joint Committee on Taxation (JCT), staffed by nonpartisan economic experts primarily serving the Committees on Finance and on Ways and Means of the Senate and House of Representatives, respectively, as well as by the Office of Management and Budget (OMB) within the Executive Office of the President, using statistics prepared by the Office of Tax Analysis (OTA) under the Treasury Assistant Secretary for Tax Policy. The estimated revenue cost of each tax expenditure as listed in these annual publications is available for congressional and public review.<sup>20</sup> However, taxpayer “behavior is assumed to remain unchanged for tax expenditure estimate purposes.”<sup>21</sup> This means that these estimates do not account for incentive effects that may alter economic behavior. As a practical matter, estimated cost is not a required factor in the scoring or enactment of a revenue or budgetary provision, nor does the cost estimate measure actual incentive effect.<sup>22</sup>

More recently, the Government Performance and Results Act of 1993 (1993 Act) has directed federal agencies to develop strategic plans and report on annual achievements, mostly for direct spending programs. At the same time, legislative history of the 1993 Act contemplates that tax expenditures also may contribute to government performance, stating:

Tax expenditures are similar to spending programs in their impact on the deficit; and like spending, are established to achieve specific national objectives. However, the effect of tax expenditures in achieving these goals is rarely studied.

To increase significantly the oversight and analysis of tax expenditures, the Committee believes that the annual overall Federal Government performance plans should include a schedule for periodically assessing the effects of specific tax expenditures in achieving performance goals.<sup>23</sup>

<sup>18</sup> Otherwise, tax expenditures would have totaled \$510 billion in 1988. See Thomas S. Neubig & David Joulfaian, *The Tax Expenditure Budget Before and After the Tax Reform Act of 1986* 1, OTA Paper 60, Dept. of the Treasury (Oct. 1988).

<sup>19</sup> See *Id.*

<sup>20</sup> See *USG Budget*, Ch. 16 at <http://www.whitehouse.gov/sites/default/files/omb/budget/fy2011/assets/receipts.pdf> (last visited Dec. 14, 2010); JCT, *Estimates of Federal Tax Expenditures* FY 2009-13, JCS-1-10 (Jan. 11, 2010), available at <http://www.jct.gov/publications.html?func=select&id=5>. As this report went to press, JCT posted *Estimates of Federal Tax Expenditures* FY 2010-14, JCS-3-10 (Dec. 21, 2010), but the figures herein are from the earlier version.

<sup>21</sup> JCT, *Estimates of Federal Tax Expenditures* 21.

<sup>22</sup> For a discussion of congressional pay-as-you-go budgetary rules, see Edward D. Kleinbard, *Tax Expenditure Framework Legislation*, L. & Econ. Working Paper 109, Univ. of So. Calif. (2010) 14-18.

<sup>23</sup> S. Rep. 103-58, 103rd Cong., 1st Sess., Comm. on Governmental Affairs (June 16, 1993).



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Consequently, OMB's budget contains a brief narrative overview as an appendix to its chapter on tax expenditures. However, this appendix merely suggests "types of measures that might be useful," acknowledging practically that "data availability is likely to be a major challenge, and data constraints may limit assessment of the effectiveness of many provisions."<sup>24</sup> Thus, OMB's analysis acknowledges the outstanding need for research.

### Conceptualizing tax expenditures may be critical

Defining tax expenditures under either academic or legislative definitions isolates "special" provisions from otherwise ordinary exclusions, exemptions, deductions, credits, rates, or deferrals. Classification of a provision as a tax expenditure could be pejorative. For example, commentators with various partisan inclinations have criticized the following tax expenditures:

- Earned Income Tax Credit (\$6.2 billion)<sup>25</sup> – Without using the technical term "tax expenditure," a *Wall Street Journal* editorial belittled refundable credit recipients as "lucky duckies."<sup>26</sup>
- Home mortgage interest deduction (\$104.5 billion)<sup>27</sup> – Commentators have criticized the provision for a second home in particular as a subsidy for those who are wealthy enough to own vacation homes.<sup>28</sup>

While it is true that provisions subject to viewpoint-based criticism may be tax expenditures, it is less clear whether the reason for a criticism is the tax expenditure mechanism itself or the underlying policy of a provision. For instance, various criticisms of government subsidies for either the poor or the rich may persist whether the subsidies take the form of tax expenditures or pure spending.

Academically, the argument against tax expenditures was that the IRS, as a collection agency, lacked institutional expertise in disbursement. If, however, a tax expenditure has eligibility criteria similar to those for other tax provisions, such as income or other dollar amounts reported by third parties, then IRS mechanisms may be effective.<sup>29</sup> Thus, evaluation of tax expenditures should be an administrative rather than a partisan matter.

## DISCUSSION

There are tax expenditures for all types of taxpayers, such as individuals, businesses, and tax-exempt entities. Some tax expenditures subsidize particular industries, while others promote geographic zones. Certain tax expenditures constitute social benefit programs.

<sup>24</sup> *USG Budget*, Ch. 16, App. A (Performance Measures and the Economic Effects of Tax Expenditures) 240, 241.

<sup>25</sup> See *USG Budget*, Table 16-1, line 159 at 212 (relating to 2011, noting a significant additional "outlay" effect of \$51.5 billion).

<sup>26</sup> See *Even Luckier Duckies*, *WALL ST. J.* (June 3, 2003) A-14.

<sup>27</sup> See *USG Budget*, Table 16-1, line 57 at 210 (relating to 2011).

<sup>28</sup> See Sima J. Gandhi, *Cracking the Code: A Closer Look at Tax Expenditure Spending 2*, *Ctr. for Amer. Progress* (Mar. 2010).

<sup>29</sup> See David A. Weisbach & Jacob Nussim, *The Integration of Tax and Spending Programs*, 113 *YALE L.J.* 955, 998 (2004).

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JCT and OMB list over 170 tax expenditures in the following categories:<sup>30</sup>

**TABLE 2.6.1, Tax Expenditure Categories**

Budget Function	\$ Millions for FY 2011	
	JCT	OMB
National Defense	5,400	11,530
International Affairs	25,700	48,210
General Science, Space, and Technology	7,500	8,410
Energy	18,800	16,320
Natural Resources and Environment	1,800	2,160
Agriculture	400	900
Commerce and Housing	356,800	369,180
Transportation	5,000	3,820
Community and Regional Development	9,100	2,580
Education, Training, Employment, and Social Services	137,100	115,920
Health	217,900	204,514
Income Security	157,700	162,961
Social Security	32,400	30,540
Veterans' Benefits and Services	5,500	5,390
General Purpose Fiscal Assistance	79,800	73,040
Interest	1,300	1,220
<b>TOTAL</b>	<b>1,062,200</b>	<b>1,056,695</b>

The JCT and OMB lists are similar, and the Government Accountability Office (GAO) has published a side-by-side comparison.<sup>31</sup> Nevertheless, JCT and OMB differ especially when new incumbents marshal different approaches. In the early 1980s and again in the early 2000s, OMB raised concerns about the tax expenditure treatment of issues such as consumption tax and corporate tax.<sup>32</sup> In sum, OMB raised fundamental concerns about the assumed scope of the tax base: "Because of the breadth of this arbitrary tax base, the Administration believes that the concept of 'tax expenditure' is of questionable analytic value."<sup>33</sup> In 2008, JCT published a detailed methodological study that proposed to identify

<sup>30</sup> See JCT, *Estimates of Federal Tax Expenditures*, Table 1 at 28-45 (totaling 2011 amounts); OMB, *USG Budget*, Table 16-1 at 209-13 (totaling 2011 amounts). Neither JCT nor OMB reports the categorical totals presented here for convenience of the reader, given that simple addition does not account for interaction effects among provisions. See Leonard Burman, Eric Toder & Christopher Geissler, *How Big Are Total Individual Income Tax Expenditures, and Who Benefits from Them?* Discussion Paper 31, 3, Amer. Soc. Sci. Assoc'n (New Orleans, La., Jan. 5, 2008), shorter version published in 98 AMER. ECON. REV. 79 (2008) (stating that despite interaction effects, "commentators have added up tax expenditures to make general statements about their magnitude"); but see OMB, *USG Budget* FY 1985, Special Analysis G, Tax Expenditures G-16 (stating "tax expenditure estimates cannot simply be added together to obtain totals for functional areas or a grand total").

<sup>31</sup> See GAO, GAO-05-690, *Tax Expenditures Represent a Substantial Federal Commitment and Need to Be Examined* 100-108 (Sept. 2005), App. III, Table 4.

<sup>32</sup> Savings would not be taxed by a consumption tax system, examples of which include sales tax and value-added tax. See *USG Budget* FY 1985 (Tax Expenditures) G-3.

<sup>33</sup> *USG Budget* FY 2002, Ch. 5 (Tax Expenditures) at 61.

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Tax-Induced Structural Distortions, which JCT ultimately did not do.<sup>34</sup> At this point, the main methodological difference is the baseline against which JCT and OMB estimate revenue cost.

In identifying special provisions as tax expenditures, JCT assumes as a baseline an economically normal income tax that encompasses, in the case of individuals, personal exemptions, standard deductions, and deductions for investment and employee business expenses. In the case of businesses, normal assumptions encompass the accrual method of accounting, the economic performance test for deductibility (allowing write-off when payment is irrevocable), and the concept of matching income with expenses, as well as the existence of a distinct corporate income tax.<sup>35</sup>

Even as a special provision deviating from a normal baseline may result in a tax expenditure, conversely it may result in a negative tax expenditure.<sup>36</sup> For example, the First-Time Homebuyer Credit (FTHBC) as originally enacted by the Housing Assistance Tax Act of 2008 and applicable to purchases that year required recapture of the credit amount, resulting in a tax expenditure followed by a negative tax expenditure in the out years.<sup>37</sup>

Similarly, OMB (through OTA) assumes a normal tax baseline that allows personal exemptions, standard deduction, and deduction of expenses incurred in earning income by individuals. For businesses, OMB likewise assumes that income is taxable only when realized and that there is a separate corporate income tax.<sup>38</sup>

Since 1983, OMB has assumed additionally a “reference tax law” encompassing general rules of taxation from which a provision would have to deviate to be classified as a tax expenditure. The assumption was that “the tax laws provided general rules to enable a taxpayer to determine his income tax.”<sup>39</sup> Thus, for example, reference tax law excludes from gross income most government transfer payments, which are included in gross income under the normal tax baseline. Moreover, reference tax law encompasses accelerated depreciation, which gives rise to a tax expenditure under the normal tax baseline. Consequently, the OMB list annotates normal baseline tax expenditures whose revenue effect would be zero under reference tax law.<sup>40</sup>

<sup>34</sup> While tax expenditures may be characterized as exceptions from a general rule of taxation, some expenditures may not be exceptions *per se*, yet may alter economic decisions. For an example of a so-called Tax-Induced Structural Distortion, current tax law treats debt and equity differently. That is, interest on corporate bonds generally is taxed as ordinary income while gain on capital stock may be taxed at favorable rates, potentially creating an incentive to issue stocks rather than bonds. See JCT, JCX-37-08, *A Reconsideration of Tax Expenditure Analysis* 41 (May 12, 2008).

<sup>35</sup> See JCT, *Estimates of Federal Tax Expenditures* at 5, 9.

<sup>36</sup> See *Id.* at 5.

<sup>37</sup> See IRC § 36.

<sup>38</sup> As an economic matter, corporate income arguably falls outside income conceived as consumption plus net saving. See Henry C. Simons, *Federal Tax Reform* 20-21 (Chicago: Univ. of Chicago Press, 1950).

<sup>39</sup> See OMB, *USG Budget FY 1985, Special Analysis G, Tax Expenditures G-5*. Inspiration for a baseline of reference tax law may be found in Seymour Fiekowsky, *The Relation of Tax Expenditures to the Distribution of the “Fiscal Burden,”* 2 *CAN. TAX’N* 211 (1980).

<sup>40</sup> See OMB, *USG Budget 207-08 & 224*.

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The methodological differences between assumptions that are either normative or referenced by law may result in significant revenue differences reflecting alternative visions of taxation. Generally, a normal tax baseline contains economically normative concepts, while reference tax law implies acceptance of enacted rules.<sup>41</sup> Neither of the baselines reflects a consumption tax, although current law incorporates many elements of consumption taxation, especially income tax exclusions, exemptions, or deferrals, as well as deductions and credits, for saving.<sup>42</sup> Both normal and referential visions, however, may have more relevance for potential tax reform than effective administration of expenditures in whatever form.

### Tax expenditures may be characterized by type of taxpayer.

An overview of tax expenditures may proceed with examples by type of taxpayer. For example, individual taxpayers may benefit (in the amount of \$26.9 billion) from a special tax rate on qualified dividends.<sup>43</sup> That is, qualified dividends are subject to a marginal rate of only 15 percent even if the individual taxpayer who includes them in gross income is in a higher bracket.<sup>44</sup> Critics of tax expenditures for individuals may apply the term “upside down” to such a provision.<sup>45</sup> In an otherwise progressive income tax system characterized by graduated rates and other features that cause high-income taxpayers to pay proportionately more due to their higher ability to pay, logically tax expenditures will tend to be regressive, disproportionately benefitting those with high income.<sup>46</sup> Alternatively, the special rate may be conceived as an attempt to reduce so-called double taxation of dividends.<sup>47</sup>

An example of a business tax expenditure is the domestic manufacturing deduction (\$13.6 billion).<sup>48</sup> Congress enacted this provision in 2004 to encourage production of goods in the United States.<sup>49</sup> Of course, any incentive effect would be subject to empirical verification. As discussed below, authorization of empirical research could help to verify the effectiveness of an intended incentive.

### Tax expenditures may subsidize certain sectors

Examples of tax expenditures may extend beyond types of taxpayers to sectors of the economy. For instance, a significant sector of institutional investment consisting of retirement

<sup>41</sup> For example, at one time, OMB did not reflect in reference tax law the special tax rate on qualified dividends (discussed below) on the theory that if there is a corporate income tax, any dividend taxation is duplicative. See GAO, *Tax Expenditures* at 93-94.

<sup>42</sup> See Bruce Bartlett, *The Flawed Concept of Tax Expenditures*, Nat'l Ctr. for Pol'y Analysis (Feb. 13, 2002); Bartlett, *The End of Tax Expenditures as We Know Them?* 92 TAX NOTES 413 (2001).

<sup>43</sup> See *USG Budget*, Table 16-1, line 69 at 210 (relating to 2011).

<sup>44</sup> See IRC § 1(h)(11).

<sup>45</sup> See, e.g., Sima J. Gandhi, *Audit the Tax Code: Doing What Works for Tax Expenditures*, Ctr. for Amer. Progress 8 (Apr. 2010).

<sup>46</sup> From one perspective, a tax expenditure may seem “to reflect an upside-down idea of policy because the rate of reimbursement is the taxpayer’s marginal tax rate; this results in relatively generous rates of reimbursement for the well-to-do, while it provides nothing at all for the very poor who presumably have the greatest need.” William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 89 HARV. L. REV. 309, 310 (1972).

<sup>47</sup> See JCT, JCS-2-10, *Description of Revenue Provisions Contained in the President’s FY 2011 Budget Proposal* 7 (Aug. 16, 2010).

<sup>48</sup> See *USG Budget*, Table 16-1, line 80 at 210 (relating to 2011).

<sup>49</sup> See IRC § 199.

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funds benefits from a tax expenditure in the form of an exemption from income tax.<sup>50</sup> While accounts such as Individual Retirement Arrangements (IRAs) and the like represent private savings, the tax expenditure amounts to an indirect public subsidy of \$142.1 billion.<sup>51</sup> This may be viewed alternatively as hidden government spending or a consumption tax element within the income tax.

Industrial subsidies account for a significant number of tax expenditures. Specifically, commentators may identify the energy industry as a beneficiary of tax expenditures of \$2.8 billion.<sup>52</sup> Of particular note is the tax expenditure for so-called black liquor. Generally intended as an incentive for “green” biofuel, this provision contains a loophole through which paper mills may claim credit for a pulp by-product.<sup>53</sup> Loopholes are another reason to research the actual effect of tax expenditures.

### Tax expenditures may be interchangeable with spending programs

A tax expenditure may be interchangeable with a direct spending program. For example, the Low-Income Housing Tax Credit (LIHTC) is a \$6.2 billion tax expenditure.<sup>54</sup> Generally, LIHTC allows a credit to investors in qualified buildings that house a prescribed percentage of residents below certain income levels.<sup>55</sup> State housing agencies allocate the credits in stipulated amounts through a competitive process, and they physically inspect the buildings.<sup>56</sup> As long as investors have tax liability against which they wish to claim credit (often organized by real estate developers in syndicated form), LIHTC allows the federal government to subsidize low income housing without direct spending, which would entail an attendant application and administrative apparatus. Arguably, it may be more efficient to allow a tax credit directly to investors than to impose income tax only to pay back upon identifying those investors through a process administered by a housing agency. After all, the point of tax expenditure analysis is to understand the interchangeability of money never paid into the Treasury with money first paid in and then disbursed out.<sup>57</sup>

When investors’ tax liability dried up in the recent economic recession, Congress monetized a portion of the LIHTC by creating counterpart low income housing grants in the American Recovery and Reinvestment Tax Act of 2009, bringing the tax expenditure full circle to a direct outlay program.<sup>58</sup> Incidentally, such a grant program may be subject to a

<sup>50</sup> See IRC §§ 401 *et seq.*

<sup>51</sup> See *USG Budget*, Table 16-1, lines 146-50 at 212 (totaling 2011 amounts).

<sup>52</sup> The President’s 2011 Budget proposes to eliminate this amount of fossil fuel preferences. See *USG Budget*, Ch. 14 (Federal Receipts), Table 14-3 at 186 (relating to 2011).

<sup>53</sup> See *USG Budget* at 177 (explaining that “byproducts derived from the processing of paper or pulp (known as black liquor when derived from the kraft process) . . . would qualify as cellulosic biofuel and, to the extent so qualifying, could result in substantial revenue losses and a windfall to the paper industry”).

<sup>54</sup> See *USG Budget*, Table 16-1, line 63 at 210 (relating to 2011).

<sup>55</sup> See IRC § 42.

<sup>56</sup> See CRS, *Tax Expenditures* at 371 ff.

<sup>57</sup> See Shaviro, 57 *Tax L. Rev.* at 220.

<sup>58</sup> See Pub. L. No. 111-5, Div. B, § 1602.

number of procedural provisions, such as disclosure of grant recipients' identities, to which a tax credit may not be subject.<sup>59</sup> While theory and experience show that LIHTC and grant programs are interchangeable, administrative differences come to the fore, specifically ones that increase transparency of government spending.

### Tax expenditures add complexity

An example of incremental complexity relates to a tax expenditure for volunteers and employees of the U.S. Peace Corps, an organization whose mission has received bipartisan praise. Since 1997, homeowners have been able to exclude capital gain of up to \$250,000 (\$500,000 for a married couple filing jointly) on the sale of a home where they lived for two of the last five years.<sup>60</sup> In 2011, this tax expenditure was worth \$31.3 billion.<sup>61</sup> In the Heroes Earnings Assistance and Relief Tax Act of 2008, Congress decided to enhance the home-sale exclusion for the Peace Corps by allowing their personnel to suspend the five-year period while serving abroad.<sup>62</sup> Thus, a homeowner could live at home for a year, volunteer for a two-year term abroad, and still have four years, rather than just two, to sell the home free of tax on applicable gain, if any. If the five-year period had been an impediment to volunteering, especially for senior citizens with experience that would be valuable in volunteer service, the provision removed the impediment.

JCT estimated the revenue cost of the provision at less than half a million dollars for any year within the applicable budget window.<sup>63</sup> The Peace Corps has fewer than 8,000 volunteers in a year, whose average age is 28 but of whom seven percent are over 50, as well as a couple of hundred employees abroad.<sup>64</sup> Even if as many as ten percent of these personnel have homes to sell, only about 800 people need information about the special tax provision, which is not a topic in either the 12-page 2009 *Tax Guide for Peace Corps Volunteers* or the hundred-page *Working Overseas Guide: A Guide for Staff and Their Families* (June 2010), also published by the Peace Corps.

Instead, the IRS has altered Instructions, which now run over a hundred pages, to Form 1040, *U.S. Individual Income Tax Return*, the basic form used by about 150 million individual taxpayers.<sup>65</sup> Additionally, the optional suspension of the five-year rule for overseas Peace Corps personnel who might sell a home is explained in IRS Publication 523, *Selling Your Home*, which is 40 pages long, as well as the more general Publication 17, *Your Federal*

<sup>59</sup> Generally, tax return information, including a claim for a credit, is confidential with the IRS. See IRC § 6103.

<sup>60</sup> See IRC § 121.

<sup>61</sup> See *USG Budget*, Table 16-1, line 60 at 210.

<sup>62</sup> See Pub. L. No. 110-245, § 110.

<sup>63</sup> See JCT, JCX-45-08, *Estimated Budget Effects of H.R. 6081, the "Heroes Earnings Assistance and Relief Tax Act of 2008," Scheduled for Consideration by the House of Representatives on May 20, 2008* FY 2008-18, I.10 at 2.

<sup>64</sup> See Peace Corps, *Fact Sheet* (May 21, 2010). The Peace Corps has operations in 77 countries, each of which is staffed at least by a Country Director and an Administrative Officer. See Peace Corps, *Working Overseas Guide: A Guide for Staff and Their Families* 8 (June 2010).

<sup>65</sup> General Line Instructions for Form 1040 (2009) run from page 14 through page 89 (cross-referencing the home sale exclusion). Form 1040 Instructions Including Instructions for Schedules A, B, C, D, E, F, J, L, M, and SE (2009) contain 175 pages (containing the Peace Corps provision). See IRS Pub. 55B, *Data Book* (2009), Table 2 at 4 (reporting number of taxpayers).

## Evaluate the Administration of Tax Expenditures

*Income Tax*, which exceeds 300 pages. Taxpayers who use software may be prompted by computer to consider whether they are eligible for the special provision which is targeted at a mere 800 people.

The administrative issue is whether it is more efficient for the IRS to administer the provision by adding it to all the other rules applicable to American taxpayers, or for the Peace Corps to identify the estimated 800 affected persons already on the payroll.<sup>66</sup> If the latter, a cost of a few hundred thousand dollars would become a part of the Peace Corps' \$400 million budget,<sup>67</sup> rather than a revenue deficit to the Treasury.

To be fair, the Peace Corps is only the last of several constituencies of overseas government workers to receive special treatment, after the military, foreign service, and intelligence personnel.<sup>68</sup> In each case, a similar analysis applies. Which is better situated to deliver a housing benefit amount to employees abroad: the IRS or the CIA, State or Defense Department? Accretion of tax expenditures for each of these constituencies, along with numerous other targeted provisions, contributes to the confounding complexity of the tax law.<sup>69</sup>

### Tax expenditures include social programs

A significant type of tax expenditure consists of social benefit programs. Last year, the National Taxpayer Advocate expressed concern about running social programs through the tax system.<sup>70</sup> For example, the FTHBC awards a nominal amount limited to \$8,000 to residential purchasers, many of whom might have bought a house anyway.<sup>71</sup> If this tax expenditure was intended to induce purchases, research should ascertain its actual incentive effect. Similar analysis applies to various social welfare tax expenditures.<sup>72</sup> Moreover, social tax expenditures heighten the question of institutional suitability of the revenue collection agency not only for disbursements but particularly for service to an underprivileged population. This question should be answered in terms of the experience of this population. Elsewhere in this 2010 Annual Report to Congress, the National Taxpayer Advocate

<sup>66</sup> Peace Corps pays volunteers a stipend. See IRC § 912(3).

<sup>67</sup> See JCT, *Estimated Budget Effects of H.R. 6081*, l.10 at 2; Peace Corps, *Fact Sheet*.

<sup>68</sup> See JCT, JCX-44-08, *Technical Explanation of H.R. 6081, the "Heroes Earnings Assistance and Relief Tax Act of 2008," as Scheduled for Consideration by the House of Representatives on May 20, 2008* 22-23.

<sup>69</sup> See National Taxpayer Advocate 2008 Annual Report to Congress 3 (Most Serious Problem: *The Complexity of the Tax Code*) (stating that taxpayers annually devote 7.6 billion hours, or enough work for 3.8 million full-time employees, to compliance with tax filing requirements). Another example of a tax expenditure that would be impracticably complex for tax administration is the charitable deduction of easements for certain conservation purposes under IRC § 170(h), as amended by the Pension Protection Act of 2006, § 1213, Pub. L. No. 109-280. See *Whitehouse Hotel v. Comm'r*, 131 T.C. 112 (2008), vacated and remanded by 615 F.3d 321, 329 (5th Cir. 2010) (characterizing valuation of real property rights that preserve historic facades of houses as "a complex and difficult undertaking that continues to challenge appraisers and the IRS"); *Simmons v. Comm'r*, T.C. Memo. 2009-208 (judging fair market value where "no established market exists" and opining that a private easement "would be subject to a higher level of enforcement" than an applicable historic ordinance); IRS Advisory Council, General Report (2009) (focusing on complex distinction "between a legitimate deduction authorized by statute and an abusive tax shelter" especially with respect to valuation, which is "inherently subjective").

<sup>70</sup> See National Taxpayer Advocate 2009 Annual Report to Congress vol. 2, 75 ff.

<sup>71</sup> See IRC § 36.

<sup>72</sup> Commentators have dubbed certain tax expenditures the "hidden welfare state." See Christopher Howard, *The Hidden Welfare State: Tax Expenditures and Social Policy in the United States* (Princeton, NJ: Princeton Univ. Press, 1997).



has recommended that the IRS adopt a dual mission statement and hire personnel appropriate to the delivery of social benefits that already have been codified.<sup>73</sup>

## CONCLUSION

Low visibility of tax expenditures has long been a concern of commentators and officials. Yet listing of revenue estimates has had little effect, perhaps because some in Congress would support direct spending counterparts of tax expenditures in any case. Meanwhile, successive administrations have had concerns about evaluation, perhaps because each one favors some tax expenditures that it would rather not highlight as such.<sup>74</sup> On occasion, OMB has argued that a tax expenditure may relate to a direct spending program as apples to oranges.<sup>75</sup> Conceptual concerns do not address efficient administration and the taxpaying public, for whom the question should be whether a tax expenditure could be more successfully structured.

### Research is necessary to evaluate tax expenditures

Tax expenditures may disguise government spending, while administratively compounding the problem of mission fragmentation, program overlap, and service gaps.<sup>76</sup> That is, tax expenditures may divert the IRS from its historically core mission of revenue collection to disbursement in areas where other agencies, such as the Department of Energy or Housing and Urban Development, may have expertise, with an inefficient result.<sup>77</sup> This administrative inefficiency is not measured by annually published tables of revenue estimates. Originally, the motivation behind those revenue estimates may have been to expose tax expenditures as a specific amount of government spending, rather than to analyze their effectiveness at particular programmatic purposes. As discussed above, some tax expenditures may be ably administered by the IRS, while others may be interchangeable with grants or other direct spending programs. Research is necessary to evaluate the programmatic efficiency of tax expenditures.

### Policymakers should review studies of tax expenditures

Assuming that tax expenditures may be an intentional form of government spending, they should be subject to evaluation with respect to their programmatic intent. The efficacy of the IRS as the institutional host, or resources required to transform the IRS into an effective administrator of a particular tax expenditure, also should be assessed. While some tax expenditures may turn out to be efficiently administered by the IRS, others may add

<sup>73</sup> See Most Serious Problem: *The IRS's Mission Statement Does Not Reflect Its Increasing Responsibilities for Administering Social Benefits*, *supra*.

<sup>74</sup> See Leonard E. Burman, *Is the Tax Expenditure Concept Still Relevant?* 56 NAT'L TAX J. 613 (2003) (admitting that the "Treasury Department, of which I was a part . . . , was unenthusiastic about performing these evaluations, reasoning that a comprehensive evaluation of tax expenditures would necessarily raise serious objections to measures enthusiastically advanced . . . the same concerns still hold sway").

<sup>75</sup> See GAO, *Tax Expenditures*, App. II at 83.

<sup>76</sup> See GAO, *Tax Expenditures* at 51.

<sup>77</sup> See, e.g., National Taxpayer Advocate 2009 Annual Report to Congress vol. 2, 102 (stating that FTHBC may be better structured as pure spending administered by an agency directly connected with the targeted behavior).



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crippling complexity to the tax system. Of course, evaluation and assessment in turn may be ineffectual unless policy-makers review and act on published reports. The advantage of action is more efficient and effective administration.

## RECOMMENDATION

The National Taxpayer Advocate recommends adoption of a process to evaluate whether a tax expenditure presents an administrative challenge, and if so, the extent to which it achieves its intended purpose.

### Criteria for analyzing tax expenditures

Scholars have argued that the question whether to structure a spending program as a tax expenditure should be “solely a matter of institutional design.”<sup>78</sup> Noting that an organization may be arranged either by function (sales, production, purchasing, etc.) or by purpose (tax collection, national security, education, etc.), they suggest that the answer lies in whether the execution of any particular provision is more mechanical or more discretionary.

In the example of the state tax deduction discussed above, a provision that requires mere verification of amounts, IRS mechanisms may be effective. If discretionary allocation by programmatic experts is required, as in the case of LIHTC, then the tax expenditure may exceed the institutional competence of the revenue collector, who may have to rely on others such as state housing agencies, thus increasing complexity while reducing efficiency. In any case, tax expenditures may be analyzed for design efficiency, assuming that some form of spending has been authorized as a policy matter.

Consider these key criteria:<sup>79</sup>

- **Refundability:** A credit that may be refunded even in excess of tax owed, sometimes called a negative tax, shifts the tax administrator from collection into disbursement mode.
- **Eligibility:** Criteria external to the tax system, such as architecture in the case of the LIHTC, incorporate subject-matter experts into jurisdiction over a tax expenditure.

Criteria like these could help to sort between mechanical and discretionary tax expenditures.

For purposes of evaluation, the National Taxpayer Advocate recommends that all tax expenditures officially identified by either JCT or OMB, however imperfectly, would be sorted into two categories. First, those which require minimal administration, as in the case of the state tax deduction, would not be assessed or evaluated for administrative purposes. Second,

<sup>78</sup> Weisbach & Nussim, 113 YALE L.J. at 957.

<sup>79</sup> See generally Eric J. Toder, *Tax Cuts or Spending – Does It Make a Difference?* 53 NAT'L TAX J. 361 (2000).

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tax expenditures that involve expertise beyond the institutional competence of a revenue collector, such as that of energy or housing experts, would be subject to further research.

### The IRS should be authorized to evaluate tax expenditures

As noted above, there is a dearth of data on the programmatic effectiveness of tax expenditures partly because they are tax provisions to which government performance requirements do not apply. GAO has identified a lack of clarity about the roles of the IRS, OMB, Treasury, and programmatic agencies as an impediment to tax expenditure evaluation.<sup>80</sup>

To the extent that tax expenditures clearly are in an agency's jurisdiction, they fall under the enforcement function of the IRS. Under the Paperwork Reduction Act of 1995 and related requirements, the IRS collects the minimum amount of information necessary for enforcement; that is, to determine the correct liability for collection, or in case of a "negative" tax, the correct credit or other amount for refund.<sup>81</sup> Consequently, IRS forms do not solicit information that would pertain solely to the effectiveness of a tax expenditure. For example, Form 5405, *First-Time Homebuyer Credit and Repayment of the Credit*, contains ten lines to determine the amount of a credit but does not ask for information that would show whether the purchaser could or would have bought a home without the credit.<sup>82</sup>

Accordingly, IRS data may be incomplete for purposes of the recommended evaluation. While incompleteness itself would indicate that a program exceeds the IRS's traditional role, requiring taxpayers to divulge extraneous information likewise would strain voluntary compliance.<sup>83</sup> Previously, the National Taxpayer Advocate has observed that the fundamental design question for a social benefit program is whether it would be better suited to the tax system or to a pure spending program.<sup>84</sup> Further, a social tax expenditure should incorporate effectiveness measures.<sup>85</sup> If effectiveness measures would exceed IRS paperwork constraints, then the program would not be suited to the tax system. Theoretically, evaluation should take place both before and after enactment of a tax expenditure. During consideration of legislation, evaluation would focus on design implications with projected costs and benefits. After enactment, actual administrative data would become available.

In any case, programs may be enacted as tax expenditures precisely to reduce visibility, as discussed above, of the nature and cost of the legislation in question. While certain

<sup>80</sup> See GAO, *Tax Expenditures* at 5.

<sup>81</sup> See Pub. L. No. 104-13; GAO, *Tax Expenditures* at 53-55.

<sup>82</sup> See CRS, *Tax Expenditures* at 362 (stating "economic theory suggests that the credit may not be very effective at stimulating home demand. Empirical studies have found lack of liquid wealth to be the principal barrier to homeownership for first-time homebuyers").

<sup>83</sup> The prospect of incomplete IRS data for a program codified in the tax law begs the question whether a tax expenditure could be evaluated *ab initio*. Like the 1974 law for periodic tax expenditure budgets, the IRS Restructuring and Reform Act of 1998 requires complexity analysis of pending tax legislation. See Pub. L. No. 105-206, § 4022(b). Nevertheless, increasing tax complexity over the past decade, noted above, indicates that legislative analysis has not forestalled the problem. Although administrative shortcomings of tax expenditures could be projected at the time of legislation, the effect of any such projections remains unclear.

<sup>84</sup> See National Taxpayer Advocate 2009 Annual Report to Congress vol. 2, 86.

<sup>85</sup> See *Id.*

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legislative formulation may extend into matters of policy, administration of tax provisions *per se* is a concern of the National Taxpayer Advocate. Assuming the persistence of tax expenditures, their programmatic efficiency should be subject to evaluation. For this administrative purpose, the IRS should be authorized to conduct relevant research, such as surveys of representative populations. In the FTHBC example, research might investigate rates and sources of down-payment assistance (parental gifts, etc.).

Moreover, IRS statisticians should be authorized to tabulate and analyze relevant data. Generally, the IRS Research, Analysis & Statistics division compiles and analyzes data relevant to tax compliance, such as indicators of tax return irregularity that warrant audit. For tax expenditure evaluation, staffing sufficient for relevant counts, tabulations, and analyses should be authorized. This authorization should extend to collaboration on research design with agencies that have subject-matter expertise, for instance, in energy, housing, or human services. Alternatively, an authorization could allow the IRS to hire subject-matter experts. An intermediate option would be for IRS statisticians to compile relevant data for further analysis by an agency with subject-matter experts. In any case, programmatic agencies could formulate research questions to be answered. Then the IRS could collect the requisite information for analysis by statisticians with expertise in interpreting tax data.

### Evaluation of tax expenditures could extend to policy matters

Although the scope of the instant recommendation is limited to tax administration, it is possible that data also could help to determine if a tax expenditure is effectuating intended policy. For example, a major justification for the home mortgage interest deduction has been a “desire to encourage homeownership.”<sup>86</sup> However, economic research has shown that the deduction “does little if anything to encourage homeownership. Instead, it serves mainly to raise the price of housing and land and to encourage people who do buy homes to borrow more and to buy larger homes than they otherwise would.”<sup>87</sup> Research like this can interest policy-makers. In 2005, a bi-partisan commission recommended substantial modification of the home mortgage interest deduction because it “encourages overinvestment in housing.”<sup>88</sup> As long as relevant data are available, policy evaluation as such is beyond the scope of this recommendation. At any rate, in cases where external data turn out to be sufficient, then no recommendation would be necessary.

If, however, paperwork reduction and related requirements impede collection of relevant data outside the traditional scope of tax administration, expansion of that scope deserves consideration. In the case of the mortgage interest deduction, substantial data on the housing market were available for economic research. In another case, such as that of the

<sup>86</sup> CRS, *Tax Expenditures* at 330-32 (noting that interest historically had been deductible regardless of personal or business purpose).

<sup>87</sup> William G. Gale, Jonathan Gruber & Seth Stephens-Davidowitz, *Encouraging Homeownership Through the Tax Code*, 115 TAX NOTES 1171 (June 18, 2007).

<sup>88</sup> President’s Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America’s Tax System* 59 (Nov. 2005); see also *The Moment of Truth: Report of the National Commission on Fiscal Responsibility and Reform* 30-31 (Dec. 2010) (recommending restriction of the mortgage interest deduction to main homes, rejecting secondary residences).

domestic manufacturing deduction mentioned above,<sup>89</sup> it is possible that the IRS could conduct additional research for evaluative rather than administrative purposes. Such research would be parallel to, but outside of, this recommendation. While the National Taxpayer Advocate's recommendation is limited to administration of tax expenditures, research also could evaluate the policy performance of tax expenditures.

### **Taxpayer privacy law should be maintained**

The collaboration recommended above would preserve the taxpayer privacy law, which is a keystone of voluntary assessment that should be preserved, as previously outlined by the National Taxpayer Advocate.<sup>90</sup>

Generally, the taxpayer privacy law, as amended in the Watergate era, is designed to preclude, among other things, partisan manipulation of tax return information.<sup>91</sup> As discussed above, tax expenditure analysis is vulnerable to such manipulation, while the recommended evaluation goes to administrative efficiency. As long as IRS statisticians do the recommended tabulations and analysis, no change to the taxpayer privacy law is necessary. On the contrary, the existing taxpayer privacy law should have the effect of protecting government researchers, as civil servants, from political pressure in evaluating tax expenditures. Under existing law, research results reporting tax data in aggregate form that cannot be associated with any particular taxpayer may be published.<sup>92</sup> Once programmatic experts design research questions and statisticians tabulate the results, the published reports should be directed to the disposition of policy decision-makers.

<sup>89</sup> See CRS, *Tax Expenditures* at 471 (observing that tax provisions cannot “permanently affect the balance of trade, since exchange rates would adjust”).

<sup>90</sup> See National Taxpayer Advocate 2003 Annual Report to Congress 232.

<sup>91</sup> See IRC § 6103.

<sup>92</sup> See IRC § 6103(b)(2).

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National Taxpayer Advocate

Annual Report to Congress

2010 Annual Report to Congress

**TELEFILE – TAXPAYERS’  
CHARACTERISTICS AND  
FILING BEHAVIORS**

**A STUDY TO ENHANCE TAXPAYER  
ASSISTANCE BLUEPRINT (TAB) KNOWLEDGE**

## TeleFile – Taxpayers’ Characteristics and Filing Behaviors: A Study to Enhance Taxpayer Assistance Blueprint Knowledge<sup>1</sup>

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## EXECUTIVE SUMMARY

### Introduction

In the 1990s, the IRS developed a system known as TeleFile, enabling taxpayers who filed relatively simple tax returns and met specific requirements to file their returns using a touch-tone telephone. TeleFile was a type of electronic filing that helped the IRS move toward its goal of having 80 percent of tax returns filed via electronic means. However, the IRS discontinued TeleFile in 2005, citing increasing maintenance costs and decreasing use. Proponents of the system suggest the IRS abandoned TeleFile prematurely and left a segment of the taxpaying population with no convenient means of filing electronically. While some former Telefilers adopted alternative methods of electronic filing, others did not. As part of the Taxpayer Assistance Blueprint (TAB) efforts, the IRS would like to know more about taxpayers who previously used TeleFile to help understand their needs and behaviors, and what would be needed to encourage those filing paper returns to use an electronic filing method.

### Findings

One of the arguments for eliminating TeleFile was that taxpayers would use other electronic filing mechanisms, including the then newly developed Free File system. The data analyzed in this study show, however, that a considerable number of taxpayers with relatively simple tax returns still file on paper. Less than seven percent of former Telefilers used Free File to submit their tax returns, and nearly 30 percent of former TeleFile users filed a paper tax return in 2008. The IRS was not successful in converting these taxpayers to different electronic filing methods.

Computer use and internet access are contributing factors to electronic filing use. A recent Pew Internet Project survey shows, however, that about one in four U.S. households does not have Internet access. A telephone filing system offers the benefit of being available to taxpayers who do not have personal computers or Internet access, or who are simply not computer savvy. The U. S. Census Bureau’s American Community Survey shows that nearly 98 percent of U.S. households have some type of telephone service – either a landline or cell phone. Further, more than half (53 percent) of Americans who do not use the Internet at all do have cell phones. Overall, 82 percent of Americans own a cell phone, with ownership more prevalent among minorities. The ready availability of telephones makes telephone tax filing an attractive option.

By relaxing eligibility qualifications for a telephone system, the IRS could greatly expand the number of taxpayers who could use such a system - more than 27 million taxpayers could have used a telephone based system in tax year 2008. For a TeleFile system to be successful, the IRS must encourage new taxpayers to use the system to offset the taxpayers that can no longer use it because of changing life circumstances.



### Recommendations

The IRS’s original assumption that taxpayers who previously used TeleFile would automatically turn to another electronic method overstated some taxpayers’ commitment to electronic filing. It would be worthwhile for the IRS to consider adding another filing method, thereby minimizing or eliminating problems associated with paper filing.

The National Taxpayer Advocate recommends that the IRS explore reinstating TeleFile with less restrictive eligibility criteria that allow taxpayers who move to use the system. Changes in the use of telephones and their technologies should be considered and included in the system evaluation so the IRS does not develop a system based on obsolete assumptions or technology. This would include evaluating current telephone technologies to determine the feasibility of allowing taxpayers with simple tax returns (with less restrictive eligibility requirements than those applicable to the former TeleFile system) to interact with the IRS using cell phones and smart phones, as well as being able to file tax returns and interact with the IRS by voice or text.

Absent a telephone-based system, it is likely that the IRS will need to find more efficient alternatives for processing paper returns, because it appears some taxpayers will continue filing on paper unless they are forced to change. The IRS should evaluate how to capture information from paper returns by scanning a bar code rather than by transcription.

## INTRODUCTION

In the 1990s, the IRS developed a system known as TeleFile, enabling taxpayers who filed relatively simple tax returns and met specific requirements to file their returns using a touch-tone telephone. The IRS started TeleFile as a test in one state and eventually expanded it to qualified taxpayers in all 50 states.

TeleFile is a type of electronic filing that helped the IRS move toward its goal of having 80 percent of tax returns filed via electronic means.<sup>2</sup> However, the IRS discontinued TeleFile in 2005, citing increasing maintenance costs and decreasing use. Proponents of the system suggest that the IRS abandoned TeleFile prematurely, and consequently left a segment of the taxpaying population with no convenient means of filing electronically.

The Taxpayer Advocate Service (TAS) Research and Analysis staff agreed to work a project on TeleFile as part of the Taxpayer Assistance Blueprint (TAB) research. One of the goals of the TAB was to ‘Establish a credible taxpayer and partner baseline of needs, preferences, and behaviors.’<sup>3</sup> To this end, the IRS would like a more thorough evaluation of the TeleFile system so it can better understand taxpayers who previously used the system; specifically, how did these taxpayers file their subsequent returns? This information will allow IRS to make informed decisions on how to reach its electronic filing goals.

## BACKGROUND

TeleFile was popular with the IRS and taxpayers in the 1990s and early 2000s. This interactive computer program allowed qualified taxpayers to file a simple federal tax return (Form 1040EZ) electronically by using the TeleFile toll-free number. A personal computer was not necessary. The program would compute the earned income tax credit (EITC) if the taxpayer was eligible, and also automatically computed the refund or balance due.

Several states established programs with the IRS, making it easier for taxpayers to file both their federal and state returns and streamlining processing for both the IRS and its state counterparts. When the IRS abandoned the program in 2005, several states followed suit. Today, the states generally use TeleFile programs to collect business and sales taxes rather than income tax. Canada continues to operate a TeleFile program for individual income tax filers.<sup>4</sup>

For individual income tax returns, the IRS limited TeleFile use to those with a relatively simple return. Eligibility requirements included an income and interest threshold, no dependents, age, filing status, disability, no paid tax preparer use, and address change limitations; and filers had to receive a TeleFile tax package from the IRS. Some of the more

<sup>2</sup> Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98), Title II. In RRA 98, Congress stated that the IRS should have a plan to increase electronic filing and established a goal that at least 80 percent of all federal tax and information returns should be filed electronically by 2007.

<sup>3</sup> Taxpayer Assistance Blueprint (TAB), Final TAB Phase 1 Report, 2 (Apr. 2006).

<sup>4</sup> <http://www.cra-arc.gc.ca/esrvc-srvce/tx/ndvdlst/tfif/bt-eng.html> (last visited Nov. 8, 2010). See Appendix D for a more detailed description of the Canadian system.

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popular characteristics of TeleFile were its availability 24 hours a day, seven days a week, the promise of a quick refund, and clear instructions that used graphics. Other important features included simplicity, the ability to correct mistakes, a filing acknowledgement or confirmation number, the toll-free phone calls, that there was no need to file supporting documents, and the ability to have refunds deposited directly in a bank account.<sup>5</sup>

Although this report will focus on TeleFile for individual income tax returns, it should be noted that taxpayers could also use TeleFile for employment tax returns. For tax year (TY) 2004, TeleFile accounted for over 800,000, or nearly 19 percent of electronically filed Form 941 returns, *Employer’s Quarterly Federal Tax Return*.<sup>6</sup> When the IRS eliminated TeleFile, it also eliminated an easy and free method of filing employment tax returns.

The IRS developed TeleFile as a gateway from paper to electronic filing. When deciding to eliminate TeleFile, the IRS did not consider how filing requirements could be expanded to increase the TeleFile eligibility base and reduce the costs of processing each return.<sup>7</sup> Rather than expanding TeleFile and easing its restrictions on eligibility, the IRS chose to discontinue the system and to shift users to Free File, which would allow qualified taxpayers to create and file their returns electronically at no charge. The Free File system requires taxpayers to use a personal computer with Internet connections to access [www.irs.gov](http://www.irs.gov) and then select a link for one of several software companies. In this study, TAS looks at Telefilers, their subsequent behaviors, and how less restrictive TeleFile eligibility requirements could increase the number of taxpayers who could use the system.

### Related Research

Several factors affect the ability of the IRS to meet its electronic filing goals. Among them are computer use and Internet access. A recent Pew Internet Project survey shows that about one in four U.S. households does not have Internet access. Those making less than \$30,000 per year or who lack a high school diploma are considerably less likely to use the Internet than others. Only about 60 percent of adults with low incomes and less than 40 percent without high school diplomas use the Internet.<sup>8</sup> The only viable way for these taxpayers to file electronically is to hire a professional tax preparer, use a computer located elsewhere, or have someone else complete and file their returns for them.

Telephone access is also an important factor when considering a method that involves filing a return by phone. The U. S. Census Bureau’s American Community Survey shows that nearly 98 percent of U.S. households have some type of telephone service – either a landline

<sup>5</sup> 1992 TeleFile Evaluation, 24-29. Report includes findings from taxpayers’ surveys and focus group interviews held with both TeleFile users and eligible non-users.

<sup>6</sup> Small Business/Self-Employed Division (SB/SE) Research, Fiscal Year (FY) 2005 Nationwide Analysis, *Electronic Tax Administration Business Master File Marketing Database* (June 2005).

<sup>7</sup> Treasury Inspector General for Tax Administration (TIGTA), Ref. No. 2003-40-092, *Opportunities Exist to Expand the TeleFile Program* 5-7 (Mar. 2003).

<sup>8</sup> Pew Internet & American Life Project, Pew Research Center, *Internet, Broadband, and Cell Phone Statistics* 2, 7 (Jan. 5, 2010). Study methodology includes interviews with 2,258 adults age 18 or older and has a margin of error of plus or minus 2.4 percent. The United States Census Bureau reports that more than 30 percent of households do not use the Internet at home. Current Population Survey (CPS) Table 1 (Oct. 2009).

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or cell phone.<sup>9</sup> Cell phone use is more prevalent today than when the IRS last offered TeleFile, and technological advances in cell phones and smart phones open up new possibilities for filing tax returns by phone.<sup>10</sup> Taxpayers’ accessibility and willingness to use a telephone to file will play a large role in their decision of whether to use a system like TeleFile.

Taxpayers who elected to use the TeleFile system could do so at no cost and have the assurance of having a more accurate return than one prepared on paper because of the error checking built into the system. Returns filed through the TeleFile system were subjected to the same data screening validations as those filed through other e-filing methods to identify potentially erroneous claims. If errors were identified, the IRS would not accept the return for processing and would notify the taxpayer of the error by letter, telling him or her to resubmit the return on paper or by another e-file method.<sup>11</sup>

The preparation time for a TeleFile tax return was much faster than for a paper return. For TY 2002, the IRS estimated that it took one hour and 43 minutes to prepare a TeleFile tax return, whereas it took the same taxpayer three hours and 43 minutes to prepare a paper Form 1040EZ.<sup>12</sup> The Treasury Inspector General for Tax Administration estimated this two-hour time saving would translate into monetary savings of \$53 per taxpayer.<sup>13</sup>

The decision to discontinue the TeleFile Program followed a recommendation made by the Electronic Tax Administration Advisory Committee (ETAAC) to eliminate TeleFile and redirect the funds to the Modernized e-File Project. The IRS testified that it would save

<sup>9</sup> U.S. Census Bureau, *2009 American Community Survey*, C25043. The universe for this data is occupied housing units which were estimated at 113.6 million. Roughly two percent of households do not have telephone service available. In one study, 83 percent of households indicated that they have some type of cell phone. Pew Internet & American Life Project, Pew Research Center, *Internet, Broadband, and Cell Phone Statistics* 12 (Jan. 5, 2010). There are two major differences between smart phones and cell phones: smart phones can run applications and can access the Internet directly, while cell phones cannot run applications and rely on a carrier to get Internet access. Cell phones’ primary purpose is to make phone calls although they are no longer limited to voice calls and text messaging. Many can play music, take pictures, or connect to the web through a phone carrier. Smart phones come with advanced data features including the ability to manage and transmit data, use third party applications, and make voice calls. Computer World, *Cell Phone, Smartphone – What’s the Difference?*, [http://www.computerworld.com/s/article/9129647/Cell\\_phone\\_smartphone\\_what\\_s\\_the\\_difference\\_](http://www.computerworld.com/s/article/9129647/Cell_phone_smartphone_what_s_the_difference_) (last visited Dec. 20, 2010) and Yahoo Technology, *The Real Difference Between Smart Phones and Regular Cell Phones*, [http://www.associatedcontent.com/article/5868240/the\\_real\\_difference\\_between\\_smart\\_phones.html](http://www.associatedcontent.com/article/5868240/the_real_difference_between_smart_phones.html) (last visited Dec. 20, 2010).

<sup>10</sup> Eighty-three percent of households indicated that they had some type of cell phone in December 2009 compared with 66 percent in January 2005. See Pew Internet & American Life Project, Pew Research Center, *Internet, Broadband, and Cell Phone Statistics* 12-13 (Jan. 5, 2010); Pew Internet & American Life Project, *Cell Phones and American Adults*, 1-5, 28 (Sept. 2, 2010). Overall, 82 percent of Americans own a cell phone, with ownership more prevalent in minorities – 87 percent of African Americans and English speaking Hispanics report owning a cell phone (compared with 80 percent of whites). Lower income, elderly, and rural Americans are less likely to have a cell phone than others. Seventy-one percent of those making less than \$30,000, 57 percent of those 65 or older, and 72 percent of rural Americans own cell phones. Interestingly, more than half (53 percent) of Americans who do not use the Internet at all have a cell phone.

<sup>11</sup> TIGTA, Ref. No. 2003-40-092, *Opportunities Exist to Expand the TeleFile Program* 7 (Mar. 2003).

<sup>12</sup> IRS, *2002 1040EZ Instructions*, 24; *2002 TeleFile Tax Record and Instructions*. For 2008, the IRS estimates the time to prepare a paper Form 1040EZ at over ten hours. *IRS Form 1040EZ Instructions*. The IRS now provides only one combined estimated time figure for 1040EZ and 1040A returns.

<sup>13</sup> TIGTA, Ref. No. 2003-40-092, *Opportunities Exist to Expand the TeleFile Program* 15 (Mar. 2003).

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between \$17 and \$23 million by eliminating TeleFile.<sup>14</sup> The ETAAC proposed putting this money into other electronic filing methods. While the IRS has made significant strides in expanding the use of electronic filing, a sizeable population of taxpayers, most notably those with low incomes, continues to file paper returns.

## METHODOLOGY

TAS Research extracted data for taxpayers who filed their federal income tax returns using the TeleFile system at least once in tax years 2002, 2003, or 2004, using the IRS’s Compliance Data Warehouse (CDW). Research identified these returns from the Electronic Tax Administration (ETA) Individual Marketing database by filing type. The ETA data was supplemented with data from the Individual Returns Transaction File (IRTF) to obtain general characteristics of the target group (such as preparer indicators, type of return filed, date of death, unemployment compensation, additional child tax credit, and other form/schedule indicators). Appendix A also compares taxpayers using TeleFile to eligible taxpayers who chose another method.

Next, Research created a longitudinal data file by capturing filing pattern data for this population for TYs 2005, 2006, 2007, and 2008 from the ETA Individual Marketing database and IRTF. The TeleFile population for this study consists of 6.3 million taxpayers.<sup>15</sup> The longitudinal analysis of those using TeleFile included any primary taxpayer who used TeleFile for any of the tax years 2002 through 2004.

The data file was used to determine subsequent filing behaviors (how tax returns were filed – paper, electronic, TeleFile, etc.) and general characteristics of the target group. The data were used to evaluate how TeleFile filers filed their tax returns over time.

### Limitations

The longitudinal file contained all taxpayers who TeleFiled in tax years 2002, 2003 or 2004, except for taxpayers who:

- Died during the 2002 - 2008 tax years;
- Had inconsistent data over time;
- Were no longer primary taxpayers in tax years 2005 - 2008; or
- Were originally listed as spouses.

<sup>14</sup> ETAAC, which consisted of members selected by the IRS to represent a broad spectrum of the private sector, included tax preparers, tax software developers, payroll companies, financial institutions, small businesses, state governments and taxpayers. TIGTA, Ref. No. 2007-40-116, *Eliminating TeleFile Increased the Cost and Burden of Filing a Tax Return for Many Taxpayers* 2-3 (July 2007). *2005 Tax Return Filing Season and the IRS Budget for Fiscal Year 2006, Hearing Before the Subcommittee on Oversight of the Committee on Ways and Means, U.S. House of Representatives*, 109th Cong. (Apr. 14, 2005). However, ETAAC does not include representatives of consumer organizations.

<sup>15</sup> Some taxpayers were removed from the analysis – taxpayers who used TeleFile in 2002, 2003, or 2004 and passed away sometime before 2009 were eliminated from the data file. For tax years 2003 - 2008, fewer than one million former primary taxpayers were no longer shown as a primary taxpayer. This, along with non-filers and deaths, contribute to the changing population from one year to the next. The final longitudinal dataset consists of 6,294,604 taxpayers.

During data cleaning, nearly 20,000 taxpayers were removed from the longitudinal dataset because they died during the 2002 - 2008 tax years. Records with inconsistent data over time were also removed. For example, six records included multiple birth dates for one Social Security number (SSN) and thus were removed because of inconsistent data. The dataset excludes taxpayers who were originally listed as a spouse (the secondary taxpayer) on a TeleFile return in TY 2002, 2003, or 2004 and subsequently filed their own returns. Data was based on taxpayers’ primary SSNs and limited to those who used TeleFile in TY 2002, 2003, or 2004. Taxpayers who moved were identified by whether they had a different nine-digit zip code from one year to the next.

### Objectives

The IRS wanted to learn about the behavior of former TeleFile users, particularly what might contribute to the changes in their use of various tax return filing methods. TAS developed a plan to identify appropriate research questions and answered them based on ETA and IRTF data. The research questions for this study follow:

- How many taxpayers used TeleFile in tax years 2002, 2003, and 2004?
- What are the characteristics of the TeleFile population in tax years 2002, 2003, and 2004?
  - What are the differences in demographic characteristics (*e.g.*, age, filing status, total taxable income) of Telefilers compared to other taxpayers who did not TeleFile?
- What method did former Telefilers use to file subsequent tax returns?
  - What are the characteristics of TeleFile eligible taxpayers who were filing via some electronic means versus those who filed by paper in tax year 2008?
- How many taxpayers would be eligible to use TeleFile today given the qualifying restrictions?
  - What filing method are these eligible taxpayers using?
- How many taxpayers would be eligible to use TeleFile if the restrictions were modified?
  - Is there a group of taxpayers who would be eligible for TeleFile who are not filing electronically?

## FINDINGS

### How Many Taxpayers Used TeleFile in Tax Years 2002, 2003, and 2004?

More than 11 million tax returns were filed via TeleFile for tax years 2002 – 2004. About 6.3 million taxpayers filed via TeleFile during TY 2002, 2003, or 2004. Approximately 60 percent of taxpayers who received the TeleFile package were eligible to use the system.<sup>16</sup>

<sup>16</sup> Taxpayers had to receive a TeleFile package to be eligible to use the system. Tax packages were not forwarded to taxpayers.



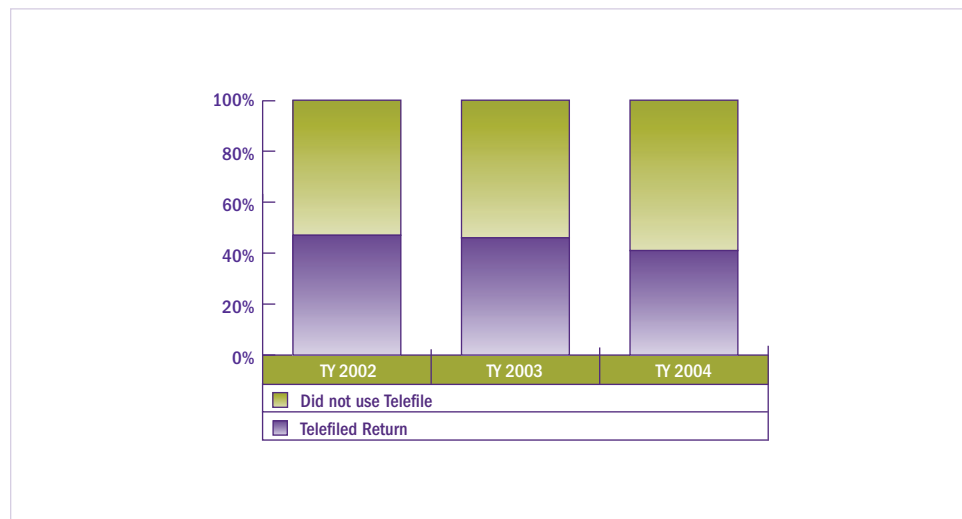
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**TABLE 2.7.1, TeleFile Packages Sent, Eligible Taxpayers, and Users for TY 2002 - 2004<sup>17</sup>**

	TY 2002	TY 2003	TY 2004
IRS Sent TeleFile Package <sup>18</sup>	14,194,544	14,056,571	13,290,499
TeleFile Eligible <sup>19</sup>	8,492,703	8,214,726	7,903,490
TeleFile Ineligible <sup>20</sup>	5,701,841	5,841,845	5,180,100
TeleFile Users <sup>21</sup>	4,026,693	3,769,606	3,293,652

About 40 percent of taxpayers who received the TeleFile package were not eligible to use the system. Overall, only about 25 percent of those who received the package actually TeleFiled. Yet as Figure 2.7.1 shows, more than 40 percent of those eligible used the system to submit their tax returns.

**FIGURE 2.7.1, Package Recipients Who Were Eligible for TeleFile<sup>22</sup>**



<sup>17</sup> Electronic Tax Administration (ETA), *Marketing Database, TY 2002 - 2004 and Individual Returns Transaction File, TY 2002 - 2004*.

<sup>18</sup> Which forms were filed with the previous year's return and whether the taxpayer used a paid preparer were primary factors in deciding whether to send a taxpayer a tax package and if so, which package was sent. The IRS limited who would receive a TeleFile package based on the amount and types of income, filing status, dependents, and whether they moved since their account was last updated.

<sup>19</sup> Wage and Investment Division (W&I) Research Group Phoenix-Los Angeles, *ETA Project 5-06-08-1-015N*, Full Year ETA Individual Marketing Databases for TY 2001, TY 2002, TY 2003 and Partial Year Database for TY 2004 (filed through July 2, 2005 – cycle 26) (Dec. 2005).

<sup>20</sup> W&I Research Group Phoenix-Los Angeles, *ETA Project 5-06-08-1-015N*, Full Year ETA Individual Marketing Databases for TY 2001, TY 2002, TY 2003 and Partial Year Database for TY 2004 (filed through July 2, 2005 – cycle 26) (Dec. 2005).

<sup>21</sup> ETA, *Marketing Database, TY 2002 - 2004*.

<sup>22</sup> ETA, *Part Year TeleFile Analysis, Project 5-06-08-1-015N*.

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## What Were the Characteristics of the TeleFile Population in Tax Years 2002, 2003, and 2004?

### Demographic Characteristics of Telefilers

The TeleFile population is different from the general taxpaying population. Its members are younger, have lower incomes, tend to be single, file relatively simple tax returns, prepare the returns themselves, and move more than other taxpayers. Many of these differences are expected because of the limiting criteria for TeleFile use. The following table compares Telefilers in the year indicated to the remaining taxpayers for various return characteristics.

**TABLE 2.7.2, Characteristics of Individual Tax Returns: TeleFiled vs. Other (All Individual Returns not TeleFiled) for Tax Years 2002 - 2004<sup>23</sup>**

Tax Year	2002		2003		2004	
	TeleFile Returns	Other Returns	TeleFile Returns	Other Returns	TeleFile Returns	Other Returns
<b>Number of Returns</b>	<b>4.0 M</b>	<b>122.7 M</b>	<b>3.8 M</b>	<b>123.3 M</b>	<b>3.3 M</b>	<b>125.3 M</b>
Age						
- Mean	31	44	32	45	32	44
- Median	25	41	25	42	26	42
Filing Method						
- Paper	0%	60.2%	0%	53.2%	0%	48.0%
- TeleFile	100%	0%	100%	0%	100%	0%
- Practitioner – ELF	0%	30.3%	0%	35.5%	0%	38.4%
- Online	0%	9.6%	0%	11.3%	0%	13.6%
Filing Status						
- Single	96.6%	42.1%	96.0%	41.9%	95.6%	42.2%
- Married filing joint	3.4%	40.9%	4.0%	40.9%	4.4%	40.5%
- Married filing separate	0%	2.0%	0%	2.0%	0%	2.0%
- Head of Household	0%	15.0%	0%	15.2%	0%	15.3%
- Qualifying Widower	0%	0.1 %	0%	0.1%	0%	0.1%
Income						
- Mean	\$17,905	\$46,896	\$18,463	\$51,808	\$19,508	\$53,020
- Median	\$15,298	\$29,203	\$15,817	\$29,681	\$16,709	\$30,558
Income Type						
- Wages & Interest	93.5%	84.1%	87.9%	83.9%	84.5%	83.9%
- Schedule C	0%	14.7%	0%	15.4%	0%	15.7%
- Other	6.5%	7.9%	12.2%	8.0%	15.5%	8.1%
<b>Moved in Last Year<sup>24</sup></b>	<b>0%</b>	<b>3.1%</b>	<b>0%</b>	<b>3.2%</b>	<b>0%</b>	<b>3.1%</b>
<b>Refund Returns</b>	<b>93.3%</b>	<b>79.5%</b>	<b>93.2%</b>	<b>80.9%</b>	<b>93.0%</b>	<b>78.7%</b>
Refund						
- Mean	\$557	\$2,388	\$569	\$2,486	\$574	\$2,513
- Median	\$444	\$1,349	\$453	\$1,428	\$464	\$1,433

table continued on next page

<sup>23</sup> ETA, *Marketing Database, TY 2002 - 2004 and Individual Returns Transaction File, TY 2002 - 2004*. This data is only comparing Telefilers in the indicated year to all other filers for that tax year.

<sup>24</sup> Taxpayers were identified as moving if the nine-digit ZIP codes did not match from one year to the next. By definition those who used the TeleFile system could not have moved.

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Tax Year	2002		2003		2004	
	TeleFile Returns	Other Returns	TeleFile Returns	Other Returns	TeleFile Returns	Other Returns
Repeat TeleFile Users <sup>25</sup>	60.4%	n/a	60.3%	n/a	58.9%	n/a
Return Complexity <sup>26</sup>		n/a <sup>27</sup>				
- Simple	100%		100%	31.1%	100%	29.3%
- Intermediate	0%		0%	29.0%	0%	39.3%
- Complex	0%		0%	40.0%	0%	31.4%
Who Prepared Return						
- Self	100%	39.4%	100%	38.0%	100%	37.9%
- Paid Preparer	0%	60.6%	0%	62.0%	0%	62.1%

In addition to looking individually at Telefilers in tax years 2002, 2003, and 2004, this study explores the entire group of taxpayers who used TeleFile from 2002 to 2004 and how their characteristics changed over the course of tax years 2005 - 2008. The following data are based on this longitudinal analysis.

Overall, the number of taxpayers using the TeleFile system declined from tax year 2002 to 2004. One factor contributing to this decline was that taxpayers who used a preparer were no longer sent a TeleFile tax package and thus could not use the system. Several other changes can be seen over this time: Telefilers’ incomes rose and came from sources other than just wages and interest. Similarly, a greater portion of Telefilers moved, making them ineligible for the system. The following discussion highlights several of these demographics in more detail.

### Age

TeleFile users tend to be relatively young with an average age of 32 and a median age of 25. This does not mean that older taxpayers did not use the system, as those over 35 account for nearly one of every three Telefilers. However, even by 2008, few former Telefilers would have been disqualified from using the system if it had been in existence because they exceeded age eligibility requirements.<sup>28</sup>

Taxpayers who do not use TeleFile are considerably older, with the average age in the mid-forties and the median in the early forties, surpassing the average and median ages of Telefilers by about 13 and 16 years respectively. This is not unexpected, given that the eligibility criteria for TeleFile specifically targeted returns with lower income and less complexity.

<sup>25</sup> Repeat Telefilers are defined as taxpayers who filed tax returns using TeleFile for at least two years for tax years 2001 - 2004.

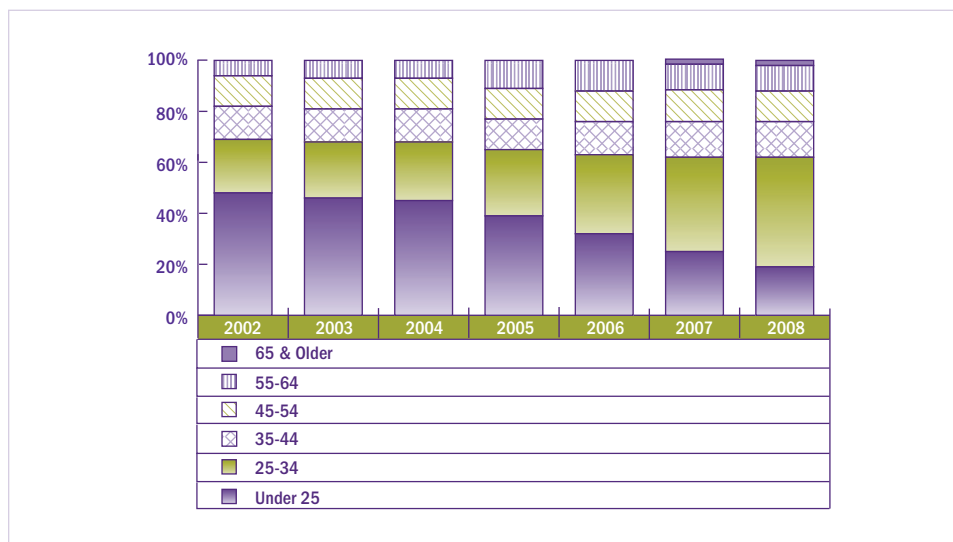
<sup>26</sup> Simple returns include Forms 1040, 1040A, or 1040EZ and no additional forms or schedules. Intermediate returns are Form 1040A with schedules or 1040 with schedules A, B, D, Additional Child Tax Credit, Educational Credits, Child Care Credit, Credit for the Elderly, or EIC. Complex returns are defined as Form 1040 with schedules C, E, or F or other schedules and all other specific Forms 1040, e.g., 1040(PR).

<sup>27</sup> The Return Complexity definition contained only two categories – simple and complex – in tax year 2002. Beginning in 2003, it was expanded to three categories.

<sup>28</sup> About two percent (106,435) of the remaining 4,915,470 taxpayers who used Telefile in tax years 2002, 2003, or 2004 would not have been qualified to use the system if it were still available in tax year 2008 because they exceeded the age criteria.

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**FIGURE 2.7.2, Age Ranges of Former TeleFile Users Tax Years 2002 - 2008<sup>29</sup>**



### Income

As expected, TeleFile users’ incomes are low, with *median* levels in the \$15,000 to \$18,000 range or 52 to 60 percent of the income of non-TeleFile users. The *average* income ranged from \$18,000 to \$24,000 or 38 to 46 percent of the average income for those not using TeleFile.<sup>30</sup>

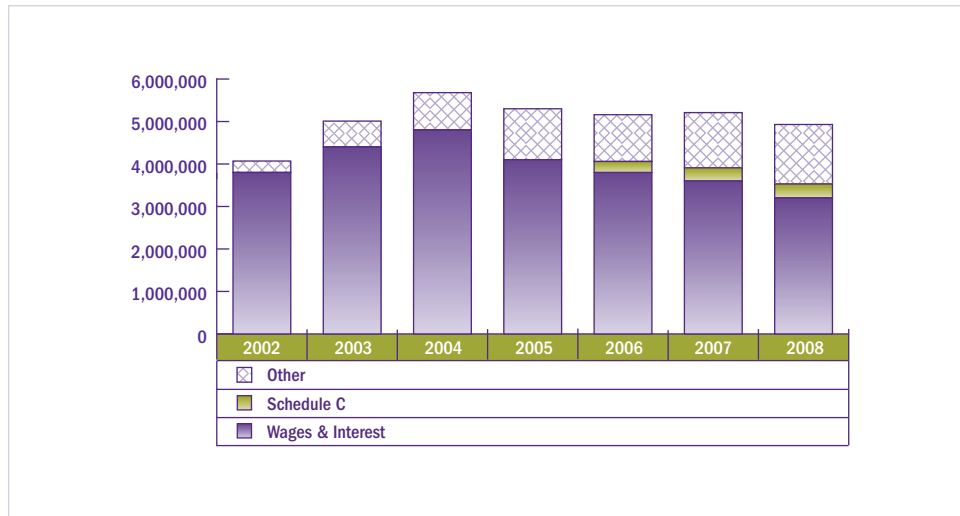
Because of system eligibility criteria, TeleFile users are primarily wage and interest earners with small amounts of income coming from other sources. In 2002, more than 93 percent of TeleFile users’ income came from wages and interest; by 2008, that figure had dropped to 65 percent. Inversely, the percent of former TeleFile users with Schedule C income increases to about seven percent and other income sources increased from nearly seven percent to 28 percent. Since sources of income impact whether taxpayers are eligible to use the TeleFile system, it is apparent that as taxpayers acquire income from additional sources, their returns increase in complexity and they would not qualify to use a telephone system.

<sup>29</sup> ETA, *Marketing Database for Tax Years 2002 – 2008*, based on taxpayers who used the Telefile system in 2002, 2003, or 2004.

<sup>30</sup> Beginning in TY 2004, the TeleFile taxable income threshold was increased to \$100,000.

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**FIGURE 2.7.3, Income Sources of Former TeleFilers for Tax Years 2002 - 2008<sup>31</sup>**



### Filing Status

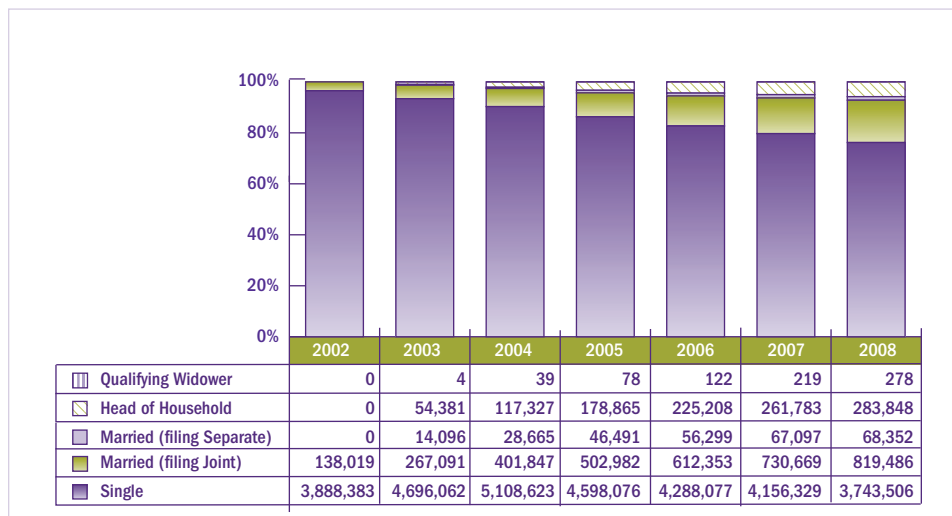
Ninety-seven percent of TeleFilers in TY 2002 filed using single status compared with just 76 percent of the 2002 to 2004 TeleFile population in TY 2008. The majority of taxpayers with different filing statuses moved to the married filing joint group, which increased by 13 percent from 2002. Head of Household status was the only other category with a notable increase (six percent) in filers from 2002. This is just one example of how life changes can impact TeleFile eligibility.

Filing status is one of the characteristics where TeleFilers differ dramatically from the remaining population, at least in part because of the eligibility criteria. For tax years 2002 to 2004, only about 42 percent of taxpayers who do not use TeleFile are single and more than 40 percent use the married filing joint category. Fifteen percent of the remaining taxpayers file as Head of Household.

<sup>31</sup> ETA, Marketing Database, TY 2002 - 2008 and Individual Returns Transaction File, TY 2002 - 2008.

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**FIGURE 2.7.4, Filing Status Used by Former TeleFile Users for Tax Years 2002 - 2008<sup>32</sup>**



### *Moved in Last Year*

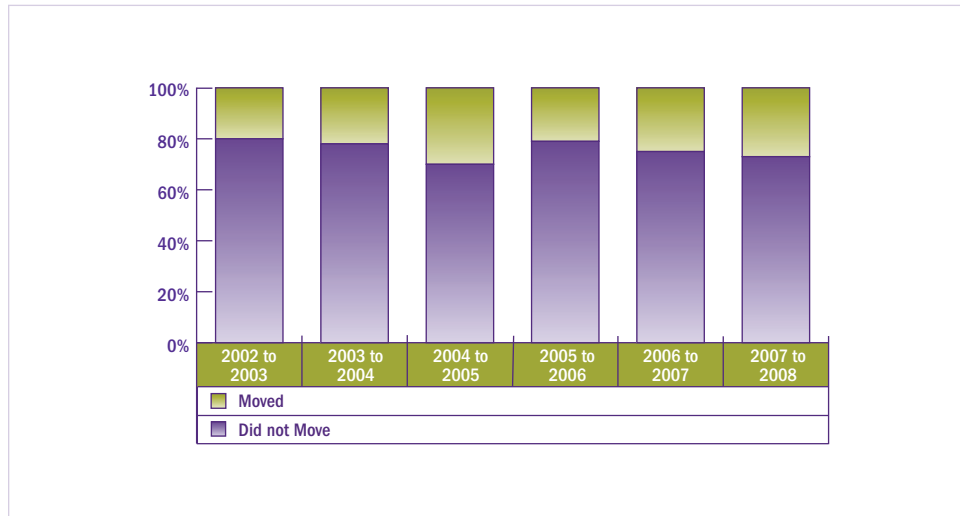
Another example of TeleFile users’ changing life circumstances is shown by how many of these taxpayers moved. At least 20 percent of those who used the TeleFile system moved in any given year between TY 2002 and TY 2008. These taxpayers would not be eligible to use TeleFile in the years they moved unless they informed the IRS of their moves before the TeleFile tax packages were printed and mailed.<sup>33</sup> Only about three percent of the remaining taxpayers moved in any given year from 2002 to 2004.

<sup>32</sup> ETA, *Marketing Database, TY 2002 - 2008 and Individual Returns Transaction File, TY 2002 - 2008*.

<sup>33</sup> One of TeleFile’s eligibility requirements was that the taxpayer could not have moved because he or she had to have the package to use TeleFile and tax packages were not forwarded. In 2009, more United States residents with low income moved than those with higher incomes. More than 19 million citizens 15 or older with incomes of \$25,000 or less (18 percent of those at this income level) moved compared with nearly eight million (about 14 percent) of those with incomes from \$25,000 to \$50,000, and nearly five million of those who made more than \$50,000 (almost ten percent). U.S. Census Bureau, 2009 American Community Survey, Table B07010.

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**FIGURE 2.7.5, Number of Former TeleFile Filers Moving in Tax Years 2002 - 2008<sup>34</sup>**



This type of requirement contributes to the decline in the use of TeleFile. Other governments have found ways to overcome this challenge and allow movers to file using TeleFile if they meet the other eligibility criteria.<sup>35</sup>

### Refund

About 90 percent of TeleFile filers are due refunds, although the amounts are smaller than those owed to the remaining taxpayers. The difference in refunds is in part attributable to the TeleFile eligibility criteria. A large portion of the group continued to receive refunds over time, dropping a few percentage points from 2002 - 2008. By 2008, former TeleFile users received an average refund of nearly \$1,800 and a median refund of almost \$1,100. The average and median refunds of former TeleFile filers increased over time, doubling and tripling respectively, by tax year 2008.

### Repeat TeleFile Filers

TeleFile users continued to use the system to file their returns. Repeat customers are those who used TeleFile in more than one of the tax years studied. About 60 percent of those who filed via TeleFile in tax years 2002 to 2004 used the system in more than one year. Of those who did not repeat TeleFile use in 2003 or 2004, about 20 percent were no longer eligible.

<sup>34</sup> ETA, *Marketing Database, TY 2002 - 2008 and Individual Returns Transaction File, TY 2002 - 2008*. Taxpayers were considered to move if their nine-digit zip code changed from one year to the next.

<sup>35</sup> See Appendix D for a description of Canada's TELEFILE system. In Canada, taxpayers who did not receive the TELEFILE tax package but believe they meet the system requirements can call a representative to see if they qualify and receive information needed to use the system. <http://www.cra-arc.gc.ca/esrvc-srvce/tx/ndvdl/tlfi/bt-eng.html> (last visited Nov. 8, 2010).

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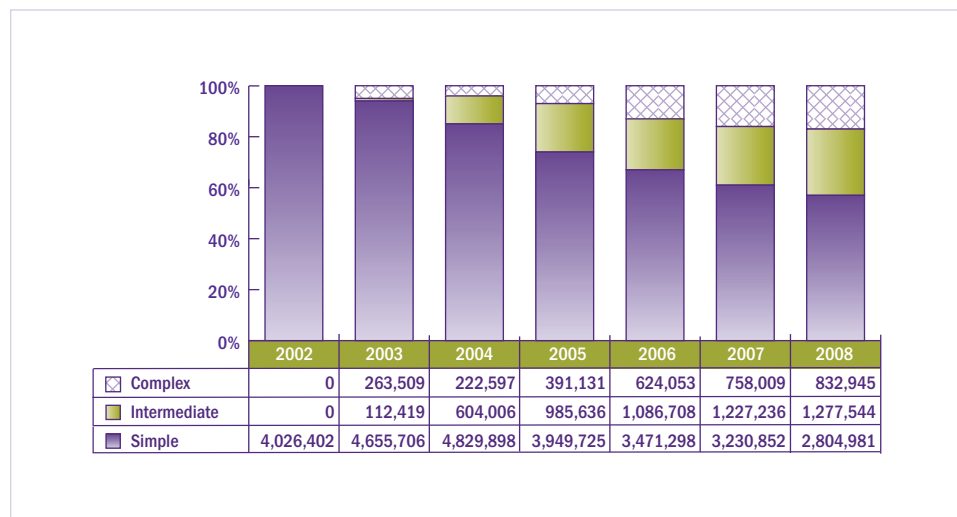
### Return Complexity

Return complexity is determined by the forms and schedules that are included in an individual’s income tax return. Tax return complexity is based on the following definitions:

- **Simple Return** – Form 1040EZ, 1040A, or 1040 with no schedules;
- **Intermediate Return** – Form 1040A with schedules or Form 1040 with Schedules A, B, D, Additional Child Tax Credit, Educational Credits, Child Care Credit, Credit for the Elderly, or Earned Income Tax Credit; and
- **Complex Return** – Form 1040 with Schedules C, E, F, or any other forms or schedules.

The TeleFile users’ tax returns became more complex over time. Less than 60 percent filed returns that could be categorized as simple four years after TeleFile’s final year. More than 40 percent of taxpayers who filed a simple return for tax year 2002 (no schedules) filed an intermediate or complex return in TY 2008 (either a Form 1040 or 1040A with schedules or forms attached). The increasing complexity of returns filed by former TeleFile users makes it very important to instill electronic filing behaviors early. If taxpayers are comfortable with electronic transmission of documents for simple tax returns using some system like TeleFile, they may be more likely to use electronic filing means to submit more complex documents or returns.

**FIGURE 2.7.6, Return Complexity of Former TeleFile Users Tax Years 2002 - 2008<sup>36</sup>**



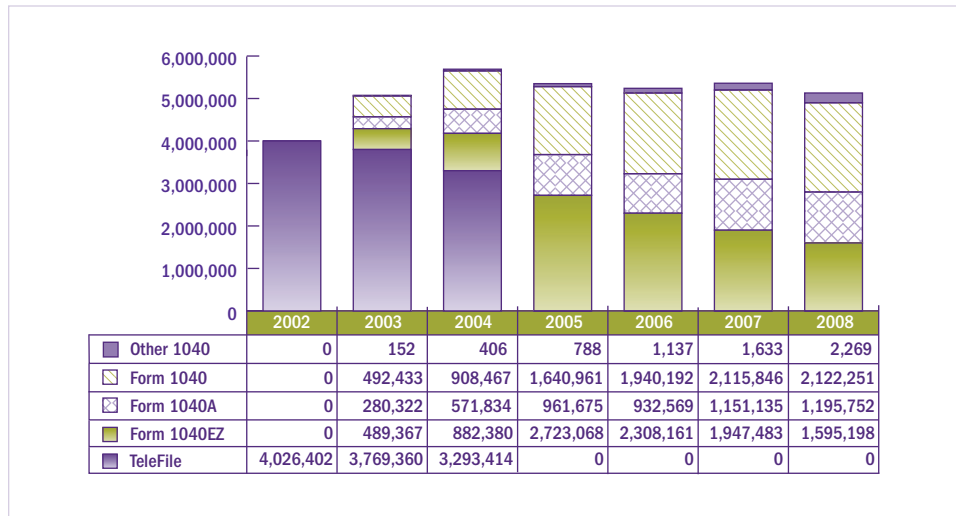
An analysis of forms filed supports the finding that return complexity increased with time for many former TeleFile users. By tax year 2008 only 32 percent of TeleFile users were still filing a Form 1040EZ, and nearly 45 percent were filing Form 1040.

<sup>36</sup> ETA, Marketing Database, TY 2002 - 2008 and Individual Returns Transaction File, TY 2002 - 2008.



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**FIGURE 2.7.7, Type of Tax Form Filed by Former TeleFile Tax Years 2002-2008<sup>37</sup>**

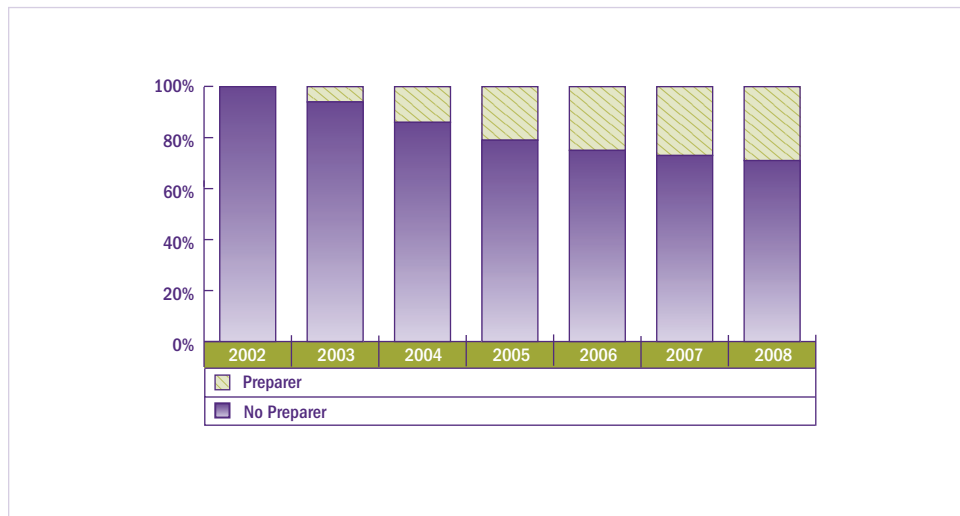


**Who Prepared the Return**

The number of former TeleFile users using a paid preparer doubled four years after the system was eliminated. This suggests that taxpayers either could no longer complete and file their own tax returns or chose not to. It is possible that the elimination of TeleFile was a factor in the decision to start using a tax preparer. By 2008, about 30 percent of former TeleFile users hired a paid tax preparer to complete and file their tax returns, or about half as many as all individual taxpayers.<sup>38</sup>

<sup>37</sup> The “Other 1040” category consists of Forms 1040PC, 1040SS, 1040PR, and 1040NR.

<sup>38</sup> Taxpayer Filing Attribute Report, Pub. 4822, 2 (Aug. 2010). Approximately 60 percent of individual taxpayers hired a tax preparer in TY 2008 to complete and file their individual tax returns.

**FIGURE 2.7.8, Paid Preparer Use by Telefilers for Tax Years 2002 - 2008<sup>39</sup>**

### Other Characteristics

Other factors such as having dependents play a part in TeleFile eligibility. For instance, by TY 2008, nearly 14 percent of taxpayers who used TeleFile in tax years 2002 to 2004 gained dependents and could not use TeleFile.

Over time, taxpayers’ returns change as their lives become more complicated. These changes lead to taxpayers growing out of TeleFile eligibility and using different methods for filing their tax returns. For a system like TeleFile to be effective, the IRS needs to keep bringing new taxpayers into the system, *i.e.*, continually refreshing users. Expanding eligibility criteria and marketing the system to those who are eligible would help bring different taxpayers into the TeleFile system.

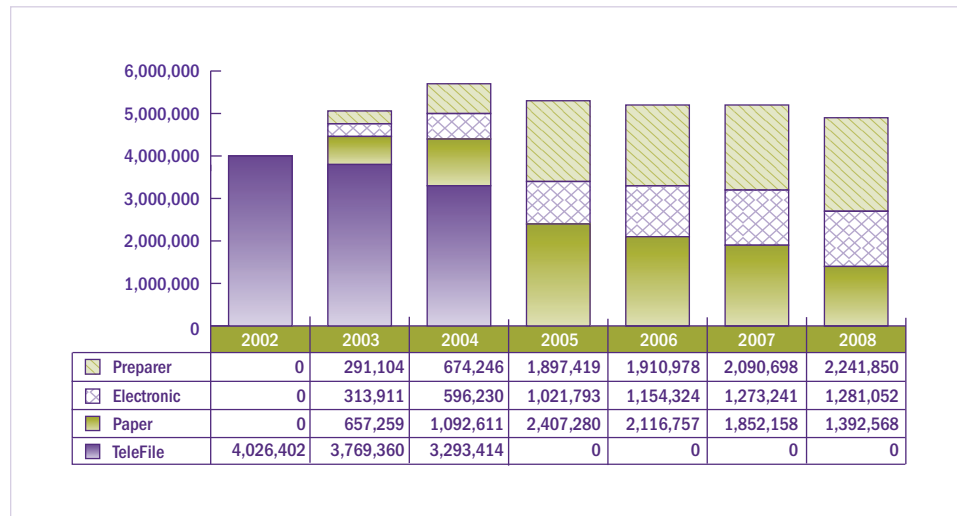
### What Method Did Former Telefilers Use to File Subsequent Tax Returns?

Once the TeleFile system was eliminated, users were forced to change to alternative filing methods. The IRS hoped that taxpayers had a positive experience with a system that did not rely on paper, and would then migrate to electronic filing. To some extent, this has been the case. Over time, electronic filing increased among those who previously used TeleFile while paper filing decreased. Of the 4.9 million former Telefilers who filed in 2008 with their SSN as primary, nearly 30 percent filed a paper return, compared with 26 percent who filed electronically through a preparer and more than 45 percent who filed electronically without preparers.

<sup>39</sup> ETA, Marketing Database, TY 2002 - 2008 and Individual Returns Transaction File, TY 2002 - 2008.

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**FIGURE 2.7.9, How TeleFile Users Filed in Subsequent Years<sup>40</sup>**



One of the arguments for eliminating TeleFile was that taxpayers would use other electronic filing mechanisms, including the then newly developed Free File system. Following TeleFile taxpayers’ behaviors in subsequent years, over 12 percent used Free File in 2006 (the first year statistics were kept) but that percentage dropped to less than seven percent in tax year 2008.

When a return prepared on a computer is printed and filed on paper, the IRS refers to it as V-coded.<sup>41</sup> Taxpayers may use a software package to calculate their taxes due or may just fill in a form on a personal computer (PC) before printing the forms and filing them. In tax years 2005 and 2006, nearly 13 percent of former TeleFile users completed their returns on PCs before printing and mailing them to the IRS. By tax year 2008, only nine percent of former TeleFile users were completing their returns on computers and filing them on paper.

### Filing Patterns over Time

Looking at the method of filing over time for taxpayers who used TeleFile in tax years 2002, 2003, or 2004, about 60 percent were consistent in their filing method, so once they switched from TeleFile, they used the same method in subsequent years.<sup>42</sup> More than 20

<sup>40</sup> ETA, *Marketing Database, TY 2002 - 2008 and Individual Returns Transaction File, TY 2002 - 2008*. Chart includes data for the first year that a taxpayer (identified by the primary SSN) filed via TeleFile and moves forward. For example, if 2003 was the first year a taxpayer used TeleFile; his or her 2002 return is excluded from the analysis.

<sup>41</sup> During the processing of paper tax returns at the IRS service centers, employees in returns analysis check for the presence of an IRS-issued three-digit number on the bottom margin of paper forms 1040 and Forms 1040A. The three-digit number indicates that the return was computer generated. When the three-digit number is detected, a V-code is entered on the return. The V-code is transcribed for inclusion in the Individual Returns Transaction File. This procedure was initially included in the processing routine to enable IRS to suppress the mailing of tax return packages to those individuals who submitted a computer generated form. The V-code indicator has also proved useful in identifying segments of the filing population that may be more easily persuaded to take the next step and file electronically. Individual ETA Marketing Research Part-Year Profile Report Processing Year 2002, 17.

<sup>42</sup> Another seven percent of former TeleFile users were no longer listed as the primary taxpayer and our database did not contain information for secondary SSNs. Filing method data was not extracted for these returns. Consequently it is not clear if these taxpayers used consistent filing methods when submitting subsequent income tax returns.

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percent of these former TeleFile taxpayers reverted to consistently filing paper tax returns. These taxpayers represent a group that might return to electronic filing if the IRS offered TeleFile (if eligible) or something other than computer filing. About 40 percent of former TeleFile filers switched to consistent use of other methods of electronic filing.<sup>43</sup>

**TABLE 2.7.3, Taxpayers’ Filing Methods for Tax Years 2002 - 2008<sup>44</sup>**

Method from	Method to	Quantity	Percent of Former TeleFile Filers (2002-2004)
TeleFile	Paper	1,273,727	20.2%
TeleFile	Electronic	2,515,374	40.0%
TeleFile	No Record <sup>45</sup>	457,063	7.3%
TeleFile	Inconsistent Methods	2,048,878	32.5%

As seen in Table 2.7.3, more than two million or nearly one in three taxpayers used a mixture of filing methods since they last used TeleFile in tax years 2002 - 2004. They may have started out filing a paper return and changed to electronic filing, or the other way around, or kept switching back and forth. Analysis for these taxpayers focused on how they filed in the final year included in the data file – tax year 2008. Nearly 70 percent of former TeleFile filers who used inconsistent filing methods filed electronically for 2008. Since these taxpayers used multiple filing methods, there is no way to be sure they will continue using the methods they used in 2008.

**TABLE 2.7.4, Former TeleFile Taxpayers with Inconsistent Filing Methods 2002 - 2008, Shown with 2008 Filing Method<sup>46</sup>**

Method from	Method in 2008	Quantity	Percent
TeleFile	Paper	444,706	21.7%
TeleFile	Electronic	1,414,193	69.0%
TeleFile	No Record	189,979	9.3%

<sup>43</sup> ETA, *Marketing Database, TY 2002 - 2008 and Individual Returns Transaction File, TY 2002 - 2008*. About 60 percent of the 2002 - 2004 TeleFile filers filed their income tax returns using the same filing method in each year since they last used TeleFile. Analysis covered tax years 2002 - 2008 for every year they were the primary SSN.

<sup>44</sup> ETA, *Marketing Database, TY 2002 - 2008 and Individual Returns Transaction File, TY 2002 - 2008*. Numbers may not total to 100 percent due to rounding. About 60 percent of the 2002 - 2004 TeleFile filers used the same filing method each year since they last used TeleFile and another seven percent did not have a record in the dataset of filing a tax return after their last TeleFiled return in tax years 2002 - 2004. Analysis covered tax years 2002 - 2008 and the following is the count of taxpayers who had a secondary SSN for each tax year: 2003 - 110,716; 2004 - 149,653; 2005 - 184,862; 2006 - 179,491; 2007 - 177,102; 2008 - 157,578; for a total of 959,402.

<sup>45</sup> Taxpayers with no record did not have a filing method associated with their SSNs after they last used TeleFile. This could be because they were no longer the primary taxpayer listed on an account or they did not have a filing requirement.

<sup>46</sup> ETA, *Marketing Database, TY 2002 - 2008 and Individual Returns Transaction File, TY 2002 - 2008*. This analysis excluded taxpayers who were previously categorized as consistent filers. The taxpayers included in the inconsistent filing method group filed using multiple methods from 2002 - 2008 and used the indicated method in 2008.

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### What are the Characteristics of Those Who Filed via Some Electronic Means (TeleFile, Other Electronic Filing) Versus Those Who Reverted to Paper in Tax Year 2008?

As shown in Table 2.7.5 below, nearly 30 percent of former TeleFile users filed a paper tax return in 2008, meaning the IRS was not successful in converting them to different electronic filing methods in 2008. The table below depicts some of the differences between paper and electronic filers who previously used the TeleFile system to submit their tax return. Paper filers who previously used TeleFile tend to be older, have simpler tax returns, and prepare their own returns more than those who filed electronically in 2008. Those who used a paid preparer were more than six times as likely to file electronically as those who self-prepared.

**TABLE 2.7.5, Characteristics of Former TeleFilers (2002 - 2004) in Tax Year 2008**

2008 Characteristics of Former TeleFilers – Comparing Paper to Electronic Filers						
Category	Paper		Electronic		Total	
2008 Former TeleFilers	1,392,568	28.3%	3,522,902	71.7%	4,915,470	100%
<b>Age</b>						
24 & under	217,209	15.6%	703,017	20.0%	920,226	18.7%
25 to 34	430,323	30.9%	1,654,012	47.0%	2,084,335	42.4%
35 to 44	214,453	15.4%	481,483	13.7%	695,936	14.2%
45 to 54	257,952	18.5%	356,063	10.1%	614,015	12.5%
55 to 64	226,862	16.3%	267,661	7.6%	494,523	10.1%
65 and Over	45,769	3.3%	60,666	1.7%	106,435	2.2%
<b>Filing Status</b>						
Single	1,154,075	82.9%	2,589,431	73.5%	3,743,506	76.2%
Married – Joint	185,325	13.3%	634,161	18.0%	819,486	16.7%
Married – Separate	23,722	1.7%	44,630	1.3%	68,352	1.4%
Head of Household	29,404	2.1%	254,444	7.2%	283,848	5.8%
Qualified Widow	42	0.0%	236	0.0%	278	0.0%
<b>Income Source</b>						
Wages & Interest	909,371	65.3%	2,299,232	65.3%	3,208,603	65.3%
Schedule C	86,420	6.2%	241,805	6.9%	328,225	6.7%
Other	396,777	28.5%	981,865	27.9%	1,378,642	28.0%
<b>Return Complexity</b>						
Simple	1,028,196	73.8%	1,776,785	50.4%	2,804,981	57.1%
Intermediate	197,710	14.2%	1,079,834	30.7%	1,227,544	26.0%
Complex	166,662	12.0%	666,283	18.9%	832,945	16.9%
<b>Who Prepared</b>						
Self	1,198,864	86.1%	2,264,317	64.3%	3,463,181	70.5%
Paid Preparer	193,704	13.9%	1,258,585	35.7%	1,452,289	29.5%

**How Many Taxpayers Would Be Eligible to Use TeleFile If the System Was Available?**

Telefilers’ life situations change over time and some would no longer be eligible to use TeleFile based on the limiting criteria, thus reducing the number of previous users who could use TeleFile. Of course, some taxpayers with new filing requirements would be eligible to use a TeleFile type of system. For a TeleFile system to be successful, it must encourage new taxpayers to use the system to offset the taxpayers that can no longer use it because of changing life circumstances.

The IRS TeleFile system required a touch-tone phone for submitting information and filing the return. Given today’s technological advancements, this type of restriction may no longer be necessary. However, any technology modifications should be thoroughly evaluated for security concerns, data capture, and ease of use.<sup>47</sup> Additionally, taxpayers with some characteristics that were out of the ordinary, such as being blind or 65 or older, could not use TeleFile because these factors added complexity to the tax return.

Some eligibility restrictions did not affect many taxpayers, while others impacted a substantial number. Modifying the restriction on moving or preparer use holds the most promise for expanding the system without making it unwieldy.

**How Many Taxpayers Would Be Eligible to Use TeleFile If the Restrictions Were Modified?**

If the taxable income threshold remained at \$100,000 and the other eligibility criteria were held constant, more than eight million taxpayers would be eligible for TeleFile.<sup>48</sup> If only the limitation on moving was changed, about two and a half million taxpayers could be added to the base of more than eight million for a total of more than ten million people qualified to use an expanded telephone filing system.<sup>49</sup>

By changing multiple eligibility requirements more than 27 million taxpayers could have Telefiled in tax year 2008. Table 2.7.6 shows the number of taxpayers who would be added to the group eligible to use TeleFile if these criteria are added in the order shown. For example, while eliminating the restriction only on moving would add over two million users, as discussed above, removing all of the other restrictions explored in Table 2.7.6 below in addition to ending the restriction on moving would add over nine million users (*i.e.*, because most of those who moved were also affected by one or more of the other restrictions on eligibility and these other restrictions would also need to be removed for these taxpayers

<sup>47</sup> Pew Internet & American Life Project, *Cell Phones and American Adults* 1-5 (Sept. 2010). More than 80 percent of American adults have cell phones, with African American and Hispanic (English speaking) ownership rates exceeding white Americans. Further, some segments of the population that are typically difficult to reach report having cell phones, giving this technology the potential to improve reach to more Americans. Americans do not just use their cell phones to make calls, they text, use the Internet, use social media and other activities with their cell phones. This willingness to use cell phones for other activities offers possibilities for future use including government interactions or other purposes not previously considered.

<sup>48</sup> See eligibility restrictions, *supra*. The income threshold was raised to \$100,000 in TY 2004. ETA, *Marketing Database, TY 2002 - 2008* and *Individual Returns Transaction File, TY 2002 - 2008*.

<sup>49</sup> 8,039,042 taxpayers represent the base of those eligible to use a telephone system in 2008. Another 2,452,506 taxpayers moved and would be eligible by expanding the criteria to include movers for a total of 10,491,548 taxpayers eligible to use the TeleFile system by removing one eligibility restriction.

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to be eligible to use the system). If dividend or pension income, and education deductions and credits could all be claimed using TeleFile, another two million (above the base level of eight million) could file by telephone. These numbers represent unique individual tax returns, so someone who both claimed dividend income and moved in the same tax year would only be counted once.

**TABLE 2.7.6, Impact of Changing Some TeleFile Eligibility Requirements<sup>50</sup>**

Type of Income, Deduction, or Credit	Increase in TeleFile Eligible
Base Eligible with latest criteria <sup>51</sup>	8,039,042
Dividend Income	362,878
Pension Income	521,749
Education Credits, Tuition fees, student loans, etc	1,509,583
Preparer	7,701,629
Moving	9,287,161
<b>Total that could be eligible for TeleFile</b>	<b>27,422,043</b>

***What Filing Method Are These Eligible Taxpayers Using?***

Taxpayers who would be eligible to file using a telephone system available to more taxpayers (because of less restrictive eligibility criteria) used three different methods for filing their 2008 tax returns. Method use is split fairly evenly between paper, online, and preparer use. Please note that the returns submitted by tax preparers (shown in the table) are also filed electronically. As shown in the following table, the IRS would have the potential to migrate over 9.7 million paper filers to electronic filing if a TeleFile system with less restrictive eligibility requirements had been available for the 2008 tax year.

**TABLE 2.7.7, Impact of Changing Some TeleFile Eligibility Requirements – What Filing Method are these Eligible Taxpayers Using<sup>52</sup>**

2008 Filing Method	Volume	Percent
Paper	9,713,003	35.4%
Preparer ELF (electronic)	8,852,619	32.3%
Online	8,856,421	32.3%
<b>Total</b>	<b>27,422,043</b>	<b>100.0%</b>

<sup>50</sup> ETA, *Marketing Database, TY 2002 - 2008 and Individual Returns Transaction File, TY 2002 - 2008*. The figures in this table are based on changing TeleFile restrictions and starting from the \$100,000 taxable income base. The analysis used an income range use of + or - \$5 to account for rounding. Taxpayers who used a paid tax preparer the previous tax year were not sent a tax package and thus could not use TeleFile to submit their tax return.

<sup>51</sup> Criteria included a taxable income of \$100,000 or less, and interest income of \$1,500 or less.

<sup>52</sup> ETA, *Marketing Database, TY 2002 - 2008 and Individual Returns Transaction File, TY 2002 - 2008*. The figures in this table are based on keeping the TeleFile restrictions for taxable income at \$100,000 and expanding the eligibility criteria so that those taxpayers with dividend or pension income, more tax credits, who use a paid tax preparer, and who move are still eligible to use the system.

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### *Is There a Group of Taxpayers Who Would Be Eligible for TeleFile Who Are Not Filing Electronically?*

As the above table indicates, more than one in three taxpayers who could be eligible for expanded TeleFile continues to file paper returns. Moreover, nearly another third of taxpayers potentially eligible for TeleFile are using paid preparers. There is insufficient data to determine whether some taxpayers who are using a paid preparer would change to TeleFile.

The mean and median incomes for the group of taxpayers filing by paper are much lower than for those using a paid preparer or an online method. Taxpayers using preparers have lower incomes than those using an online method. These income amounts, as illustrated by the following table, suggest that lower income taxpayers are either not filing electronically or are possibly being channeled to paid preparers who they may not be able to afford.

**TABLE 2.7.8, Mean and Median Incomes by Filing Method<sup>53</sup>**

Filing Method	Mean Income	Median Income
Paper	\$ 21,735	\$ 11,960
Preparer ELF	\$ 25,704	\$ 19,224
Online	\$ 27,275	\$ 21,758

## CONCLUSION

The data analyzed in this study suggest that a considerable number of taxpayers with relatively simple tax returns still file on paper. The IRS’s original assumption that taxpayers who previously used TeleFile would automatically turn to another electronic method overstated some taxpayers’ commitment to electronic filing. It would be worthwhile for IRS to consider adding another filing method, thereby minimizing or eliminating problems associated with paper filing. An evaluation of any new filing method should include a thorough analysis of technologies, costs, adoption rates, ease of use, and taxpayer burden associated with the proposed filing method.

A telephone filing system offers the benefit of being available to taxpayers who do not have personal computers or Internet access, or who are simply not computer savvy. By modifying eligibility qualifications for a telephone system, the IRS could greatly expand the number of taxpayers who could use such a system. Changes in the use of telephones and their technologies should be considered and included in the evaluation so the IRS does not develop a system based on obsolete assumptions or telephone technology.<sup>54</sup>

<sup>53</sup> ETA, *Marketing Database, TY 2002 - 2008 and Individual Returns Transaction File, TY 2002 - 2008*. The figures in this table are based on changing TeleFile restrictions starting from the \$50,000 taxable income base for TY2002 to \$100,000.

<sup>54</sup> The IRS estimated that it would save \$17 to \$23 million by eliminating TeleFile. *2005 Tax Return Filing Season and the IRS Budget for Fiscal Year 2006, Hearing Before the Subcommittee on Oversight of the Committee on Ways and Means, U.S. House of Representatives, 109th Cong. (Apr. 14, 2005)*.



**For example:** Overall, 82 percent of Americans own a cell phone, with ownership more prevalent in minorities with 87 percent of African Americans and English speaking Hispanics owning a cell phone (compared with 80 percent of whites). Seventy-one percent of those making less than \$30,000, 57 percent of those 65 or older, and 72 percent of rural Americans own cell phones. Interestingly, more than half (53 percent) of Americans who do not use the Internet at all have a cell phone.<sup>55</sup> A TeleFile-type system could introduce these taxpayers to a type of electronic filing, which may result in some converting to computer-based e-filing as they age and their tax situations become more complex.

Absent a telephone-based system, it is likely that the IRS will need to find alternatives for processing paper returns that are more efficient than current methods, because it appears some taxpayers will continue filing on paper unless they are forced to change. The objective would be to eliminate many of the human handling requirements that introduce costly, time consuming inaccuracies into the paper handling process. Bar code technologies might be one alternative that offers promising results.

## RECOMMENDATIONS

The National Taxpayer Advocate offers these recommendations:

1. Explore reinstating TeleFile with less restrictive eligibility criteria that allow taxpayers who move to use the system.
2. Evaluate current telephone technologies to determine the feasibility of allowing taxpayers with simple tax returns (that meet less restrictive eligibility requirements than those applicable to the former TeleFile system) to interact with the IRS using cell phones and smart phones. This would include being able to file tax returns and interact with the IRS by voice or text capabilities.
3. Evaluate how current bar code technologies could be applied to processing tax returns so that information could be captured from paper returns by scanning a bar code rather than by transcription.

<sup>55</sup> Pew Internet & American Life Project, *Cell Phones and American Adults* (Sept. 2010), available at <http://www.pewInternet.org/Reports/2010/Cell-Phones-and-American-Adults.aspx> (last visited Dec. 8, 2010).

## Appendices

### Appendix A: Telefile Eligibles – Comparing Those who Filed a Paper Return Versus Those who Filed Electronically in tax years 2002 - 2004

#### What are the characteristics of TeleFile eligible taxpayers who used TeleFile versus those who filed by some other means in tax years 2002, 2003, and 2004?

The following table includes primary taxpayers who were eligible to use TeleFile in 2002, 2003, or 2004. The analyses in this appendix compare taxpayers who were eligible and filed via TeleFile to those who could have used the telephone to file but chose some other filing method in tax years 2002 – 2004. While these two groups are very similar to one another, there are differences. Those who used TeleFile had slightly higher incomes, were slightly more likely to get a refund, and received larger refunds than those who were eligible and used another filing method. Those filing by a method other than TeleFile were more likely to hire a preparer.

**TABLE 2.7.9, Telefile Eligibles - Users vs. Non-Users**

TeleFile Eligible Taxpayers						
Tax Year	2002		2003		2004	
	Filed via TeleFile	Filed Using Some Other Method	Filed via TeleFile	Filed Using Some Other Method	Filed via TeleFile	Filed Using Some Other Method
<b>Number of Returns</b>	4.0 M	4.2 M	3.8 M	4.2 M	3.3 M	4.4 M
<b>Age</b>						
- Mean	31	30	32	31	32	30
- Median	25	25	25	24	26	23
<b>Filing Method</b>						
- Paper	0%	72.8%	0%	69.6%	0%	64.9%
- TeleFile	100%	0%	100%	0%	100%	0%
- Practitioner – ELF	0%	11.1%	0%	11.1%	0%	10.2%
- Online	0%	16.1%	0%	19.3%	0%	24.9%
<b>Filing Status</b>						
- Single	96.6%	95.8%	96.0%	94.8%	95.6%	94.4%
- Married filing joint	3.4%	4.2%	4.0%	5.2%	4.4%	5.6%
<b>Income</b>						
- Mean	\$17,905	\$15,850	\$18,463	\$16,349	\$19,508	\$17,563
- Median	\$15,298	\$11,863	\$15,817	\$12,138	\$16,709	\$12,984
<b>Income Type</b>						
- Wages & Interest	93.5%	93.0%	87.9%	93.1%	84.5%	93.9%
- Other	6.5%	7.0%	12.2%	6.9%	15.5%	6.1%
<b>Refund Returns</b>						
Percent of Returns	93.3%	88.8%	93.2%	88.8%	93.0%	88.8%

table continued on next page

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TeleFile Eligible Taxpayers						
Tax Year	2002		2003		2004	
	Filed via TeleFile	Filed Using Some Other Method	Filed via TeleFile	Filed Using Some Other Method	Filed via TeleFile	Filed Using Some Other Method
<b>Refund</b>						
- Mean	\$557	\$515	\$569	\$527	\$574	\$541
- Median	\$444	\$371	\$453	\$376	\$464	\$390
<b>Who Prepared Return</b>						
- Self	100%	86.3%	100%	86.1%	100%	86.4%
- Paid Preparer	0%	13.7%	0%	13.9%	0%	13.6%

## Appendix B: Description of the IRS’s TeleFile Program for Individuals

### The following information comes from “e-file Using a Telephone (TeleFile)”, TeleFile system facts from the IRS’s internal (intranet) website.

A taxpayer could use TeleFile and file his or her taxes by phone, if he or she received the TeleFile tax package in the mail<sup>56</sup> and:

- Had access to a touch-tone telephone;
- Was still using the address printed on the TeleFile Tax Package for mail purposes;
- Filed single or married filing jointly and had no dependents;
- Was under 65 on January 1;
- Was not blind;
- Had income only from:
  - Wages, salaries, tips, taxable scholarship or fellowship grants;
  - Unemployment compensation;
  - Interest (less than \$1,500 and no withholding deduction);
  - Alaska Permanent Fund Dividends;
  - Qualified state tuition program earnings;
- Had total taxable income of less than \$100,000 (\$50,000 prior to tax year 2004)

A taxpayer could not use TeleFile if he or she:

- Needed to change filing status, name, or address;
- Needed to claim any dependents;
- Needed to claim a deduction(s) for being over 65 or blind;
- Did not receive the tax package;
- Was filing the return of a deceased taxpayer;
- Received any advanced EITC payments; or
- Repaid any unemployment compensation during the year for which the return was being filed.

<sup>56</sup> In general, TeleFile tax packages were mailed to taxpayers who used a Form 1040EZ, were eligible to use Form 1040EZ, or used TeleFile for the prior tax year. The taxable income level for Form 1040EZ was raised from \$50,000 to \$100,000 for tax year 2004, so TeleFile tax packages were sent to 1040EZ eligible taxpayers with a taxable income of less than \$100,000 in the previous tax year.

There are numerous other qualifications for receiving a TeleFile package, including: filed a Form 1040EZ the previous year, did not use a preparer for the prior year’s return (except for those that live in 8 specified states), did not file an amended return that would change their eligibility to use Form 1040EZ, the primary and secondary dates of birth and SSNs are valid, zip code is valid, taxpayer cannot be deceased or in the prisoner file, or have an open Criminal Investigation. This list is not all inclusive, there are numerous other criteria.

These qualifications significantly reduced the number of TeleFile packages that were mailed.

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**Benefits of the system included:**

- **Fast Refunds** – Receive refunds quickly;
- **Quick** – A ten-minute call with proof of acceptance provided before the end of the call;
- **Accurate** – The computer does all the math;
- **Secure** – A dedicated phone line provides a safe transmission;
- **Convenient** – File from home, 24 hours a day seven days, a week;
- **Electronic Payments** – Pay balance due by electronic funds withdrawal or with a credit card;

The phone call typically took about ten minutes. TeleFile did the math and calculated the tax owed or the refund due. There was no need to mail anything to the IRS, and the TeleFile system provided a confirmation number at the end of the call as proof the return was accepted.

## Appendix C: Description of the IRS’s TeleFile Program for Businesses

**The following information comes from a press release issued by the IRS in 1997 announcing the new telephone filing system for Form 941, *Employer’s Quarterly Federal Tax Return*.**

The Internal Revenue Service has good news for over 890,000 business taxpayers – many of them may now be able to throw away the paper and file their quarterly payroll returns, Forms 941, by telephone. The TeleFile system is free and paperless telephone filing method that automatically figures the tax and any refund or balance owed.

The Form 941 TeleFile pilot will begin with returns for the first quarter of 1997. Special TeleFile packages with the necessary information were sent to potential filers. These packages included payment vouchers for those who owe money, along with paper Forms 941 for those who may not qualify for TeleFile. The system started as a test limited to taxpayers in 14 states and expanded to all 50 states in 1998.<sup>57</sup>

### Background

**Purpose** – Employers use Form 941 to report income tax that was withheld from wages (including tips), distributions from nonqualified pension plans (including nongovernmental Form 941 section 457(b) plans), supplemental unemployment benefits, and third-party payments of sick pay. Also use Form 941 to report social security and Medicare taxes.

**Who Must File** – Employers who withhold income tax on wages, or who must pay social security or Medicare tax, must file Form 941 each calendar quarter. After you file your first Form 941, you must file a return for each quarter, even if you have no taxes to report.

**Zero Wage return** – Beginning in April of 2004, U.S.-based (domestic) taxpayers may file their “Zero Wage” Forms 941 by telephone using the 941 TeleFile. Eligible filers must have had: (a) no withholding, (b) no federal tax deposits, and (c) no taxes to report the quarter. Dial 1-800-583-5345 (toll free) to use 941 TeleFile. If the company goes out of business or stops paying wages, file a final return.<sup>58</sup>

TeleFile was discontinued in August 2005, leaving business taxpayers fewer options for filing their tax returns.<sup>59</sup> When the IRS eliminated TeleFile, an easy and free method for taxpayers to file employment tax returns was also eliminated.

<sup>57</sup> IRS News Release, IR-97-10 (Mar. 1997).

<sup>58</sup> IRS, Instructions for Form 941, *Employer’s Quarterly Federal Tax Return* (Rev. Jan. 2004).

<sup>59</sup> SB/SE Research, Project BKN0045, *FY 06 Nationwide Analysis, ETA BMF Marketing Database* (May 2006).

## Appendix D: Canada’s TELEFILE System

### The following information comes from Canada Revenue Agency’s website about the TELEFILE Service.

Canada’s TELEFILE is a service designed for taxpayers with the most common types of income tax information such as employment income, pension income, interest income, registered pension plan contributions, and charitable donations. The system does not accept more complex information, such as self-employment income, capital gains, and rental income. First-time filers are not eligible to use TELEFILE.

The TELEFILE service is available to taxpayers who have received a specified income tax package or those whose tax situations make them eligible. TELEFILE is designed to accept certain income, deduction, and tax credit amounts. The TELEFILE tax package includes an access code. Taxpayers who do not receive the tax package but feel they are eligible can call a toll-free number to obtain a code if they meet the criteria.<sup>60</sup>

Canada promotes TELEFILE as paperless, quick, free, and easy. Additionally, taxpayers receive a confirmation number showing receipt of the tax return.<sup>61</sup>

### Steps for filing with TELEFILE:

**Step 1**—Complete your tax return, including all necessary forms and schedules, using the information in your tax package.

**Step 2**—Call the TELEFILE service toll-free. You must use a touch-tone telephone and call from within Canada or the continental United States. TELEFILE is available seven days a week.

**Step 3**—Enter your tax information using your telephone keypad. The TELEFILE service will guide you every step of the way.

We will ask you for your Social Insurance Number (SIN) and personalized access code (shown on your personal label sheet included in your income tax package). We will also ask you to confirm your marital status, and if applicable, your spouse or common-law partner’s SIN. We may ask for his or her net income and the amount of Universal Child Care Benefit (UCCB) that is included in their net income to determine amounts for which you may qualify, such as the goods and services tax/harmonized sales tax (GST/HST) credit and the Canada Child Tax Benefit (CCTB). You will then be guided through the entry of the information from your tax return.

<sup>60</sup> Changing address does not automatically disqualify a taxpayer from using TELEFILE as was the case with the American TeleFile system. Canadian taxpayers who meet the system qualifications can receive an access code over the phone that allows them to use the TELEFILE system.

<sup>61</sup> <http://www.cra-arc.gc.ca/esrvc-srvce/tx/ndvdlst/tf/bt-eng.html> (last visited Nov. 8, 2010).

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**Step 4**—Confirm that you want to file the information as your tax return. We will give you a confirmation number and immediately begin processing your tax return. Write down this confirmation number and keep it for your records. It is your proof that we have received your tax return.

Note

Your income tax return has not been filed until we issue your confirmation number. Be sure to listen for it before hanging up.





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