

NATIONAL TAXPAYER ADVOCATE

2012 ANNUAL REPORT TO CONGRESS

Volume Two:
TAS Research &
Related Studies



YOUR VOICE AT THE IRS

NATIONAL TAXPAYER ADVOCATE

2012 ANNUAL REPORT TO CONGRESS

Volume Two:
TAS Research &
Related Studies



YOUR VOICE AT THE IRS

This page intentionally left blank.

Table of Contents

Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results	1
Study of Tax Court Cases In Which the IRS Conceded the Taxpayer was Entitled to Earned Income Tax Credit (EITC)	71
Investigating the Impact of Liens on Taxpayer Liabilities and Payment Behavior.....	105
Options for Expanding the Remedies to Address Taxpayer Rights Violations.....	131
Research Prospectus: Comparing the Effect of Revenue Officers and the Automated Collection System on Future Compliance.....	141
Research Prospectus: When Do Accuracy-Related Penalties Improve Future Reporting Compliance by Schedule C Filers?.....	149

This page intentionally left blank.

**FACTORS INFLUENCING
VOLUNTARY COMPLIANCE
BY SMALL BUSINESSES:
PRELIMINARY SURVEY RESULTS**

Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results¹

EXECUTIVE SUMMARY 4

INTRODUCTION 7

DISCUSSION 9

Methodology 9

 TAS sorted taxpayers with DIF scores in the highest or lowest deciles into low- or high-compliance groups. 9

 TAS identified communities with median DIF scores in the highest and lowest deciles as low- or high-compliance communities, but found few high-compliance communities. 10

 TAS developed survey questions and contracted with Russell Research to administer the survey. 11

Important Assumptions and Limitations 11

 TAS used DIF scores as a proxy for compliance by those in the top and bottom DIF deciles. 11

 The Community and National Surveys are different in kind. 12

Key Findings of the National Survey 13

 Taxpayers in the high-compliance group were more likely to trust the government and the IRS. 13

 Those in the low-compliance group expressed less trust in a preparer. 17

 Taxpayers in the low-compliance group were more likely to participate in local organizations and to report that other participants view the law and the IRS negatively. 19

 Both high- and low-compliance groups professed a “moral” obligation to report income accurately. 24

 Economic deterrence may not drive compliance decisions by those in either the high- or low-compliance groups. 24

 Views about complexity were mixed, but most agreed the tax rules are so complicated it is very difficult to get a tax return exactly right. 27

Summary of the National Survey Results 28

¹ The principal authors of this study are Tom Beers, Senior Research Advisor, Eric LoPresti, Senior Attorney Advisor, and Eric San Juan, Senior Attorney Advisor, of the Office of the Taxpayer Advocate.

Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results

Key Findings of the Community Survey	29
Taxpayers in the high-compliance communities were more geographically dispersed than those in the low-compliance communities.....	30
Respondents from low-compliance communities were suspicious of the tax system and its fairness, whereas those from high-compliance communities responded positively to government.	31
Respondents from high-compliance communities were more likely to rely on preparers.....	32
Among business classifications, the biggest cluster in low-compliance communities was under “professional, scientific, or technical services”; in high-compliance communities, the “other” service industry.....	33
Low-compliance community respondents reported more participation in civic institutions than their high-compliance community counterparts.....	33
High-compliance community respondents were motivated by morals and deterrence.	35
The effect on compliance of financial concerns by those in high- or low-compliance communities was unclear.	35
Those in the high- and low-compliance communities responded similarly to questions addressing complexity.....	35
Summary of the Community Survey Results	35
Preliminary Observations	36
CONCLUSION	38
APPENDIX I: SURVEY QUESTIONS	40
APPENDIX II: RUSSELL RESEARCH TOPLINE SUMMARY	52

EXECUTIVE SUMMARY

The Taxpayer Advocate Service (TAS) surveyed sole proprietors (*i.e.*, those filing Form 1040, *U.S. Individual Income Tax Return*, Schedule C) to better understand the factors that may affect their income tax reporting compliance. Identifying how to improve compliance among this segment is particularly important because sole proprietor income is generally not subject to information reporting, is difficult for the IRS to detect, and represents the largest portion of the tax gap — tax that is not timely and voluntarily paid.

Because actual reporting compliance is difficult to measure, TAS used IRS tax compliance estimates to identify sole proprietors most likely to have high or low levels of reporting compliance. Unlike researchers outside the IRS, TAS was uniquely positioned to know these IRS estimates. TAS surveyed a stratified random national sample of each group (the “National Survey”).

As discussed in prior reports, a large body of research discusses the potential effect of various factors on tax compliance, but this study is the first to link survey responses to IRS estimates of the respondent’s actual tax compliance. Thus, the National Survey provides an unprecedented look at the differences between the views of the Schedule C filers that are the most and least compliant, at least according to IRS estimates.

Because some of the factors thought to influence compliance could be affected by local conditions and attitudes, TAS also sought to identify geographic communities where a disproportionate number of taxpayers were in the high- or low-compliance group. TAS surveyed taxpayers at random in certain communities (the “Community Survey”) using the same survey questions.

TAS designed survey questions to reveal the effect, if any, on reporting compliance of various factors, such as deterrence, tax morale, compliance norms, trust in the government and the tax administration process, complexity and the convenience of complying, and the influence of preparers. TAS contracted with a consulting firm, Russell Research, to refine the questions and conduct the surveys by telephone.

TAS’s preliminary analysis of the National Survey results revealed the following key findings:

- Taxpayers in the high-compliance group expressed more trust in government and the IRS.
- Those in the low-compliance group expressed less trust in preparers. Although most used a preparer, they were less likely to follow the preparer’s advice.
- Taxpayers in the low-compliance group were more likely to participate in local organizations. They were also significantly more likely to report that other participants view the law and the IRS negatively.
- Both groups professed a “moral” obligation to report income accurately.

Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results

- Responses do not show that economic deterrence motivates compliance decisions. Those in the low-compliance group were less likely to agree that noncompliance goes unpunished.
- Most respondents agreed the tax rules are so complicated that it is very difficult to get a tax return exactly right. Those in the high-compliance group were somewhat more likely to agree with this statement, potentially suggesting they were more concerned about getting a return exactly right.

TAS's preliminary analysis of the Community Survey results revealed the following key findings:

- There were more low-compliance communities than high compliance communities because taxpayers with high compliance were not concentrated in communities.
- Respondents from the low-compliance communities were suspicious of the tax system and its fairness, whereas those from the high-compliance communities viewed government positively.
- Respondents from the high-compliance communities were more likely to rely on preparers.
- Among business classifications, the biggest cluster in low-compliance communities was under "professional, scientific, or technical services"; in high-compliance communities, the "other" service industry (*e.g.*, repair & maintenance, personal & laundry, and private household services).
- The low-compliance community respondents reported more participation in civic institutions than their high-compliance counterparts.
- The high-compliance community respondents were motivated by morals and deterrence.
- The effect on compliance of financial concerns was unclear.
- Those in the high- and low-compliance communities responded similarly to questions addressing tax complexity.

In sum, all groups and communities agreed that it is morally wrong to cheat and that they would feel embarrassed if others learned they were not reporting all of their income. Surprisingly, those in the low-compliance group were also more likely than those in the high-compliance group to believe that the IRS detects and penalizes noncompliance. Thus, other factors appeared to overshadow these positive moral, social, and economic pressures for those in the low-compliance group and communities.

Specifically, the results of both surveys associate distrust of the national government and the IRS with the low-compliance groups and communities. For example, respondents from the low-compliance group were more likely to report that the government is too big and wastes tax dollars, that tax laws are unfair, and that the IRS is unfair (*e.g.*, often believing

Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results

the IRS is more concerned with collecting as much as possible instead of the correct amount, and indicating less satisfaction with IRS services).

The Community Survey selection process also revealed that those with low compliance levels clustered in geographic communities, while those with high compliance levels were more dispersed. Perhaps those with low levels of compliance are more likely to associate with each other.

In addition, those in the low-compliance group and communities were more likely to participate in local organizations and to report that other members of those organizations believe the law and the IRS are unfair. The closer association with local organizations by members of the low-compliance group and communities could have undermined their connection with the nation and the national tax system as a whole. The negative views they attributed to other members appeared to mirror their own views. In other words, they affiliated with others who reinforced noncompliance norms locally, feeling a closer connection here than nationally.

Those in the low-compliance group were somewhat more likely to use a preparer, who could have persuaded them to comply or facilitated noncompliance. However, they were also less likely to follow the preparer's advice than those in the high-compliance group, potentially weakening any positive influence that the preparer may have sought to exert.

These preliminary findings may suggest that traditional enforcement measures designed to deter could be ineffective, both because those likely to respond may be predisposed to comply and because the survey results did not suggest that asocial behavior (*i.e.*, behavior that may be addressed by increasing deterrence) is prevalent. Rather, they may suggest that the government could improve reporting compliance by improving the perceived fairness and efficiency of the government, the tax law, and the IRS; and by simplifying the tax code, improving procedural protections, and minimizing the IRS's reliance on procedures that may seem unfair (*e.g.*, excessive automation and lack of personal contact). As a practical matter, this might include tax simplification, an expansion of taxpayer protections and remedies, improved or expanded tax services, and taxpayer education.

To address the perception by members of local organizations that the tax law and the IRS are unfair, the IRS might retain a local presence and conduct outreach and education events, particularly in low-compliance communities. Such treatments might pay for themselves if they improve reporting compliance by those responsible for the largest portion of the tax gap and most resistant to other treatments.

INTRODUCTION

A principal goal of the IRS is to maximize the rate at which taxpayers pay their taxes voluntarily. To do so, the IRS needs to understand why they comply. The National Taxpayer Advocate 2007 Annual Report to Congress, which included a review of existing research (the “2007 Review”) and the National Taxpayer Advocate 2010 Annual Report to Congress, which included a proposal for this research (the “2010 Proposal”) identified numerous types of noncompliance, as shown below.²

TABLE 1, Typology of Noncompliance³

Type	Description
Procedural	Failed to follow complicated procedural rules, such as quarterly filing requirements
Lazy	Failed to follow burdensome procedural rules, such as recordkeeping requirements
Unknowing	Misunderstood the legal rules
Asocial	Motivated by economic gain
Brokered	Acted on the advice of a professional
Symbolic	Perceived the law or the IRS as unfair
Social	Acted in accordance with social norms and peer behavior
Habitual	Knowingly repeated previous noncompliance

The 2007 Review and 2010 Proposal also identified various factors driving taxpayer compliance decisions. TAS conducted a study to investigate whether and how these factors affect voluntary compliance by sole proprietors (*i.e.*, those who file Form 1040, Schedule C, *Profit or Loss from Business*), as described in the 2010 Proposal. The factors are reflected in the following table:

² 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 Review”]; National Taxpayer Advocate 2010 Annual Report to Congress vol. 2, 71-88 (*Researching the Causes of Noncompliance: An Overview of Upcoming Studies*) [hereinafter “2010 Proposal”]. Because the 2007 Review and the 2010 Proposal cite much of the literature discussing each of the relevant factors, this discussion does not revisit the underlying literature or theoretical basis for the factors previously identified.

³ See 2010 Proposal at 81 (Table 2.4.1, *Typology of Noncompliance and Potentially operative Factor(s) Identified by the Literature*) (citing 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) and Leslie Book, *The Poor and Tax Compliance: One Size Does Not Fit All*, 5 *Kans. L. Rev.* 1, 23-33 (2003)).

Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results

TABLE 2, Factors Identified as Potentially Driving Voluntary Compliance⁴

Factor	Description
Deterrence	"[P]eople comply when the potential sanction multiplied by the perceived likelihood of getting caught outweighs the economic gain from cheating." [However,] "the deterrence model is incomplete because it seems economically irrational for so many taxpayers to comply given the low probability of getting caught cheating."
Norms	"According to social norms and reciprocity theories, taxpayers who believe most other taxpayers comply are more likely to reciprocate by complying."
Tax morale	Taxpayers "who cheat may feel guilty when they break the norm if it has been adopted as the taxpayer's own tax morale." In addition, "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."
Trust	Taxpayers "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."
Complexity and convenience	"Taxpayers who face complicated rules may be unable to comply, or may use complexity as a reason to justify noncompliance."
Preparers and other third parties	"Tax preparers may have a significant effect on tax compliance."

TAS also asked questions about demographics and affiliations. While these items may not directly affect compliance decisions, TAS included them because they may be correlated with or help explain the factors that do. For example, information about a person's affiliations could help TAS draw conclusions about the person's norms, tax morale, and related factors.⁵

TAS focused on sole proprietors because underreporting by sole proprietors represents the largest portion of the tax gap (*i.e.*, taxes not voluntarily and timely paid).⁶ The IRS is unlikely to be able to detect or deter noncompliance by this segment without expending significant enforcement resources because most sole proprietor income is not subject to third-party information reporting. Relatively inexpensive measures, such as document matching and correspondence examinations, cannot reliably detect such income. Thus, it is particularly important for the IRS to gain a better understanding of how to improve compliance among sole proprietors using levers other than economic deterrence.

TAS contracted with Russell Research to help conduct a telephone-based survey of two groups: a nationally representative sample of sole proprietors (the "National Survey"); and sole proprietors located in high- and low-compliance communities (the "Community Survey"). The discussion below describes the methodology and key preliminary results of both surveys.

⁴ The factors and their descriptions come from the 2010 Proposal (pages 76-81), which synthesized them from tax compliance literature, including the 2007 Review.

⁵ 2010 Proposal at 87.

⁶ IR-2012-4, *IRS Releases New Tax Gap Estimates; Compliance Rates Remain Statistically Unchanged From Previous Study* (Jan. 6, 2012), available at <http://www.irs.gov/uac/IRS-Releases-New-Tax-Gap-Estimates;-Compliance-Rates-Remain-Statistically-Unchanged-From-Previous-Study>.

DISCUSSION

Methodology

TAS sorted taxpayers with DIF scores in the highest or lowest deciles into low- or high-compliance groups.

TAS relied on internal IRS computer-generated estimates that an audit would produce an adjustment (called a Discriminant Index Function or “DIF” score) as a proxy for a person’s tax compliance, as described in the 2010 Proposal.⁷ The IRS develops DIF scores for taxpayers in each “examination activity code” or EAC. For sole proprietors, EACs are based on the taxpayer’s total gross receipts (TGR) on Schedules C and F and total positive income (TPI), which is positive income from all sources before adjusting for deductions, exemptions, or negative income (*e.g.*, negative income from post-holiday returns). TAS excluded the EACs for low income taxpayers claiming the earned income tax credit (EITC) because they may present a unique set of tax compliance issues.⁸ For 2009, six EACs included all sole proprietors residing in the United States who did not claim the EITC, as shown in the following table.

TABLE 3, Total Gross Receipts (TGR) and Total Positive Income (TPI) Limits for Certain Schedule C Examination Activity Codes (EACs)⁹

EAC	TGR	TPI
274	<\$25,000	<\$200,000
275	\$25,000 - \$99,999	<\$200,000
276	\$100,000 - \$199,999	<\$200,000
277	>\$199,999	<\$200,000
280	-	\$200,000 - \$999,999
281	-	>\$999,999

For each of the six EACs, TAS sorted 2009 returns by DIF score, then divided them into ten deciles. Taxpayers with returns in the first and second deciles have the lowest DIF scores and are assumed to be the most compliant. Those in the ninth and tenth deciles have the highest DIF scores and are assumed to be the least compliant.¹⁰ All other deciles are considered moderately compliant.

⁷ The DIF is a computer algorithm that estimates the likelihood that an audit of a particular return would produce an adjustment. The DIF is based on data obtained and periodically updated from IRS National Research Program examinations. See 2010 Proposal at 86 n. 49 (and sources cited therein).

⁸ Because it is sometimes difficult to distinguish between a hobby and a real business, TAS considered, but ultimately rejected, the idea of excluding those in the lowest income ranges. Thus, the survey may have captured the views of some taxpayers who were conducting a hobby. However, the number of respondents likely to fall into that category was limited because TAS stratified the sample by EAC, as described below.

⁹ IRS, Document 6209, *IRS Processing Codes and Information* 12-16 (Jan. 2012). Many parts of Document 6209 are designated as “official use only,” but these EAC definitions are not.

¹⁰ As noted below, this assumption is a significant limitation of the study. TAS relied on DIF scores because taxpayers — particularly noncompliant taxpayers — might not respond accurately to questions about their tax compliance.

Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results

To minimize selection bias and the number of surveys required, TAS selected a random sample of taxpayers in high- and low-compliance groups in each EAC for the National Survey. However, TAS combined the four EACs with the fewest taxpayers into two groups (or “strata”) with two EACs in each of these two strata. TAS also selected one group of taxpayers with medium levels of compliance from all EACs for comparison purposes. TAS received 3,306 responses to the National Survey, as shown on the following table.

TABLE 4, National Survey Responses by Strata and Population

National Sample Strata		Population	Responses
EAC 274	DIF Deciles 1 - 2	2,053,331	350
EAC 274	DIF Deciles 9 - 10	2,053,331	350
EAC 275	DIF Deciles 1 - 2	571,075	351
EAC 275	DIF Deciles 9 - 10	571,075	384
EACs 276, 277	DIF Deciles 1 - 2	268,565	359
EACs 276, 277	DIF Deciles 9 - 10	268,565	350
EACs 280, 281	DIF Deciles 1 - 2	256,306	383
EACs 280, 281	DIF Deciles 9 - 10	256,306	379
All EACs	DIF Deciles 3 - 8	9,447,830	400
Total		15,745,384	3,306

The national sample was large enough that we can be at least 95 percent confident that the results reflect the views of the universe of taxpayers in each stratum with a margin of error of five percent or less.

TAS identified communities with median DIF scores in the highest and lowest deciles as low- or high-compliance communities, but found few high-compliance communities.

TAS originally intended the Community Survey sample to have two strata with 350 respondents each, from high-compliance communities and low-compliance communities, cities, towns, and other geographic areas across the country identified by addresses with Zip codes reported by the taxpayers on their returns. To be considered “high compliance,” a community’s residents must have a median DIF score in the bottom 30 percent (*i.e.*, the bottom three deciles). To be considered “low compliance” a community’s residents must have a median DIF score in the top 30 percent (*i.e.*, the top three deciles). However, the location of taxpayers with high levels of compliance (or at least low DIF scores) was such that TAS could not identify enough high-compliance communities to generate 350 respondents. Simply put, there were few high-compliance communities. In particular, the criteria above yielded three U.S. geographic communities.¹¹ The distribution of high- and low-compliance

¹¹ In addition, the high-compliance criteria identified a military and a Native American community. This identification allows for future study, potentially observing mechanisms of authority and cohesion in those communities. For this phase of the study, however, the Army Post Office did not identify a geographic community as did other addresses, and the Native American community, with a quasi-sovereign history, had a fiduciary relation to the federal government (which was the subject of some survey questions).

taxpayers and communities was a significant discovery. In the end, the Community Survey had 535 respondents — 362 from low-compliance communities and 173 from high-compliance communities.¹²

TAS developed survey questions and contracted with Russell Research to administer the survey.

TAS developed telephone-based survey questions to investigate the factors suggested by the tax compliance literature, as described above. TAS used the same questions for both the National and Community Surveys.

TAS contracted with Russell Research to refine the survey questions, administer the surveys, and compile summary statistics. The actual survey questions, along with a topline analysis by Russell Research, are reproduced in Appendices I and II, respectively.

Russell Research conducted all interviews by telephone from January 3, 2012, to April 19, 2012. It contacted potential respondents up to four times. The response rate was 56 percent for the national sample and 54 percent for the community sample. This better-than-average response rate should help to minimize the likelihood that the survey results were affected by selection bias — the possibility that the views of non-respondents are significantly different from the views of respondents.¹³

Important Assumptions and Limitations

TAS used DIF scores as a proxy for compliance by those in the top and bottom DIF deciles.

As discussed in the 2010 Proposal, it is difficult to measure actual compliance with perfect accuracy. Taxpayers are not likely to confess any noncompliance in response to a survey, and even detailed audits conducted by the IRS's National Research Program (NRP) are likely to contain errors. Even assuming that NRP audit results, as adjusted by IRS researchers, reflect actual compliance, the audit itself has an effect on the taxpayer's attitude about the tax system, potentially biasing the taxpayer's response to any subsequent survey. Thus, TAS decided not to survey taxpayers who had been subject to an NRP audit. While surveying taxpayers immediately before they were subject to an NRP audit might have been more productive, TAS deemed it overly deceptive. Thus, TAS opted to rely on DIF scores as an imperfect, but acceptable, measure of actual compliance, at least for those in the top and bottom DIF deciles.¹⁴

¹² The DIF score for a particular survey respondent, however, may not correspond to the DIF score of the community. For example, the response of a taxpayer with a DIF score suggesting a high level of noncompliance could have been selected as a representative of a high-compliance community.

¹³ See, e.g., Scott Keeter et al., *Gauging the Impact of Growing Nonresponse on Estimates from a National RDD Telephone Survey*, 70 Pub. Op. Quart. 759-79 (2006). It may also suggest that taxpayers were somewhat more interested in discussing their views about taxes than other subjects.

¹⁴ Although some taxpayers in our sample had been subject to IRS examination or collection activity, we did not exclude them or place them into the noncompliant group, as the activity could have had an effect on their subsequent compliance behavior. Of course, any direct contact with the IRS could affect their views about the IRS and the survey results.

Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results

As noted above, this study assumes that taxpayers with high DIF scores (*i.e.*, in the ninth or tenth decile) are noncompliant and that those with low DIF scores (*i.e.*, in the first and second decile) are compliant. To the extent this assumption is incorrect, the survey results could be misleading. However, by excluding those in the middle deciles from the high- and low-compliance groups, TAS sought to improve the likelihood that taxpayers in those groups did, in fact, have high or low levels of reporting compliance.

The Community and National Surveys are different in kind.

While the National Survey is statistically representative of the United States, the Community Survey of select communities relates to a different kind of data. The National Survey may reflect a response of the general population, but given the necessarily varied circumstances across the country, may not relate that response to any particular set of local conditions that could provide a deeper context. On the other hand, the Community Survey facilitates analysis of responses in relation to a more specific set of social circumstances. Thus, the Community and National Surveys are complementary.

TAS did not design the Community Survey sample for projection to any larger group of taxpayers. As set forth above, noncompliance (and by extension, compliance) may vary according to a typology. Focusing on a community permits identification of types, if any, that may not be nationally prevalent. The purpose of the Community Survey would not be to project an ideal type on other parts of the country, but rather to identify relevant factors or characteristics, such as trust in government or traditions of authority, that may occur outside the community context as well.¹⁵ Similarly, in American studies, Middletown stands as a landmark (eponymously popularized by Public Broadcasting System (PBS) television) not because research on Muncie, Indiana (for which it was a pseudonym) was representative of the U.S. but because of the depth in which investigation of one community contextualized national trends.¹⁶ In short, the Community Survey may be prototypical rather than typical.

TAS randomly selected taxpayers for the Community Survey from high- and low-compliance communities without excluding taxpayers with unrepresentative DIF scores. Accordingly, the high-compliance community sample includes taxpayers who are non-compliant and who would be included in the low-compliance group for purposes of the National Survey. Conversely, the low-compliance community sample includes taxpayers who are compliant and who would be included in the high-compliance group for purposes of the National Survey. Thus, responses from high-compliance communities may not be similar to responses from the high-compliance group, and responses from the low-compliance communities may not be similar to responses from the low-compliance group.

¹⁵ For example, one military community appeared to be highly compliant, but that is not the only U.S. military population, where others may be embedded in different contexts.

¹⁶ Middletown (Muncie, Indiana) has been the subject of voluminous research on American social institutions. See *The First Measured Century* (PBS 2000); *Middletown* (PBS 1982); Theodore Caplow, et al., *All Faithful People: Change and Continuity in Middletown's Religion* (Minneapolis: Univ. of Minn. Press, 1983), *Middletown Families: Fifty Years of Change and Continuity* (Minneapolis: Univ. of Minn. Press, 1982); Rob't & Helen Lynd, *Middletown in Transition: A Study in Cultural Conflicts* (NY: Harcourt Brace, 1937), *Middletown: A Study in Modern American Culture* (NY: Harcourt Brace, 1929).

Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results

Key Findings of the National Survey¹⁷

The National Survey results are statistically representative of the views of Schedule C filers in the high- and low-compliance groups. As discussed in the 2007 Review and 2010 Proposal, a large body of research discusses the potential effect of various factors on tax compliance, but this study is the first to link survey responses to IRS estimates of the respondent's actual tax compliance. Thus, the National Survey results provide an unprecedented look at the differences between the views of the Schedule C filers that are the most and least compliant, at least according to IRS estimates.

Taxpayers in the high-compliance group were more likely to trust the government and the IRS.

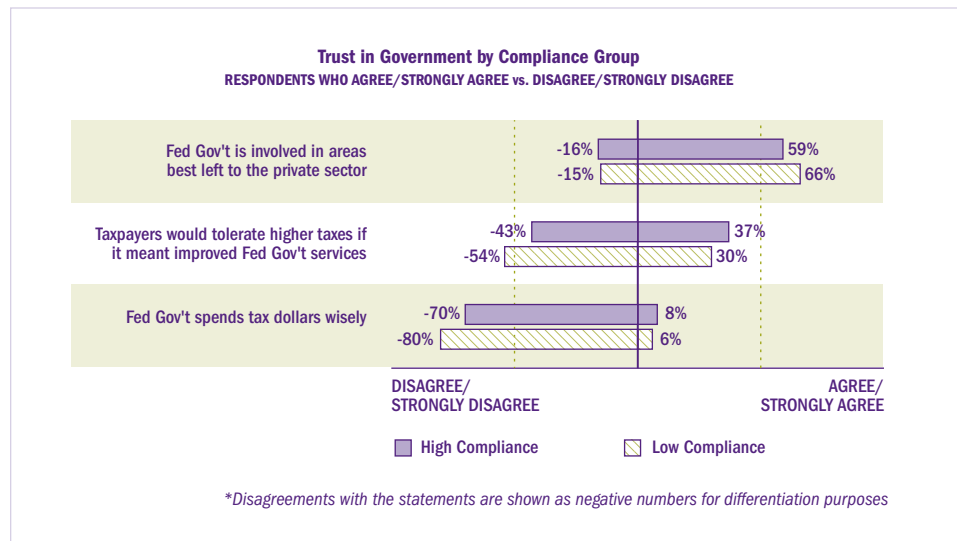
Taxpayers in the high-compliance group were more likely to trust the government than those in the low-compliance group, potentially suggesting that negative views about the government promote symbolic noncompliance, as described in the typology (above). For example, those in the high-compliance group were less likely to agree that the government is involved in areas best left to the private sector (59 percent of the high-compliance group agreed vs. 66 percent of the low-compliance group), more likely to support higher taxes in exchange for improved government services (37 vs. 30 percent), and more likely to believe that the federal government spends tax dollars wisely (80 percent of the low-compliance group disagreed vs. 70 percent of the high-compliance group).¹⁸ These results are generally consistent with research suggesting that trust in government has a positive effect on compliance.¹⁹

¹⁷ This discussion of the National Survey cites aggregate figures that are weighted by EAC and DIF decile to reduce selection bias when projecting the summary statistics to the population of sole proprietors. For example, if five percent of the survey responses came from members of a stratum that made up ten percent of the sole proprietor population, TAS gave the responses from that stratum more weight when computing summary statistics. Except as otherwise indicated, the discussion in this section generally focuses on findings where there are statistically significant differences (at a 95-percent level of confidence) between the high and low-compliance groups.

¹⁸ Most taxpayers in both groups (70 percent) also agreed or strongly agreed that taxes fund important government benefits and services.

¹⁹ 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).

Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results

FIGURE 1, Trust in the Federal Government by Compliance Group**MOST TAXPAYERS BELIEVE TAX LAWS ARE UNFAIR.**

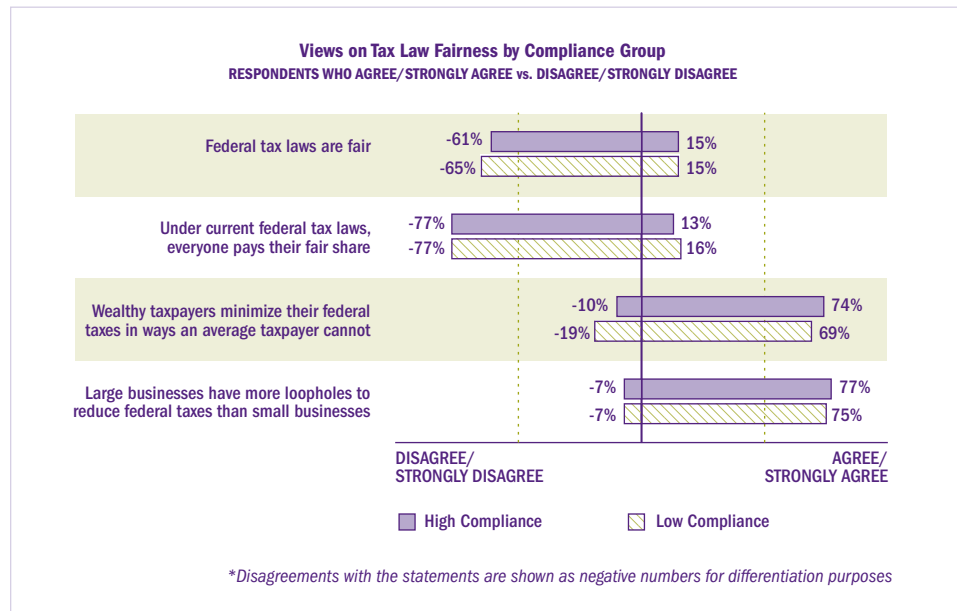
Only 15 percent of both groups agreed or strongly agreed that the tax laws are fair. Rather, most taxpayers believe that:

- Large businesses have loopholes to reduce their taxes that smaller businesses do not have;
- The wealthy have ways of minimizing their taxes that are not available to the average taxpayer;
- Not everyone pays his or her fair share; and
- The federal tax laws are unfair.

However, the low-compliance group was somewhat more likely to view the tax law as unfair than the high-compliance group (65 percent vs. 61 percent for the high-compliance group), which would be consistent with symbolic noncompliance.²⁰ These views may lend support to calls for tax simplification as a way to increase tax compliance.

²⁰ This difference is not statistically significant at a 95-percent level of confidence.

Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results

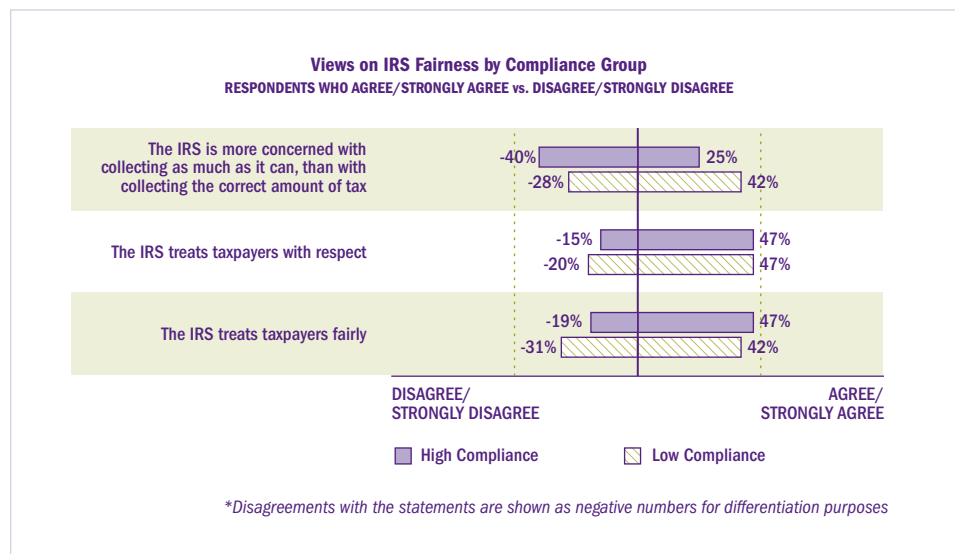
FIGURE 2, Views About Tax Law Fairness by Compliance Group**THOSE IN THE LOW-COMPLIANCE GROUP EXPRESSED LESS FAITH IN THE IRS.**

The low-compliance group generally held more negative views about the IRS, potentially suggesting that negative views of the IRS promote symbolic noncompliance.²¹ For example, those in the high-compliance group were more likely to believe that the IRS treats taxpayers fairly (47 percent of the high-compliance group agreed vs. 42 percent of the low-compliance group). The low-compliance group, by contrast, was more likely to report that the IRS is disrespectful (20 vs. 15 percent), and more concerned with collecting as much as it can than with collecting the correct amount of tax (42 vs. 25 percent — a 17 point difference!). Without adequate safeguards, the IRS's increasing use of automated procedures could give taxpayers this impression, which in turn, may contribute to noncompliance. These results may suggest the IRS could increase compliance by treating taxpayers fairly and publicly committing to initiatives promoting procedural justice and respect for taxpayers, thus promoting positive views about itself.²²

²¹ This inference is consistent with previous research. 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).

²² When IRS computers automatically propose adjustments and issue liens without reviewing all of the available information, the IRS appears more interested in collecting as much as possible than in collecting the correct amount. The National Taxpayer Advocate has suggested a wide range of steps the IRS could take to give taxpayers more confidence in the results of correspondence examinations, math error adjustments, and assessments against nonfilers. See, e.g., National Taxpayer Advocate 2011 Annual Report to Congress vol. 2, 63 (correspondence examination recommendations); National Taxpayer Advocate 2011 Annual Report to Congress 74 (math error recommendations); National Taxpayer Advocate 2011 Annual Report to Congress 93 (nonfiler recommendations). She has also recommended the IRS discontinue the practice of automatically filing the notice of federal tax lien (NFTL). See, e.g., National Taxpayer Advocate 2011 Annual Report to Congress 109, 128 (NFTL recommendations). Moreover, recent research suggest that collection alternatives (i.e., offers and installment agreements) are more closely associated with payment compliance than the automatic filing of a notice of federal tax lien. See *Investigating the Impact of Liens on Taxpayer Liabilities and Payment Behavior, infra*.

Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results

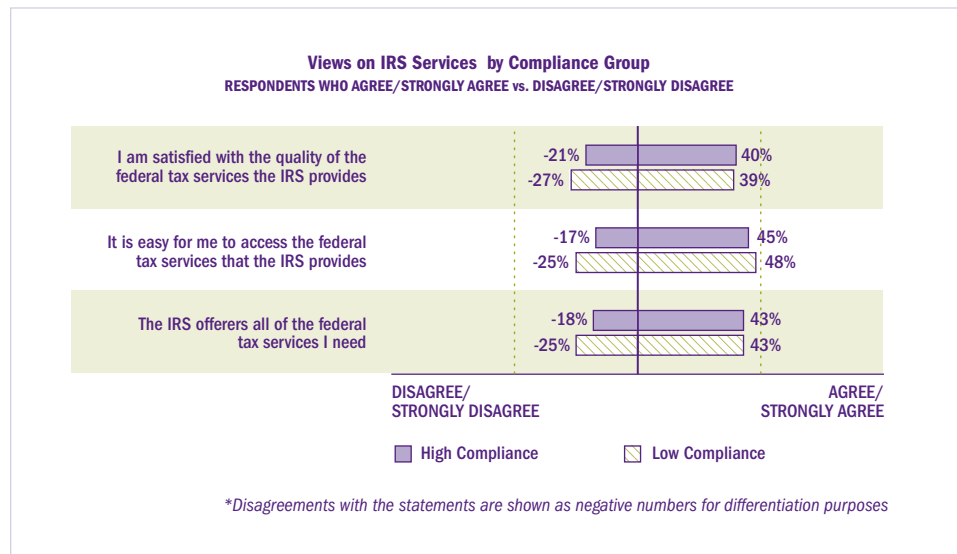
FIGURE 3, Views About IRS Fairness by Compliance Group

On the other hand, the low-compliance group was somewhat more likely to agree “that the IRS will work with you if you have difficulty paying your taxes,” as 55 percent agreed vs. 49 percent for the high-compliance group. However, this view might have a greater effect on payment compliance than on reporting compliance. It could also reflect differences in knowledge about IRS procedures held by the groups. As noted below, the low-compliance group generally had more contact with the IRS.

THOSE IN THE LOW-COMPLIANCE GROUP EXPRESSED LESS SATISFACTION WITH IRS SERVICES.

Those in the low-compliance group were more likely than those in the high-compliance group to report that the IRS does not offer the tax services they need (25 vs. 18 percent), that it is difficult to access the services the IRS provides (25 vs. 17 percent), and that they were more dissatisfied with the quality of the IRS services (27 vs. 21 percent). Thus, a lack of satisfaction with IRS services may contribute to noncompliance (*e.g.*, symbolic, procedural, lazy, or even unknowing noncompliance in terms of the typology), and the provision of better taxpayer services might increase tax revenue by improving compliance.

Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results

FIGURE 4, Views About IRS Services by Compliance Group***Those in the low-compliance group expressed less trust in a preparer.***

Those in the low-compliance group were more likely to report using a preparer than those in the high-compliance group (76 vs. 66 percent). This could be because the low-compliance group contained larger businesses (as noted below), facing larger tax preparation burdens. At least 90 percent of both groups reported that they always follow their preparer's advice, underscoring the importance of brokered compliance and noncompliance.²³ While both groups (79 and 80 percent of the low- and high-compliance groups, respectively) indicated they make sure they understand their return before signing, those in the high-compliance group were more likely to follow their preparer's advice than those in

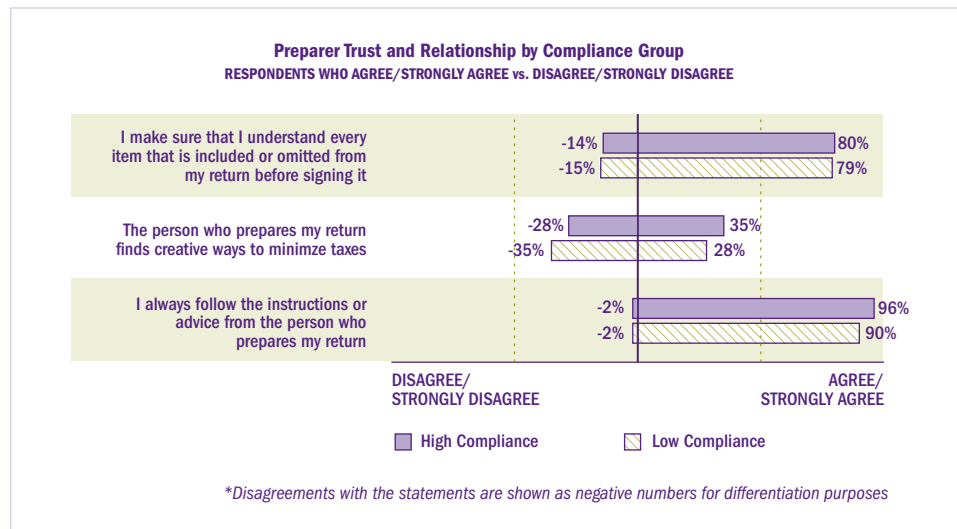
²³ As noted in the 2010 Proposal, the impact of the preparer on compliance probably depends on a combination of both the taxpayer's and the preparer's views toward compliance. Assume there are three types of preparers and taxpayers: (1) those who want to comply; (2) those who are willing to be more aggressive; 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. See National Taxpayer Advocate 2008 Annual Report to Congress, vol. 2, § 3, 73 at 79-81 (Leslie Book, *The Need to Increase Preparer Responsibility, Visibility, and Competence*) (setting forth "The Types of Taxpayers and Preparers").

Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results

the low-compliance group (96 vs. 90 percent). This may suggest that preparers more often facilitate compliance instead of noncompliance.²⁴

Those in the high-compliance group were also more likely than those in the low-compliance group to indicate that the person who prepares their return finds creative ways to minimize their taxes (35 vs. 28 percent). Perhaps the groups had different views about what it means to find creative ways to minimize taxes, with the low-compliance group expecting the preparer to propose more aggressive positions. Another possibility is that those from the low-compliance group may view their preparers as part of the tax system, which they do not trust, as the IRS increasingly enlists preparers in its efforts to improve tax compliance (*e.g.*, by imposing due diligence requirements under Circular 230). Alternatively, those in the high-compliance group may simply seek out better preparers or at least have more meaningful conversations with them.

²⁴ Some research suggests preparers may improve compliance. 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). Other research suggests they do not reliably enhance compliance. 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 their taxes 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 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 Preparers 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).

FIGURE 5, Preparer Trust and Relationship by Compliance Group

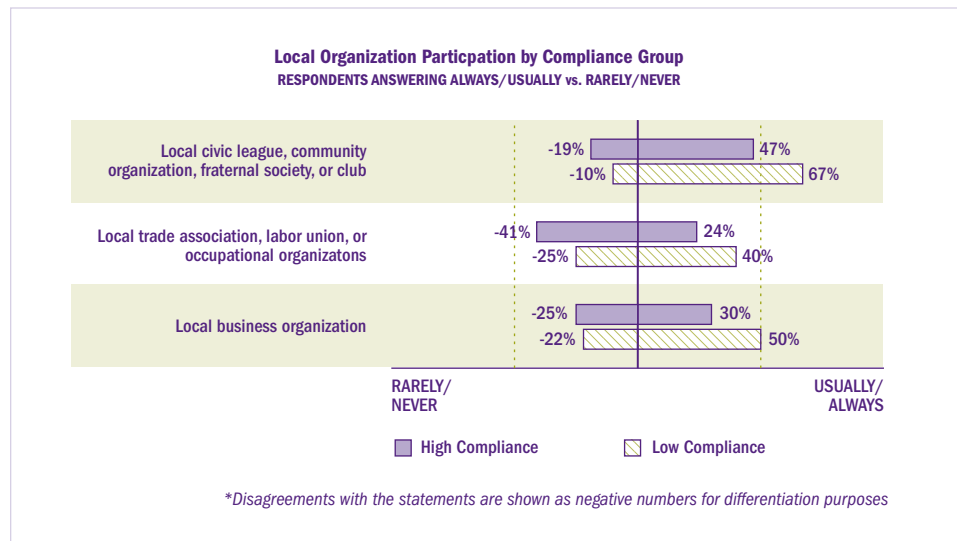
Taxpayers in the low-compliance group were more likely to participate in local organizations and to report that other participants view the law and the IRS negatively.

Taxpayers in the high-compliance group were less likely than those in the low-compliance group to belong to a local business organization (11 vs. 16 percent), a local trade, labor, or other occupational organization (15 vs. 18 percent), or religious congregation (61 vs. 71 percent). To the extent association with these groups transmits local compliance norms, those norms appear to have a negative effect on compliance, rather than a positive one.

THOSE IN THE LOW-COMPLIANCE GROUP WERE MORE LIKELY TO PARTICIPATE IN LOCAL ORGANIZATIONS.

Among respondents who belong to local organizations, those in the low-compliance group were more likely to report that they usually participate. This was true for various organizations identified by the survey, including local business organizations (50 percent from the low-compliance group usually participate vs. 30 percent from the high-compliance group), local trade, labor, or occupational organizations (40 vs. 24 percent), and local civic, community, or fraternal organizations (67 vs. 47 percent). Thus, active participation in these groups appears to be negatively correlated with tax compliance, possibly promoting social noncompliance in terms of the typology. Perhaps those with a closer connection to local groups feel a weaker connection to the federal government, and a weaker obligation to comply with federal tax laws. They may also chose to associate with those who hold similarly negative views about the federal government and tax compliance, which reinforced their own views.

Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results

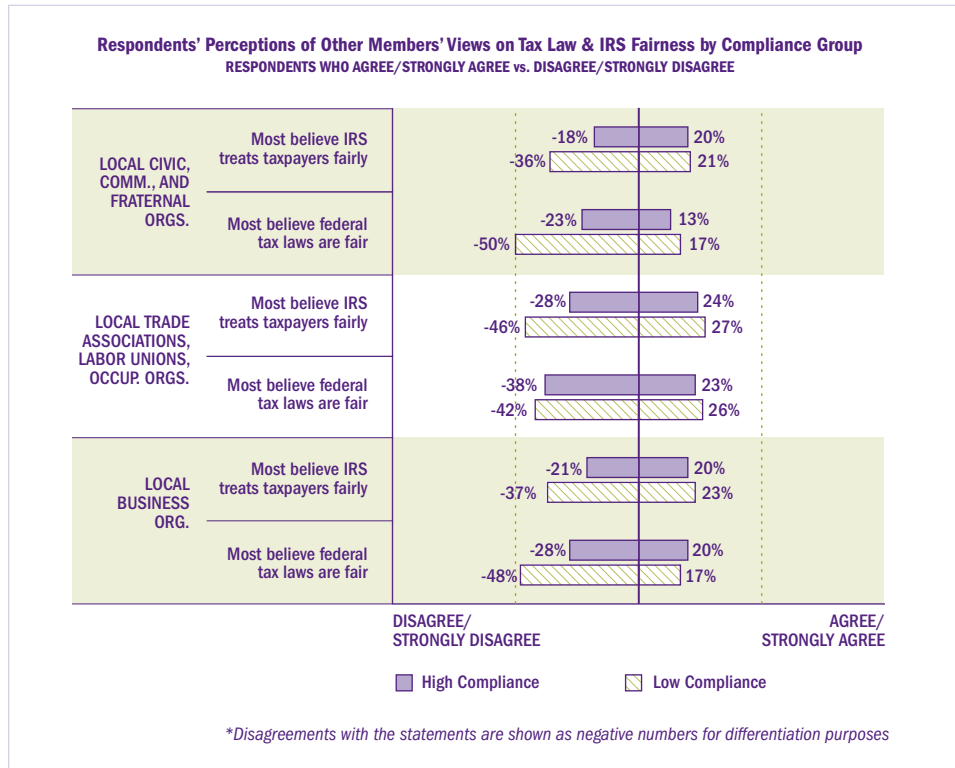
FIGURE 6, Local Organization Participation by Compliance Group**THOSE IN THE LOW-COMPLIANCE GROUP WERE MORE LIKELY TO REPORT THAT OTHER MEMBERS OF LOCAL ORGANIZATIONS VIEW TAX LAWS AND THE IRS NEGATIVELY.**

Those in the low-compliance group were more likely than those in the high-compliance group to report that other members of local business organizations believe tax laws are unfair (48 percent of the low-compliance group vs. 28 percent of the high-compliance group) or that the IRS treats taxpayers unfairly (37 vs. 21 percent). They were more likely to report that other members of local trade, labor and occupational organizations believe tax laws are unfair (42 vs. 38 percent)²⁵ or that the IRS treats taxpayers unfairly (46 vs. 28 percent). They were also more likely to report that other members of local civic, community, and fraternal organizations believe the tax laws are unfair (50 vs. 23 percent) or that the IRS treats taxpayers unfairly (36 vs. 18 percent).²⁶ Participation in these organizations may have allowed taxpayers to learn that noncompliance is an acceptable norm among other participants, or perhaps they assumed that other participants shared their negative views. In any event, the differences in the responses to these questions by members of the high- and low-compliance groups may suggest that a person's perception about whether other participants in local organizations feel the tax law or the IRS is fair has an effect on their own compliance behavior (*e.g.*, social and symbolic noncompliance), perhaps eroding tax morale.

²⁵ This difference is not statistically significant at a 95-percent level of confidence.

²⁶ Curiously, 53 percent of those in the moderate-compliance group also disagreed or strongly disagreed that other members of these organizations believe the IRS treats taxpayers fairly, and the difference between their response and the average response of members of both other groups was statistically significant at a 95-percent level of confidence. Perhaps those in the moderate-compliance group are more concerned about any perceived mistreatment of others by the IRS because they are still trying to comply, whereas more of those in the low-compliance group are slightly less concerned about fairness because they have either given up on the IRS or are noncompliant for other reasons.

Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results

FIGURE 7, Respondents' Perceptions of Other Members' Views About the Fairness of the Tax Law and the IRS by Compliance Group²⁷

WHILE MOST RESPONDENTS REPORTED THAT SMALL BUSINESSES COMPLY, THOSE IN THE HIGH-COMPLIANCE GROUP WERE MORE LIKELY TO REPORT THAT THEIR COMPETITORS DO NOT.

According to social norms and reciprocity theories, taxpayers who believe most other taxpayers comply are more likely to reciprocate by complying.²⁸ However, the survey did not find that those in the high-compliance group were more likely to report that competitors were complying. Rather, those in the high-compliance group were less likely to do so — agreeing that most of their competitors report all of their income only 22 percent of the time as compared to 31 percent for the low-compliance group.²⁹ Moreover, there was no significant difference in the views of each group about whether many small businesses report all of their income (26 percent of the high-compliance group agree and 15 percent disagree, but 27 percent of the low-compliance group agree and 16 percent disagree).³⁰

²⁷ Taxpayers were asked to provide a response with respect to members of the local organization(s) with which they most closely associate.

²⁸ See, e.g., Dan M. Kahan, *The Logic of Reciprocity: Trust, Collective Action, and Law*, 102 Mich. L. Rev. 71 (Oct. 2003).

²⁹ However, most respondents (60 percent overall) were non-committal, indicating they “don’t know” or “neither agree or disagree.”

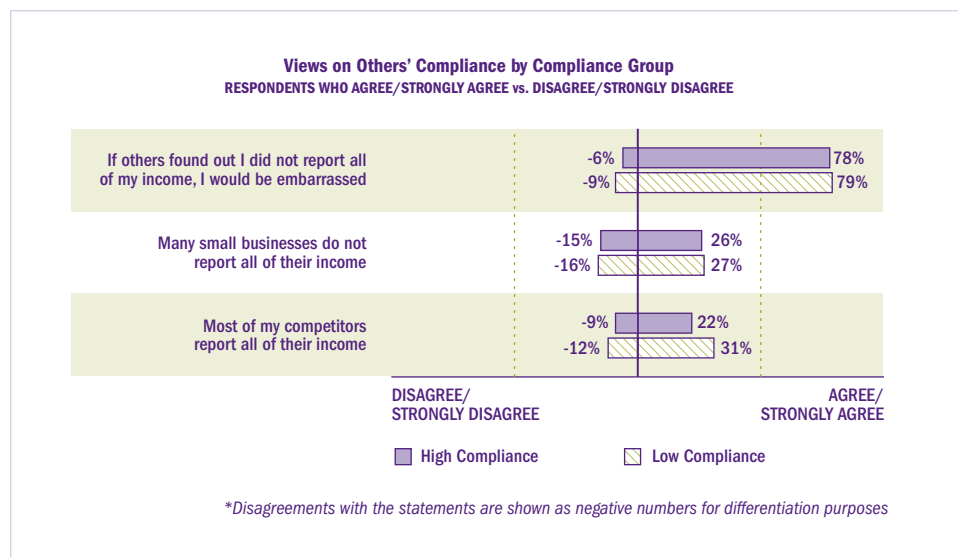
³⁰ Both groups also reported that small businesses could survive even if they reported all of their income (54 percent of the high-compliance group vs. 56 percent of the low-compliance group). These differences are not statistically significant at a 95-percent level of confidence.

Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results

Most members of both groups also reported that they would be embarrassed if others found out they did not report all of their income. It is possible that the low-compliance group answered these questions defensively or feigned innocence — to avoid giving the impression that they were cheating or that the government should do more to address non-compliance. Nonetheless, these results do not directly support the notion that social norms and reciprocity (at least among “most competitors”) drive compliance decisions. As noted above, the views of other members of local organizations toward the IRS seemed to have a greater correlation with compliance than whether most competitors comply. Perhaps the norms of that peer group are more important than the norms of competitors, though both groups said they would be embarrassed if others learned they were noncompliant.

In other words, the tax compliance decision may be less about the views of others or economics, and more about how the business views itself in relation to the federal government. As noted above, those with negative views toward the federal government more often associate with like-minded individuals at the local level.

FIGURE 8, Views on Others' Compliance by Compliance Group



SMALLER BUSINESSES WITH LOCAL CUSTOMERS AND THOSE IN PROFESSIONAL OR TECHNICAL BUSINESSES WERE MORE OFTEN IN THE HIGH-COMPLIANCE GROUP.

The low-compliance group had larger businesses. The low-compliance group had an average of about seven employees, as compared to about four for the high-compliance group. Similarly, the low-compliance group had average gross receipts of about \$87,000, as compared to about \$46,000 for the high-compliance group.³¹ The low-compliance group also identified its customers as “primarily national” more frequently — 19 percent of the time — as compared to 17 percent for the high-compliance group. While the difference is small, this finding is somewhat curious in light of the finding that those in the low-compliance group feel a closer connection to local organizations than national ones, though some local organizations may be local chapters of national ones. Of course, business owners may feel more of a connection to local organizations that they chose to associate with than to customers with whom they may not interact in this age of e-commerce.

Another explanation could be that as businesses grow, the economic benefit of noncompliance increases but the expected penalty does not — a finding consistent with economic deterrence theory. However, this explanation seems inconsistent with the notion that smaller businesses, which are more likely to have informal accounting systems and deal in cash, are less likely to be compliant than larger ones that need to have formal financial accounting systems to prevent theft and to reflect any positive net income on those systems and their tax returns to obtain financing.³² However, even businesses in the low-compliance group were relatively small, possibly small enough to retain informal accounting systems.

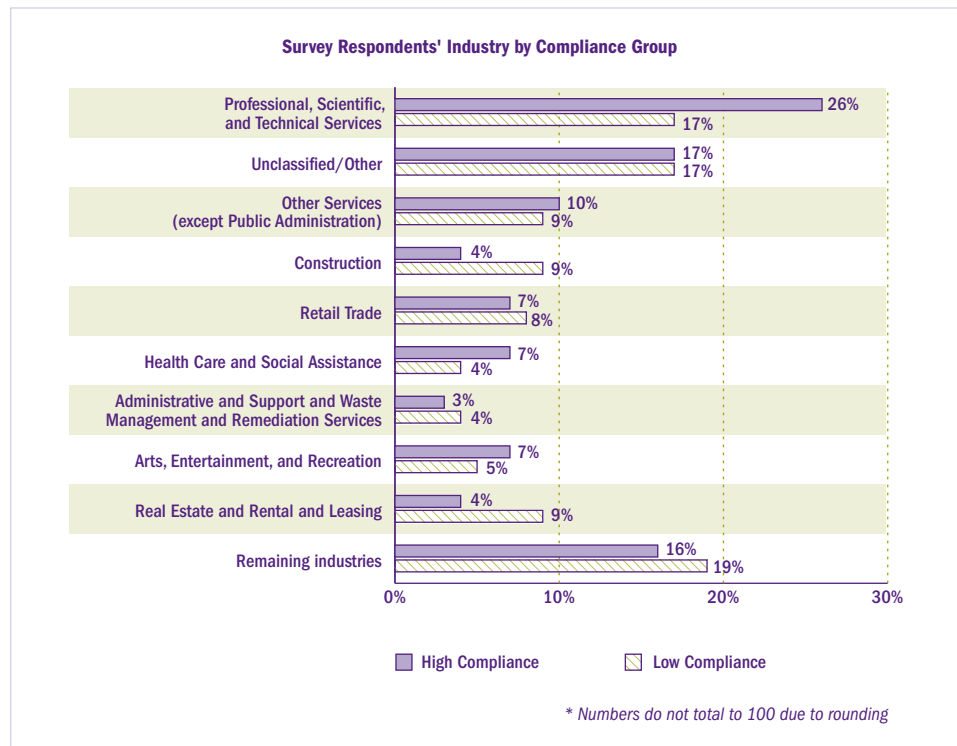
Taxpayers in construction-related and real estate-related industries appeared to be less compliant than those in other industries, as they each comprised nine percent of the low-compliance group, but only four percent of the high-compliance group. By comparison, those in professional and technical service industries appeared to be more compliant, comprising 26 percent of the high-compliance group and 17 percent of the low-compliance group.³³ Perhaps information reporting, which generally promotes compliance, was more prevalent among professional and technical service industries than in construction and real estate. Industry-related norms, the type of noncompliance involved, or the type of taxpayers involved, as described below in our analysis of the Community Survey, could also have played a role.

³¹ Concerned that some taxpayers might have lower DIF scores simply because they have less income that is not subject to information reporting, and thus less opportunity to cheat, TAS analyzed the sample further. TAS looked at all income sources (not just Schedule C income) and found that taxpayers in the high-compliance group from each EAC strata reported a significant amount of income that is not subject to information reporting. Thus, while income transparency likely affects reporting compliance, its effect on a person’s DIF score, if any, does not always overshadow other factors.

³² As noted above, the accuracy of the DIF scoring algorithm could affect the results. For example, if the DIF overestimates the actual compliance of small cash businesses, which generate income that is difficult to detect, then the results would indicate that small businesses are more compliant than they actually are.

³³ Under “professional, scientific, and technical services,” the North American Industry Classification System (NAICS) includes legal, accounting, engineering, design, computer, management, research, and advertising services.

Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results

FIGURE 9, National Survey Respondents' Industry by Compliance Group***Both high- and low-compliance groups professed a “moral” obligation to report income accurately.***

Nearly all — 96 percent of both groups — feel a moral obligation to report all of their income correctly. Moreover, those in the low-compliance group were more likely to say that everyone should correctly report all of their income — 97 percent of the low-compliance group agree vs. 94 percent of the high-compliance group.³⁴ However, the low-compliance group may have answered these questions aspirationally (*e.g.*, they may not be living up to their aspirations because tax morale does not drive their tax compliance behavior) or defensively, to avoid making an admission.

Economic deterrence may not drive compliance decisions by those in either the high- or low-compliance groups.

Those in the low-compliance group were more likely than those in the high-compliance group to report that achieving financial success is important (88 vs. 85 percent) and that taking risks is necessary to achieve financial success (68 vs. 61 percent).³⁵ One might

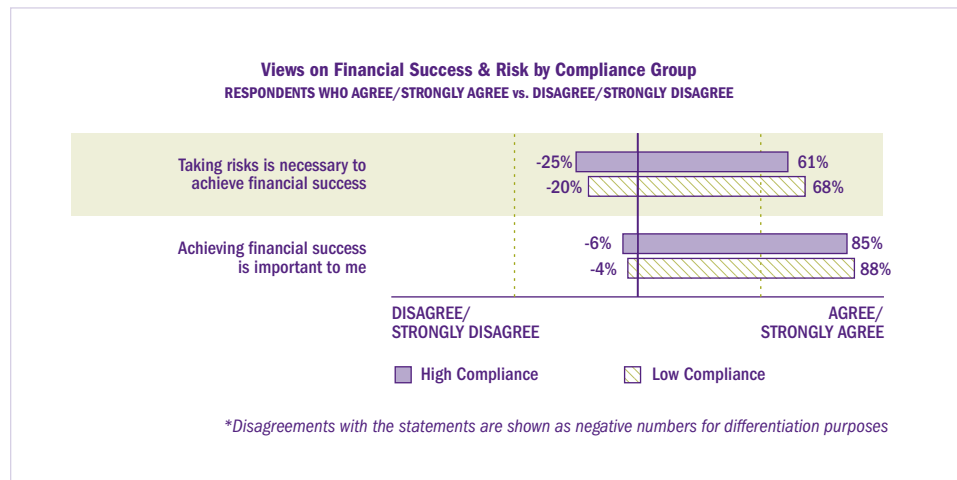
³⁴ This difference was not statistically significant at a 95-percent level of confidence.

³⁵ Those in the low-compliance group were also more likely to be male. Males are often thought to have less aversion to risk. See, *e.g.*, Alexandra Niessen and Stefan Ruenzi, *Sex Matters: Gender Differences in a Professional Setting*, Ctr. for Fin. Research, Working Paper No. 06-01, 14 (Feb. 2007), available at <http://hdl.handle.net/10419/57738>.

Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results

expect people who express financial concerns, as both groups did, to be motivated by economic deterrence.

FIGURE 10, Views on Financial Success & Risk by Compliance Group



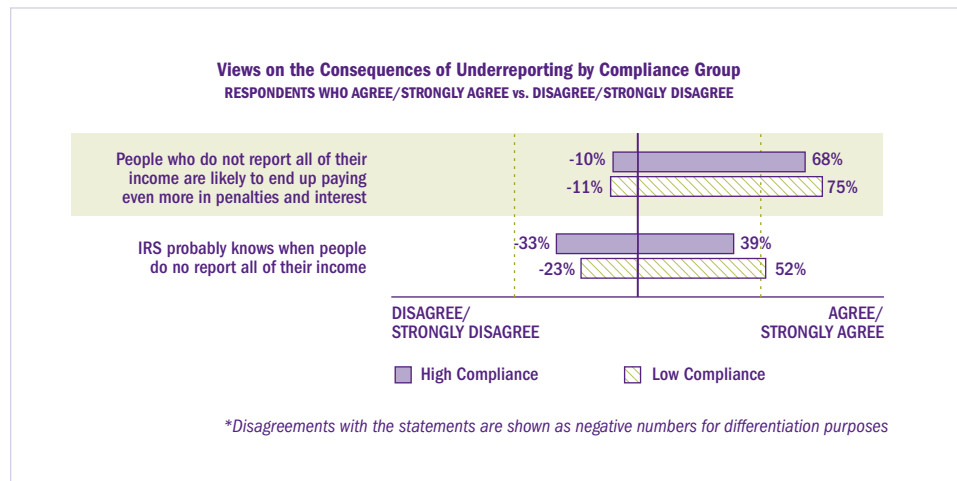
However, the survey responses provide little support for the view that economic deterrence has an effect on reporting compliance. In terms of the typology, the survey did not reveal asocial noncompliance. On one hand, those in the low-compliance group were more likely to agree that hearing about people who were caught underreporting makes them more careful with their own taxes (66 percent vs. 61 percent for those in the high-compliance group), a response consistent with the notion that economic deterrence (or a lack thereof) has a stronger effect on their compliance decisions than on those of respondents in the high-compliance group.³⁶

On the other hand, those in the low-compliance group were also more likely to agree that the IRS probably knows when people do not report all of their income (52 percent vs. 39 percent for those in the high-compliance group); and that people who do not report all of their income are more likely to end up paying even more in penalties and interest (75 vs. 68 percent). If economic deterrence was a motivating factor for those in the low-compliance group, then (if answering truthfully) they might agree more often than those in the high-compliance group that it pays to cheat. They did not. Thus, the responses to these questions do not support the notion that a lack of economic deterrence drives noncompliance for those in the low-compliance group.³⁷

³⁶ This difference was not statistically significant at a 95-percent level of confidence. Of course, most people in both groups did acknowledge that such statements make them more careful, lending some support to economic deterrence theory.

³⁷ Of course it is possible that those in the low-compliance group answered these questions defensively – to avoid the implication that they may not have reported all of their income.

Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results

FIGURE 11, Views on the Consequences of Underreporting by Compliance Group

Alternatively, even though those in the low-compliance group generally do not believe it pays to cheat, they have slightly larger businesses, slightly more employees and may be willing to take more risk on their taxes if necessary to expand their businesses or to meet payroll, particularly if the alternative is to discontinue operations.³⁸ These are the same reasons that small businesses sometimes fail to make employment tax deposits.³⁹

Another possibility is that responses by the small subset of the low-compliance group that had actually been caught cheating affected the results. Those in the low-compliance group had been subject to IRS examination or collection contacts more often than those in the high-compliance group. Nine percent of the low-compliance group had been subject to an IRS examination, as compared to two percent of the high-compliance group.⁴⁰ Similarly, three percent of the low-compliance group had been subject to IRS collection activity as compared to one percent of the high-compliance group.⁴¹

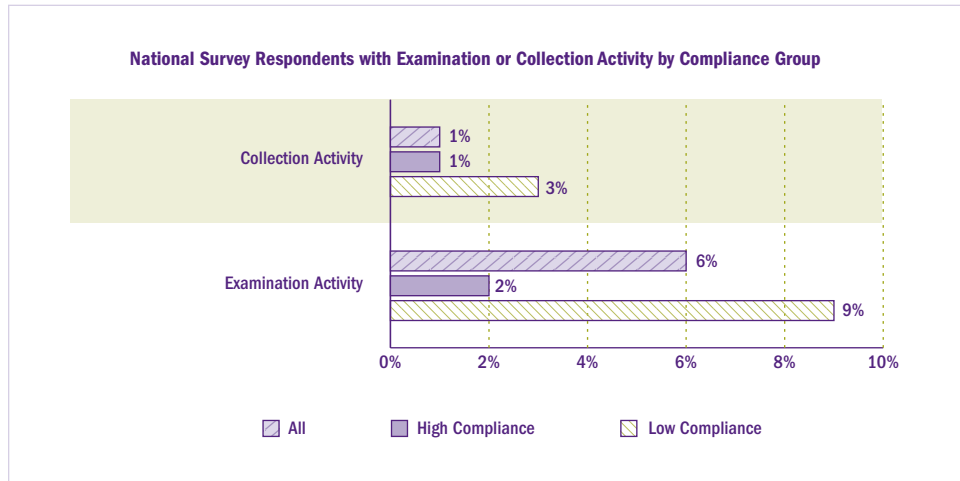
³⁸ Indeed, the low-compliance group was more likely to agree that you have to take risks to succeed.

³⁹ See, e.g., SB/SE Research, 2009 Nationwide Tax Forum Focus Groups, DEN0116, *Your Clients and the Economy – How Can the IRS Help?* 3 (Jan. 2010) (“Because there is no money to pay expenses and meet obligations, participants stated that small business taxpayers are experiencing a number of secondary effects to include: falling behind on payments; not filing tax returns on time (or at all); going ‘underground’; and ‘burying their heads in the sand’.... [t]he IRS is not seen as a priority because small business taxpayers do not experience any immediate consequences of noncompliance. Therefore, payroll taxes and estimated taxes are last on the list.”). Consistently, IRS research finds that taxpayers who owe a balance upon filing their returns are more likely than others to understate their tax liabilities. See Charles Christian, Phoenix District Office of Research and Analysis, *The Association Between Underwithholding and Noncompliance* 1-2 (July 14, 1995) (finding that “[o]n average, understated tax on balance due returns is ten times as large as understated tax on other returns.”).

⁴⁰ IRS, Collection Data Warehouse (2012).

⁴¹ *Id.*

Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results

FIGURE 12, Percentage of National Survey Respondents Subject to IRS Examination or Collection Activity by Compliance Group***Views about complexity were mixed, but most agreed the tax rules are so complicated it is very difficult to get a tax return exactly right.***

Researchers have suggested that taxpayers who face complicated rules may be unable to comply, or may use complexity as a reason to justify noncompliance.⁴² Survey responses about complexity were mixed and provide little insight about how complexity or burden affects compliance. On one hand, most taxpayers (more than 73 percent in both groups) agreed that their record-keeping system made it easy to compute their income tax. Most (about 64 percent overall) also agreed that the rules about what to report as income are clear. Thus, while complexity may have been a barrier to compliance for some, it was not a significant barrier for most respondents.

On the other hand, as noted above, most (70 percent of those who had tax preparation assistance) reported that they did not know the tax laws well enough to prepare their own returns. In addition, most agreed that the tax rules are so complicated that it is very difficult to get a tax return exactly right (56 percent overall agreed). However, taxpayers in the high-compliance group were more likely to agree with this statement than those in the low-compliance group (62 vs. 58 percent). Perhaps taxpayers in the high-compliance group were more concerned about making inadvertent errors than those in the low-compliance group.

⁴² 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).

Summary of the National Survey Results

Respondents from the low-compliance group were more likely to report that the government is too big and wastes tax dollars, that tax laws are unfair, and that the IRS is unfair (*e.g.*, often believing the IRS is more concerned with collecting as much as possible instead of the correct amount, and indicating less satisfaction with IRS services). Members of the low-compliance group may have used these beliefs to justify noncompliance.

Surprisingly, respondents in the low-compliance group were more likely than those in the high-compliance group to believe that the IRS detects and penalizes noncompliance. This finding may seem inconsistent with the popular belief that small businesses cheat on their taxes because they do not think they will get caught (*i.e.*, insufficient economic deterrence).⁴³

Both groups were idealistic, professing that it is morally wrong to cheat. Most members of both groups also reported that they would be embarrassed if others discovered they did not report all of their income. For those in the low-compliance group, however, other factors may have overshadowed these positive moral convictions and social pressures.

Those in the low-compliance group were more likely than those in the high-compliance group to participate in local organizations, which one might expect to be a source of positive tax compliance norms. However, they were more likely to report that other members of these organizations believe the law and the IRS are unfair, potentially counteracting the positive influence these affiliations might otherwise have had on tax compliance. Moreover, the closer association with local organizations by members of the low-compliance group could have undermined their connection with the nation and the national tax system as a whole.

The norms of competitors appeared to have little correlation with compliance. This may suggest that norms do not operate by reference to competitors. Rather, the views of other participants in local organizations may be more important.

Those in the low-compliance group operated slightly larger businesses and were somewhat more likely to use a preparer who could have persuaded them to comply or facilitated noncompliance — brokered compliance (or noncompliance) in the typology above. However, they were also less likely to follow the preparer's advice than those in the high-compliance group, potentially weakening any positive influence that the preparer sought to exert.

⁴³ See, *e.g.*, Susan Morse, Stewart Karlinsky, and Joseph Bankman, *Cash Businesses and Tax Evasion*, 20 *Stan. L. & Pol'y Rev.* 37 (2009) (discussing anecdotal accounts of cash businesses that did not expect the IRS to discover underreporting). This finding does not necessarily imply that taxpayers are economically irrational, particularly if they have no other source of financing and face the choice of either going out of business or underreporting. If a taxpayer could possibly use the temporary tax "savings" from underreporting to earn more than the likely tax, penalties and interest, which the IRS might collect later, then it may be rational for the taxpayer to underreport income even if he or she expects that the IRS will detect the noncompliance and impose penalties and interest. Moreover, other survey responses suggest that the low-compliance group was less risk averse than the high-compliance group.

Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results

By contrast, respondents from the high-compliance group, while slightly smaller and less likely to use a preparer, were more likely to follow the preparer's advice. They were also less likely to participate in local organizations, suggesting that their compliance level was not social but motivated rather by morality, trust in government, trust in the IRS, or other internal factors contributing to high tax morale. It is unclear if affiliations and communications with those in local organizations who have little faith in government, federal tax law, and the IRS erodes the force of one's tax morale, or if those who become noncompliant seek to affiliate with those who would be more likely to feel that noncompliance was justified.

In either case, these results may suggest that the government could improve reporting compliance by improving the perceived fairness and efficiency of the government, the tax law, and the IRS; and by simplifying the tax code, improving procedural protections, and minimizing the IRS's reliance on procedures that may seem unfair (*e.g.*, excessive automation and lack of personal contact).⁴⁴ To address the perception by members of local groups that the tax law and the IRS are unfair, the IRS might retain a local presence and conduct outreach and education events for these groups, particularly in low-compliance communities (discussed below).⁴⁵

Key Findings of the Community Survey.

According to the 2010 Proposal, the Community Survey was to address:

What types of communities have homogeneous compliance attitudes? What local social practices, institutions (*e.g.*, volunteer, educational, and religious institutions), or attitudes increase or decrease compliance at the 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?⁴⁶

One possibility was that the high-compliance communities would be homogeneous towns where residents have strong ties to local groups and institutions. This view could arise from the theory that social norms promote compliance. The Community Survey results offer a significantly different view. In short, like those in the low-compliance group, those in low-compliance communities appear to exhibit a stronger association with local

⁴⁴ See, *e.g.*, National Taxpayer Advocate 2009 Annual Report to Congress 3 (Most Serious Problem: *The Time for Tax Reform is Now*) (summarizing tax simplification proposals); *Complexity and the Tax Gap: Making Tax Compliance Easier and Collecting What's Due*, hearing before the S. Comm. on Finance (June 28, 2011) (testimony of Nina E. Olson, National Taxpayer Advocate) (same); National Taxpayer Advocate 2007 Annual Report to Congress 275 (Most Serious Problem: *The Accuracy-Related Penalty in the Automated Underreporter Units*) (recommending that IRS computers stop proposing negligence penalties); National Taxpayer Advocate 2008 Annual Report to Congress, vol. 2, at 2 (*A Framework for Reforming the Penalty Regime*) (proposing improvements to the penalty regime); National Taxpayer Advocate 2011 Annual Report to Congress 524 (recommending limits on expansion of IRS math error authority); *Options for Expanding the Remedies to Address Taxpayer Rights Violations*, *supra* (proposing remedies to strengthen procedural protections).

⁴⁵ See, *e.g.*, National Taxpayer Advocate 2009 Annual Report to Congress 346-50 (legislative recommendation to require at least one appeals officer and one settlement officer in each state); National Taxpayer Advocate 2008 Annual Report to Congress 176, 192 (Most Serious Problem: *Local Compliance Initiatives Have Great Potential but Face Significant Challenges*) (recommending ways to enhance local compliance initiatives). TAS has at least one office in each state and Local Taxpayer Advocates routinely conduct outreach to local groups.

⁴⁶ 2010 Proposal at 86-87.

Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results

institutions than national ones such as the federal government. Moreover, in constructing the Community Survey sample (described above), TAS discovered that taxpayers with high-compliance are not concentrated in homogeneous communities, at least not very many of them. Taxpayers in the low-compliance communities appeared in more concentrated geographic clusters across the country, especially in the South and West, as set forth below.

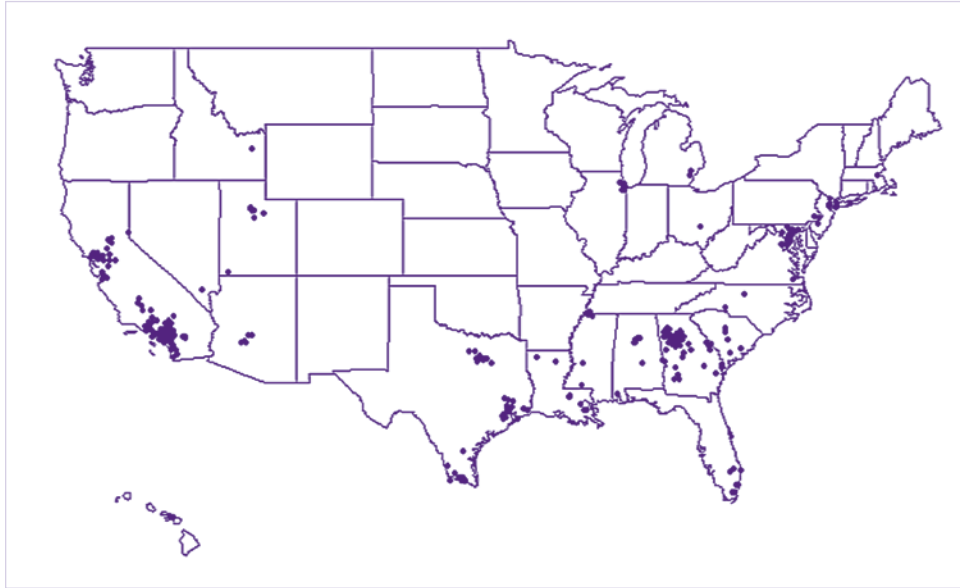
Taxpayers in the high-compliance communities were more geographically dispersed than those in the low-compliance communities.

As discussed above, to identify survey respondents, who were sole proprietors, TAS used the DIF, an IRS index of the probability of audit changes based on reported line items and their values. While this measure may be imperfect, it is not geographically biased. Consequently, it was uncertain whether returns with similar compliance levels, as measured by DIF, would cluster geographically. From all areas, cities, and towns, in the U.S., those with median DIF scores in the top or bottom 30 percent constituted the low- or high-compliance communities, respectively.⁴⁷ As it turned out, populations ranging from 20,000 to 414,000 had measurably low compliance in 365 areas, cities and towns. At the same time, populations ranging from 22,000 to 60,000 had measurably high compliance in a few sites. The site selection process confirms a geographic aspect of tax compliance. In particular, low compliance levels clustered in geographic communities, while high compliance levels were more individually dispersed.

The map below shows that low-compliance communities appeared in twenty-four states. The map shows concentrations of low compliance, as measured, where it may become socially acceptable. The map reflects the locations of low-compliance communities but not their populations, some of which were larger than others. The site selection process was not an enforcement screen, lacking indicators of type or magnitude of noncompliance. Instead, the map helps visualize the social nature of noncompliance. The geographic observation raises issues about fostering communities of compliance given a social aspect to noncompliance.⁴⁸

⁴⁷ TAS identified geographic communities from the addresses with Zip codes reported by the taxpayers on their returns, generally cities, towns, or other distinct areas as denominated by the U.S. Postal Service.

⁴⁸ Geographers have classified regions of the U.S. based on local history, values, behavior, and culture. See Colin Woodard, *AMERICAN NATIONS: A HIST. OF THE ELEVEN RIVAL REGIONAL CULTURES OF No. AMER.* (N.Y.: Viking, 2011); Joel Garreau, *NINE NATIONS OF No. AMER.* (Boston: Houghton Mifflin, 1981); Raymond Gastil, *CULTURAL REGIONS OF THE U.S.* (Seattle: Univ. of Wash. Press, 1975); Wilbur Zelinsky, *CULTURAL GEOGRAPHY OF THE U.S.* (Prentice Hall, 1973).

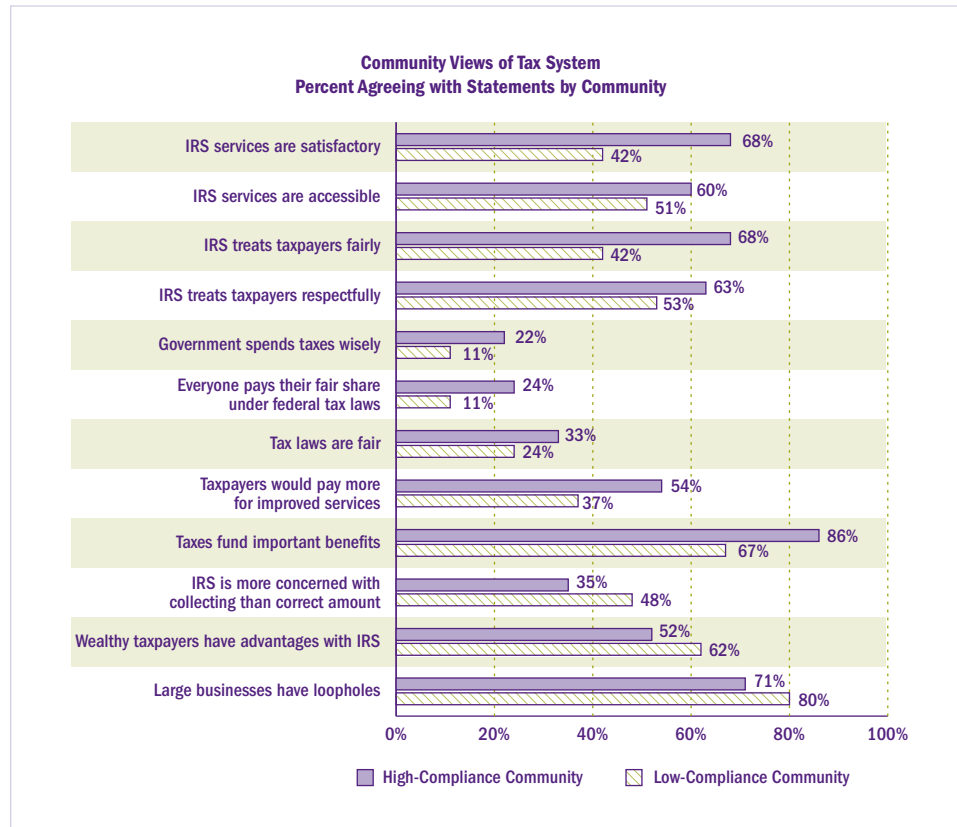
FIGURE 13, Map of Low-Compliance Communities

Respondents from low-compliance communities were suspicious of the tax system and its fairness, whereas those from high-compliance communities responded positively to government.

Respondents from low-compliance communities believed that large businesses and wealthy taxpayers have loopholes or advantages with the IRS (80 percent vs. 71 percent of those from the high-compliance communities, and 62 vs. 52, respectively), which is more concerned with collecting as much as it can rather than the correct amount (48 vs. 35 percent). On the other hand, those from high-compliance communities felt that taxes fund important benefits (86 vs. 67 percent of those from low-compliance communities); taxpayers would pay more for improved services (54 vs. 37); tax laws are fair (33 vs. 24); everyone pays their fair share under federal tax laws (24 vs. 11); and the government spends taxes wisely (22 vs. 11). Similarly, those from high-compliance communities felt the IRS treats taxpayers respectfully (63 vs. 53) and fairly (68 vs. 42) with accessible (60 vs. 51) and satisfactory services (68 vs. 42).

Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results

FIGURE 14, Community Views of Tax System



While taxpayers in the low-compliance communities may tend to identify less with federal agencies, respondents from the high-compliance communities identified with the nation as a whole. In terms of the factors introduced above, respondents from high-compliance communities expressed trust in government, while the responses of the low-compliance group suggested a symbolic type of noncompliance.

Respondents from high-compliance communities were more likely to rely on preparers.

A substantial majority of the respondents from high-compliance communities used a third-party preparer (86 vs. 65 percent of low-compliance respondents) and always followed that person's advice (98 vs. 89 percent). Nevertheless, those from high-compliance communities made sure to understand the return before signing (91 vs. 84 percent from low-compliance communities).

Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results

Among business classifications, the biggest cluster in low-compliance communities was under “professional, scientific, or technical services”; in high-compliance communities, the “other” service industry.

Respondents from the high-compliance communities most frequently clustered in “other services” (22 percent vs. 11 percent of low-compliance respondents), whereas those from the low-compliance communities most frequently clustered in “professional, scientific, or technical services” (22 vs. 11 percent from the high-compliance communities).⁴⁹ Those from the high-compliance communities were more than twice as likely to speak a language other than English at home (22 vs. 9 percent from the low-compliance communities). The Community Survey may have identified a unique type of “social” compliance related to a particular socio-economic experience, that of a linguistic minority employed in the service industry who expressed trust in government.

Low-compliance community respondents reported more participation in civic institutions than their high-compliance community counterparts.

Low-compliance community respondents were more likely than high-compliance community respondents to belong to a trade association (20 percent vs. 10 percent), volunteer organization (67 vs. 58), or church or other religious congregation (81 vs. 74),⁵⁰ and to vote (73 vs. 64) or send children to local schools (52 vs. 37).⁵¹ Within those affiliations, those from low-compliance communities were more likely to disagree (or strongly disagree) with the propositions that most members believe the tax laws and IRS are fair (respectively, 29 vs. 18 and 25 vs. 15 for volunteer organizations; 32 vs. 16 and 26 vs. 13 for churches; and 29 vs. 14 and 20 vs. 9 for elected officials).⁵² In other words, those from the low-compliance communities tend to belong to groups, which they believe share the view that taxes are unfair. In terms of the factors introduced above and the typology of noncompliance, set forth in Table 1, *Typology of Noncompliance*, above, these affiliations may be a form of social noncompliance.⁵³

⁴⁹ Under “other” services, NAICS includes repair & maintenance, personal & laundry, civic & social, and private household services.

⁵⁰ This difference is not statistically significant at a 95-percent level of confidence.

⁵¹ This trend was generally consistent with that in the National Survey, except there frequency of voting among the low-compliance group was not higher than that of the high-compliance group.

⁵² Additional comparisons, not statistically significant at a 95-percent level of confidence, were 55 vs. 47 percent and 46 vs. 36 for trade associations, and 42 vs. 15 and 37 vs. 9 for parents.

⁵³ If taxpayers from a low-compliance community feel that they have a support group in certain institutions – social noncompliance – then civic education addressing those institutions could leverage enforcement efforts. Civic education would mean not technical training on particular tax provisions, but “the cultivation of the virtues, knowledge, and skills necessary for political participation.” Amy Gutmann, *DEMOCRATIC EDUCATION* (Princeton Univ. Press, 1987) 287. Maintaining a low level of tax compliance may be a form of political non-participation motivated by a skepticism of fairness in taxation – symbolic noncompliance – as described in the typology of noncompliance. Thus, popular dissemination of information about the institutions that ensure fairness, e.g., the checks and balances created by an independent judiciary and Congressional oversight, could be a responsive form of civic education.

Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results

FIGURE 15, Taxpayer Participation by Type of Association and Community

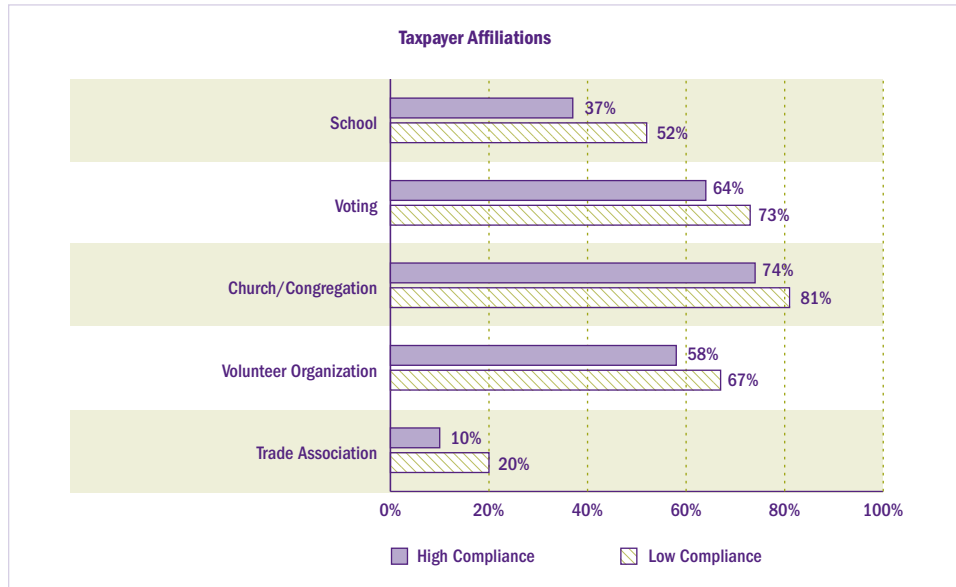
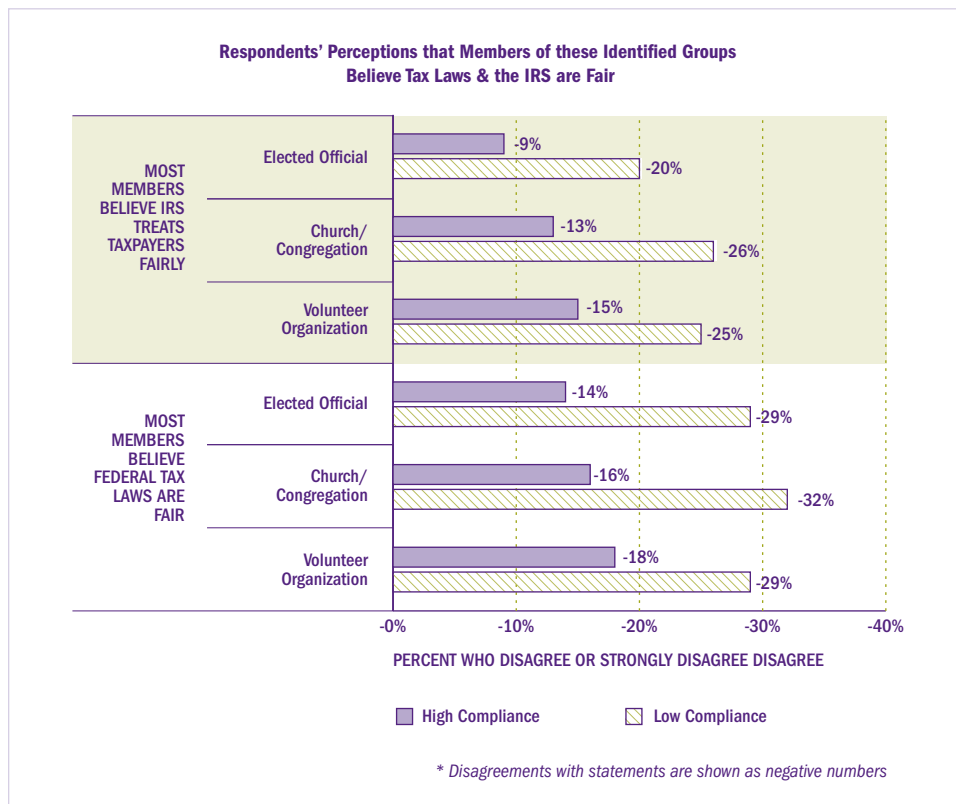


FIGURE 16, Respondents' Perceptions that Members of These Identified Groups Believe Tax Laws & the IRS are Fair



High-compliance community respondents were motivated by morals and deterrence.

High-compliance community respondents felt that tax reporting was a moral obligation (98 percent vs. 92 percent of those from low-compliance communities) and would be embarrassed if others found out they had under-reported (90 vs. 76 percent). Similarly, the high-compliance community respondents were risk-averse, more frequently agreeing that hearing about people who were caught under-reporting would make them more careful (86 vs. 70 percent). Conversely, respondents from low-compliance communities evidently were not deterred despite their belief that the IRS probably knows when people under-report income (62 vs. 52 percent from the high-compliance communities). An inference could be made that deterrence efforts affect those predisposed to compliance.

The effect on compliance of financial concerns by those in high- or low-compliance communities was unclear.

Paradoxically, respondents from high-compliance communities were more likely to feel that most small businesses could not survive if they reported all of their income (23 percent vs. 16 percent of low-compliance community respondents). However, the National Survey did not reproduce this result (12 vs. 15 percent of the low-compliance group).⁵⁴ In terms of the factors discussed above, it is unclear that deterrence motivated compliance. In terms of the typology introduced above, “asocial” noncompliance due to financial incentives did not appear as a major force in the Community Survey.

Those in the high- and low-compliance communities responded similarly to questions addressing complexity.

Both groups responded without significant difference to questions about how complicated the tax rules are (64 percent of the highly-compliant vs. 63 percent of low-compliance respondents) and the clarity of income reporting rules (73 vs. 68 percent). Consequently, the Community Survey did not reveal significant procedural, “lazy,” or unknowing noncompliance.

Summary of the Community Survey Results

The Community Survey focused on areas that did not represent the nation as a whole but did represent locales where tax compliance levels were markedly low or high. The site selection process identified hundreds of low-compliance communities, indicating a social aspect of noncompliance consistent with questionnaire responses showing a high degree of social affiliations. On the other hand, there were so few high-compliance communities as to make them prototypical rather than typical. The high-compliance communities may have had unique experiences with government contributing to an ideal type of “social compliance” that could be the obverse of social noncompliance typology. Additionally, the high-compliance communities responded positively to morals and preparers as well as deterrence. By contrast, the low-compliance communities evidently were not deterred even

⁵⁴ This difference is not statistically significant at a 95-percent level of confidence.

Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results

though they believed that the IRS could detect under-reporting. The combination of risk tolerance and geographic concentration of low-compliance communities could form the basis for targeted innovation in tax administration that would go beyond deterrence toward the social and moral factors underlying compliance.

Preliminary Observations

As reflected in the 2007 Review, social norms and related factors may explain tax compliance. As discussed above, TAS designed a survey questionnaire to probe into norms and related factors. While this survey elicited direct responses from taxpayers, the “social” nature of norms should be observable even beyond these responses, potentially by observing characteristics of the high- and low-compliance communities or regions. Future research could build upon the survey results by investigating social noncompliance and social compliance in sites where they occur.⁵⁵ While tax reporting may be a private decision, compliance levels appear to depend on values that are shared or at least commonly understood.⁵⁶

Commonly understood values are social or geographic, and therefore susceptible to study through market research or public sources beyond the questionnaire. What is the “means of communicating these learned beliefs, memories, perceptions, traditions, and attitudes that serves to shape behavior”?⁵⁷ Not all behavior stems from local interaction.⁵⁸ Yet geographically-dispersed populations, such as diasporas with common origins in the past, or virtual communities on the Internet, may be exceptions that prove the rule.⁵⁹ Like tax administration as a whole, compliance research could advance by meeting taxpayers where they are, in geographic locations where they build communities around common behavior.

In this study, tax compliance has turned out to be “retail.” Clusters of measurably similar compliance levels may lie in a cultural region. While individual predispositions like risk aversion are factors, they are expressed within regional norms.⁶⁰ Seemingly non-geographic behavior may exhibit regional effects that researchers have isolated using statistical techniques such as “regression analysis” — analysis used to understand how a “dependent

⁵⁵ Whereas the survey method may be consistent with “[m]ost theories in social science today” which “are based on the assumption that individuals are atomistic and thus independent of one another,” this assumption “leaves unresolved the problem of accounting for the order one finds in society.” James Duncan, *The Superorganic in American Cultural Geography*, 70 ANNALS OF ASSOC’N OF AMER. GEOGRAPHERS 181, 183 (1980).

⁵⁶ “Culture is public, because meaning is.” Clifford Geertz, *Thick Description: Toward an Interpretive Theory of Culture*, INTERPRETATION OF CULTURES (N.Y.: Basic Books, 1973) 12.

⁵⁷ Mona Domosh, Terry Jordan-Bychkov, et al. *THE HUMAN MOSAIC: A THEMATIC INTRO. TO CULTURAL GEOGRAPHY* 12th ed. (N.Y.: W.H. Freeman & Co., 2012).

⁵⁸ “As a cerebral entity, a culture may flourish, move and about, and propagate itself solely within the heads of a number of footloose individuals. Such extreme cases do occur, of course, but normally the facts of location and the processes of interaction with other localized or spatially structured phenomena do matter greatly.” Wilbur Zelinsky, *CULTURAL GEOGRAPHY OF THE U.S.* (Prentice Hall, 1973) 76.

⁵⁹ Even Internet use depends on users’ geographic location. See, e.g., Eric Gilbert, Karrie Karahalios & Christian Sandvig, *Network in the Garden: An Empirical Analysis of Social Media in Rural Life*, Conf. on Computer-Human Interaction of Assoc’n for Computing Machinery, Florence (2008).

⁶⁰ Why would tax compliance, among other characteristics, be part of cultural geography? “Imagine someone who is, among other things, a Czech-American Lutheran plumber, a member of the VFW, an ardent Cleveland Indian fan, a radio ham, a regular patron of a particular bar, and a member of a car pool, the local draft board, the Book-of-the-Month Club, and the Republican party, and a parent whose son attends a particular college. Each of these subcultures will tend to have its own array of gear and physical arrangements, spectrum of economic and social beliefs and practices, cluster of abstract concepts, and, not least important for our purpose, distributional spread in physical space.” Zelinsky, *CULTURAL GEOGRAPHY* at 74.

Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results

variable” (e.g., legal compliance) changes when any one of the “independent variables” (e.g., location or other relevant factor) changes.⁶¹

By identifying high- and low-compliance communities, this survey prepares the way for potential research in particular geographic areas. Relevant aspects of high compliance, such as trust in government or respect for authority, may occur throughout the country, even if not in a high-compliance community. Future research could go beyond the factors underlying compliance to test how tax administration may respond to regional traditions with certain services in particular geographic regions.⁶²

Future research could also use more sophisticated tools to analyze the National Survey data. While this preliminary analysis identified important correlations between (estimated) tax compliance and responses to the survey questions, applying “regression analysis” (described above) to the data might provide further insight into which responses (or other observable factors) have the greatest effect on (estimated) tax compliance. For example, while this preliminary analysis reveals a correlation between estimated tax compliance and attitudes about the government, the law, and the IRS, a regression analysis might reveal the relative importance of these attitudes after controlling for the effect of other factors.

Alternatively, data mining techniques (e.g., “segmentation” or “cluster” analysis) could identify groups of survey responses that are most frequently associated with each other. Such analysis might enable researchers to identify various distinct types of noncompliance. For example, this analysis might find a particular segment of the low-compliance group for whom complexity presents a barrier to compliance. It might distinguish this segment from another for whom complexity is not a barrier, but justifies noncompliance on the basis of negative views about the IRS, the law, and the government. Such analysis might help to inform policymakers about how to tailor an effective approach to address different types of noncompliance and different segments of the population.

⁶¹ “While differences in standard demographic or economic variables such as age composition, median education, or median income account for a good deal of the variance among sections of the country” in particular social statistics, “there is a significant remainder that may be related” solely to geographic characteristics. Raymond Gastil, *CULTURAL REGIONS OF THE U.S.* (Seattle: Univ. of Wash. Press, 1975) 116.

⁶² See Most Serious Problem: *The IRS Is Substantially Reducing both the Amount and Scope of its Direct Education and Outreach to Taxpayers and Does Not Measure the Effectiveness of its Remaining Outreach Activities, Thereby Risking Increased Noncompliance*, *supra*; National Taxpayer Advocate 2009 Annual Report to Congress 346 (Legislative Recommendation: *Strengthen the Independence of the IRS Office of Appeals and Require at Least One Appeals Officer and Settlement Officer in Each State*); National Taxpayer Advocate 2007 Annual Report to Congress 162 (Most Serious Problem: *Service at Taxpayer Assistance Centers*); National Taxpayer Advocate 2003 Annual Report to Congress 145 (Most Serious Problem: *Taxpayer Assistance Centers*).

CONCLUSION

In conclusion, the TAS survey has helped to identify which factors significantly influence compliance. In turn, analyses of the factors and related data point to the operative types of noncompliance. Finally, knowledge of these factors and types of noncompliance can inform service and enforcement programs.

The results of both surveys suggest that norms and distrust of the national government, the law, and the IRS may promote noncompliance. Respondents from both the low-compliance groups and from low-compliance communities held negative views about government and the IRS and were more likely to participate in local organizations. They were also more likely to believe that other members of those organizations held similarly negative views, which appeared to reinforce their own views, though they generally professed that noncompliance was morally wrong. In other words, they affiliated with others who reinforced noncompliance norms at the local level, and probably feel a closer connection to a local collective than to the national collective. In terms of the typology discussed above, this tendency to affiliate where distrust of government is the norm may be a form of social and symbolic noncompliance.

Consistently, the results also suggest that tax morale and trust in government, the law, the IRS, and preparers may promote compliance. Respondents from the high-compliance group and the high-compliance communities were less likely to participate in local organizations, suggesting that their compliance level was not social but motivated rather by morality, trust in government, trust in the IRS, or other internal factors contributing to high tax morale.

Those in both the high- and low-compliance groups also expressed a high level of trust in a preparer, but those in the high-compliance group expressed more trust. Similarly, a greater reliance on preparers by respondents from the high-compliance communities suggested a type of “brokered compliance.” Thus, the survey results suggest that “brokered compliance” may be a potential benefit of a well-regulated preparer profession, which the National Taxpayer Advocate has long championed.⁶³

The survey results did not reveal as much about the effect of deterrence and complexity on reporting compliance. With respect to deterrence, this may have been because some respondents answered defensively — to avoid explicitly implicating themselves in noncompliance. With respect to complexity, the survey did not specifically identify procedural, “lazy,” or unknowing noncompliance as posing major concerns. Nonetheless, complexity

⁶³ See 2010 Proposal at 81 (Table 2.4.1, *Typology of Noncompliance and Potentially operative Factor(s) Identified by the Literature*); National Taxpayer Advocate 2008 Annual Report to Congress 423 (Legislative Recommendation: *The Time Has Come to Regulate Federal Tax Return Preparers*); National Taxpayer Advocate 2004 Annual Report to Congress 67 (Most Serious Problem: *Oversight of Unenrolled Return Preparers*); National Taxpayer Advocate 2003 Annual Report to Congress 270 (Legislative Recommendation: *Federal Tax Return Preparers Oversight and Compliance*); National Taxpayer Advocate 2002 Annual Report to Congress 216 (Legislative Recommendation: *Regulation of Federal Tax Return Preparers*).

likely promotes the view that the government, the law, and the IRS are unfair or cannot be trusted, and the survey responses suggest that these views may reduce compliance.

Given the emergence of social and symbolic noncompliance as the primary types of noncompliance among small businesses, treatments that promote trust in government, the law, and the IRS may be most effective. As a practical matter, this might include tax simplification, an expansion of taxpayer protections and remedies, and taxpayer education.⁶⁴ This kind of education would be normative, relating to trust in government, rather than technical.⁶⁵ Traditional enforcement measures designed to deter could be ineffective, both because those likely to respond may be predisposed to comply and because the survey results did not suggest that asocial behavior (*i.e.*, behavior that may be addressed by increasing deterrence) is prevalent.

⁶⁴ For a discussion of procedural protections that could improve trust in government, see National Taxpayer Advocate 2011 Annual Report to Congress 493-518 (Legislative Recommendation: *Enact the Recommendations of the National Taxpayer Advocate to Protect Taxpayer Rights*) and National Taxpayer Advocate 2007 Annual Report to Congress 478-489 (Legislative Recommendation: *Taxpayer Bill of Rights and De Minimis "Apology" Payments*). For a summary of the National Taxpayer Advocate's simplification proposals, see *Complexity and the Tax Gap: Making Tax Compliance Easier and Collecting What's Due*, Hearing Before the S. Comm. on Finance (June 28, 2011) (statement of Nina E. Olson, National Taxpayer Advocate).

⁶⁵ For a discussion of the types of education that might be effective, see 2007 Review at 162-170.

Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results

APPENDIX I: SURVEY QUESTIONS

RESPONDENT INFO PAGE

ENTER RESPONDENT'S 5-DIGIT I.D. #

PHONE # (AC- _____) _____

CITY _____ ST _____ ZIP _____ c(xxx,xxx) ST CODE _____ c(xxx,xxx)

DESIGN & SAMPLE SIZES OF EACH STUDY:

NATIONAL SURVEY – Total Sample Size = 3,200

	Total Population	Sample Size Per Stratum	Estimated Response Rate	Est'd RR Starting Sample
Stratum 1) EAC 274—Deciles 1 - 2	2,053,331	350	50%	700
Stratum 2) EAC 274—Deciles 9 - 10	2,053,331	350	50%	700
Stratum 3) EAC 275—Deciles 1 - 2	571,075	350	50%	700
Stratum 4) EAC 275—Deciles 9 - 10	571,075	350	50%	700
Stratum 5) EACs 276, 277—Deciles 1 - 2.....	268,565	350	50%	700
Stratum 6) EACs 276, 277—Deciles 9 - 10.....	268,565	350	50%	700
Stratum 7) EACs 280, 281—Deciles 1 - 2.....	256,306	350	50%	700
Stratum 8) EACs 280, 281—Deciles 9 - 10.....	256,306	350	50%	700
Stratum 9) All EACs—Deciles 3 - 8.....	9,447,830	400	50%	800
Grand Totals	15,745,384	3,200	50%	6,400

COMMUNITIES SURVEY – Total Sample Size = 700

- Cell 1) Total Schedule C Filers In A LOW-DIFF/HIGH-Compliant Community (n=350) 1
- Cell 2) Total Schedule C Filers In A HIGH-DIFF/LOW-COMPLIANCE Community (n=350) 2

CALL TIMES ARE 9 AM TO 9 PM IN EACH TIME ZONE. KEEP RR RECORDS FOR EACH CELL WITHIN EACH STUDY, PER BELOW:

	DATE:	TIME:	(am) (pm)	1	2	3	4	5	6	7	8	9
01	DATE:	TIME:	(am) (pm)	1	2	3	4	5	6	7	8	9
02	DATE:	TIME:	(am) (pm)	1	2	3	4	5	6	7	8	9
03	DATE:	TIME:	(am) (pm)	1	2	3	4	5	6	7	8	9
04	DATE:	TIME:	(am) (pm)	1	2	3	4	5	6	7	8	9
05	DATE:	TIME:	(am) (pm)	1	2	3	4	5	6	7	8	9
06	DATE:	TIME:	(am) (pm)	1	2	3	4	5	6	7	8	9
07	DATE:	TIME:	(am) (pm)	1	2	3	4	5	6	7	8	9
08	DATE:	TIME:	(am) (pm)	1	2	3	4	5	6	7	8	9
09	DATE:	TIME:	(am) (pm)	1	2	3	4	5	6	7	8	9
10	DATE:	TIME:	(am) (pm)	1	2	3	4	5	6	7	8	9

INTERVIEWER ID _____

Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results

INTERVIEW ONLY THE OWNER OF A COMPANY ON EACH LIST PROVIDED BY TAS. INTRODUCE YOURSELF WITH: HELLO, I'M _____ OF RUSSELL RESEARCH, A NATIONAL RESEARCH FIRM. WE ARE CONDUCTING AN ANONYMOUS NATIONAL SURVEY OF BUSINESS OWNERS, IN WHICH WE WILL BE ASKING ABOUT ATTITUDES AND OPINIONS ABOUT FEDERAL INCOME TAXES. WE WILL BE ASKING QUESTIONS BOTH ABOUT YOUR ATTITUDES AND ABOUT YOUR PERCEPTION OF THE ATTITUDES OF OTHERS YOU KNOW THROUGH YOUR PARTICIPATION IN LOCAL ORGANIZATIONS. MAY I SPEAK WITH THE OWNER OF (READ NAME OF COMPANY FROM LIST)?

IF OWNER NOT AVAILABLE, RECORD THIS AND SECURE BEST TIME TO TRY AGAIN. AFTER REACHING OWNER (AND IF NECESSARY, REPEATING THE ABOVE INITIAL INTRO), CONTINUE WITH...

YOUR PARTICIPATION IN THIS SURVEY IS ENTIRELY VOLUNTARY AND YOUR RESPONSES WILL BE KEPT STRICTLY ANONYMOUS AND NEVER REVEALED TO ANYONE. THE SURVEY WILL TAKE NO MORE THAN 15 MINUTES AND WE'D APPRECIATE YOUR PARTICIPATION. IF YOU HAVE ANY QUESTIONS ABOUT RUSSELL RESEARCH, PLEASE LOG ONTO WWW.RUSSELLRESEARCH.COM AND YOU CAN VERIFY WHO WE ARE AND OUR RESEARCH WORK.

>> CONTINUE w/Q1 – UNLESS YOU DETECT THAT THE OWNER SPEAKS MAINLY SPANISH, IN WHICH CASE, ASK HIM/HER TO HOLD WHILE YOU TRANSFER TO A BI-LINGUAL INTERVIEWER, WHO WILL SECURE A LANGUAGE PREFERENCE AND CONTINUE THE INTERVIEW.

1. FIRST, FOR CLASSIFICATION PURPOSES ONLY, ARE YOU MALE OR FEMALE? (CLICK ANSWER.)

- MALE (MONITOR AND CONTROL TO TAS %s – TBD)..... 1**
- FEMALE (MONITOR AND CONTROL TO TAS %s – TBD)..... 2**

2. AND WHICH OF THE FOLLOWING AGE CATEGORIES INCLUDES YOUR AGE? (READ CHOICES & CLICK ANSWER.)

- UNDER 18 [THANK, TERM & TALLY]**
- 18-24 (MONITOR AND CONTROL TO TAS %s – TBD) 1**
- 25-34 (MONITOR AND CONTROL TO TAS %s – TBD) 2**
- 35-44 (MONITOR AND CONTROL TO TAS %s – TBD) 3**
- 45-54 (MONITOR AND CONTROL TO TAS %s – TBD) 4**
- 55-64 (MONITOR AND CONTROL TO TAS %s – TBD) 4**
- AGE 65 OR OVER (MONITOR AND CONTROL TO TAS %s – TBD) 5**
- (DO NOT OFFER, BUT CLICK IF:) PREFER NOT TO ANSWER..... [THANK, TERM & TALLY]**

Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results

3. **NEXT, TO CONFIRM, ARE YOU THE OWNER OF...(READ NAME OF COMPANY FROM LIST)? (DO NOT READ CHOICES – JUST CLICK ANSWER.)**

- YES (CONTINUE WITH REST OF SURVEY) 1
- NO (ASK FOR THE BEST TIME TO SPEAK WITH THE OWNER AND CALL BACK)..... 2
- PREFER NOT TO ANSWER (THANK, TERM & TALLY AS A REFUSAL)..... 3
- REFUSED TO PROVIDE BEST TIME FOR OWNER (THANK, TERM & TALLY) 4

ASK ALL:

4. **OTHER THAN YOURSELF, HOW MANY PEOPLE ARE EMPLOYED BY YOUR BUSINESS/COMPANY? (DO NOT READ CHOICES. CLICK ONE ANSWER.)**

- NONE 1
- 1 2
- 2 TO 4..... 3
- 5 TO 9..... 4
- 10 TO 19..... 5
- 20 TO 49..... 6
- 50 TO 99 7
- 100 TO 249 8
- 250 TO 499 9
- 500 TO 999 1
- 1,000 OR MORE 2
- (DO NOT OFFER AS A CHOICE, BUT CLICK IF:) PREFER NOT TO ANSWER..... 3

5. **ARE YOUR CUSTOMERS PRIMARILY...? (READ RANDOMIZED CHOICES AND CLICK ANSWER.)**

- LOCAL 1
- NATIONAL..... 2
- OR, INTERNATIONAL..... 3
- (DO NOT OFFER AS A CHOICE, BUT CLICK IF:) PREFER NOT TO ANSWER..... 4!

Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results

6. **IN PREPARING YOUR MOST RECENT FEDERAL INCOME TAX RETURN, DID YOU...? (READ RANDOMIZED CHOICES & CLICK ANSWER.)**

- COMPLETE IT YOURSELF USING TAX SOFTWARE 1
- COMPLETE IT YOURSELF WITHOUT USING TAX SOFTWARE 2
- HAVE IT COMPLETED BY A PAID TAX PREPARER 3
- HAVE IT COMPLETED BY AN UNPAID THIRD PARTY..... 4
- (READ LAST:) OR, NONE OF THESE 5**
- (DO NOT OFFER AS A CHOICE, BUT CLICK IF:) PREFER NOT TO ANSWER..... 6**

7. **(GROUP B SELF-RATINGS – ASK ALL:) NEXT, I’LL READ SOME STATEMENTS WHICH MAY OR MAY NOT DESCRIBE YOUR VIEWS ON PERSONAL FINANCES AND YOUR EXPERIENCES IN PREPARING AND FILING YOUR TAXES. AFTER I READ EACH STATEMENT, TELL ME HOW MUCH YOU AGREE OR DISAGREE WITH IT, USING A RATING SCALE OF: *STRONGLY AGREE, AGREE, NEITHER AGREE NOR DISAGREE, DISAGREE, OR STRONGLY DISAGREE*. HERE ARE THE STATEMENTS: (START WITH 1ST STATEMENT IN RANDOMIZED SET AND CONTINUE UNTIL ALL STATEMENTS HAVE BEEN RATED. NOTE: DO NOT OFFER “DON’T KNOW” AS A CHOICE, BUT CLICK IT IF RESPONDENT CANNOT CHOOSE A RATING POINT.)**

	STRONGLY AGREE	AGREE	NEITHER AGREE NOR DISAGREE	DISAGREE	STRONGLY DISAGREE	DON’T KNOW
<input type="checkbox"/> (DETERRENCE) THESE DAYS, IT IS DIFFICULT TO MAKE ENDS MEET1	2	3	4	5	6	
<input type="checkbox"/> (DETERRENCE) ACHIEVING FINANCIAL SUCCESS IS IMPORTANT TO ME1	2	3	4	5	6	
<input type="checkbox"/> (DETERRENCE) TAKING RISKS IS NECESSARY TO ACHIEVE FINANCIAL SUCCESS1	2	3	4	5	6	
<input type="checkbox"/> (DETERRENCE) A PERSON’S STATUS IN MY COMMUNITY DEPENDS ON THEIR FINANCIAL STATUS1	2	3	4	5	6	
<input type="checkbox"/> (CCB) THE RULES ABOUT WHAT TO REPORT AS INCOME ARE CLEAR.....1	2	3	4	5	6	
<input type="checkbox"/> (CCB) MY RECORD KEEPING SYSTEM MAKES IT EASY FOR ME TO COMPUTE THE AMOUNT OF INCOME TAX I NEED TO REPORT ON MY RETURN1	2	3	4	5	6	
<input type="checkbox"/> (DETERRENCE) HEARING ABOUT PEOPLE WHO WERE CAUGHT NOT REPORTING THEIR TAXES MAKES ME TEND TO BE EVEN MORE CAREFUL WITH MY OWN TAXES1	2	3	4	5	6	
<input type="checkbox"/> (PREP—IF Q6—#3 OR #4) EVEN THOUGH SOMEONE ELSE PREPARED MY RETURN, I KNOW THE FEDERAL TAX LAWS WELL ENOUGH TO PREPARE MY OWN TAX RETURN1	2	3	4	5	6	
<input type="checkbox"/> (PREP—IF Q6—#3 OR #4) I MAKE SURE THAT I UNDERSTAND EVERY ITEM THAT IS INCLUDED OR OMITTED FROM MY RETURN BEFORE SIGNING IT1	2	3	4	5	6	
<input type="checkbox"/> (PREP—IF Q6—#3 OR #4) THE PERSON WHO PREPARES MY RETURN FINDS CREATIVE WAYS TO MINIMIZE TAXES1	2	3	4	5	6	
<input type="checkbox"/> (PREP—IF Q6—#3 OR #4) I ALWAYS FOLLOW THE INSTRUCTIONS OR ADVICE FROM THE PERSON WHO PREPARES MY RETURN1	2	3	4	5	6	

8. **(GROUP C SELF-RATINGS – ASK ALL:) NOW I AM GOING TO READ SOME STATEMENTS ABOUT THE FEDERAL GOVERNMENT AND THE FEDERAL TAX LAWS. AFTER I READ EACH STATEMENT, TELL ME HOW MUCH YOU AGREE OR DISAGREE WITH IT, USING A RATING SCALE OF: *STRONGLY AGREE, AGREE, NEITHER AGREE NOR DISAGREE, DISAGREE, OR STRONGLY DISAGREE*. HERE ARE THE STATEMENTS: (START WITH 1ST STATEMENT IN RANDOMIZED SET AND CONTINUE UNTIL ALL STATEMENTS HAVE BEEN RATED. NOTE: DO NOT OFFER “DON’T KNOW” AS A CHOICE, BUT CLICK IT IF RESPONDENT CANNOT CHOOSE A RATING POINT.)**

Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results

	STRONGLY AGREE	AGREE	NEITHER AGREE NOR DISAGREE	DISAGREE	STRONGLY DISAGREE	DON'T KNOW
<input type="checkbox"/> (GOVT & TAXES) THE FEDERAL GOVERNMENT SPENDS TAX DOLLARS WISELY.....	1	2	3	4	5	6
<input type="checkbox"/> (GOVT & TAXES) TAXES FUND IMPORTANT FEDERAL GOVERNMENT BENEFITS AND SERVICES	1	2	3	4	5	6
<input type="checkbox"/> (GOVT & TAXES) TAXPAYERS WOULD TOLERATE HIGHER TAXES IF IT MEANT IMPROVED FEDERAL GOVERNMENT SERVICES	1	2	3	4	5	6
<input type="checkbox"/> (GOVT & TAXES) THE FEDERAL GOVERNMENT IS INVOLVED IN AREAS BEST LEFT TO THE PRIVATE SECTOR	1	2	3	4	5	6
<input type="checkbox"/> (TAXES & FAIRNESS) THE FEDERAL TAX LAWS ARE FAIR.....	1	2	3	4	5	6
<input type="checkbox"/> (CCB) THE TAX RULES ARE SO COMPLICATED THAT IT IS VERY DIFFICULT TO GET A TAX RETURN EXACTLY RIGHT	1	2	3	4	5	6
<input type="checkbox"/> (TAXES & FAIRNESS) UNDER OUR FEDERAL TAX LAWS, EVERYONE PAYS THEIR FAIR SHARE OF TAXES	1	2	3	4	5	6
<input type="checkbox"/> (TAXES & FAIRNESS) LARGE BUSINESSES HAVE LOOPHOLES TO REDUCE THEIR FEDERAL TAXES THAT SMALLER BUSINESSES DO NOT HAVE	1	2	3	4	5	6
<input type="checkbox"/> (TAXES & FAIRNESS) THE WEALTHY HAVE WAYS OF MINIMIZING THEIR FEDERAL TAXES THAT ARE NOT AVAILABLE TO THE AVERAGE TAXPAYER	1	2	3	4	5	6

9. (GROUP D SELF-RATINGS – ASK ALL:) NEXT ARE SOME STATEMENTS ABOUT THE IRS AND HOW IT INTERACTS WITH TAXPAYERS. AFTER I READ EACH STATEMENT, TELL ME HOW MUCH YOU AGREE OR DISAGREE WITH IT, USING A RATING SCALE OF: **STRONGLY AGREE, AGREE, NEITHER AGREE NOR DISAGREE, DISAGREE, OR STRONGLY DISAGREE.** HERE ARE THE STATEMENTS: (START WITH 1ST STATEMENT IN RANDOMIZED SET AND CONTINUE UNTIL ALL STATEMENTS HAVE BEEN RATED. NOTE: DO NOT OFFER “DON’T KNOW” AS A CHOICE, BUT CLICK IT IF RESPONDENT CANNOT CHOOSE A RATING POINT.)

	STRONGLY AGREE	AGREE	NEITHER AGREE NOR DISAGREE	DISAGREE	STRONGLY DISAGREE	DON'T KNOW
<input type="checkbox"/> (TRUST IRS GEN) THE IRS TREATS TAXPAYERS FAIRLY	1	2	3	4	5	6
<input type="checkbox"/> (TRUST IRS GEN) THE IRS IS MORE CONCERNED WITH COLLECTING AS MUCH AS IT CAN, THAN WITH COLLECTING THE CORRECT AMOUNT OF TAX	1	2	3	4	5	6
<input type="checkbox"/> (TRUST IRS GEN) THE IRS TREATS TAXPAYERS WITH RESPECT.....	1	2	3	4	5	6
<input type="checkbox"/> (TRUST IRS GEN) THE IRS WILL WORK WITH YOU IF YOU HAVE DIFFICULTY PAYING YOUR TAXES	1	2	3	4	5	6
<input type="checkbox"/> (TRUST IRS GEN) BECAUSE THE IRS TREATS TAXPAYERS FAIRLY, I ACCEPT ITS DECISIONS EVEN IF I DISAGREE WITH THEM	1	2	3	4	5	6
<input type="checkbox"/> (TRUST IRS GEN) WEALTHY TAXPAYERS HAVE AN ADVANTAGE WHEN DEALING WITH THE IRS	1	2	3	4	5	6
<input type="checkbox"/> (DETERRENCE) THE IRS PROBABLY KNOWS WHEN PEOPLE DO NOT REPORT ALL OF THEIR INCOME	1	2	3	4	5	6
<input type="checkbox"/> (TRUST IRS SVCS) THE IRS OFFERS ALL OF THE FEDERAL TAX SERVICES I NEED.....	1	2	3	4	5	6
<input type="checkbox"/> (TRUST IRS SVCS) IT IS EASY FOR ME TO ACCESS THE FEDERAL TAX SERVICES THAT THE IRS PROVIDES	1	2	3	4	5	6
<input type="checkbox"/> (TRUST IRS SVCS) I AM SATISFIED WITH THE QUALITY OF THE FEDERAL TAX SERVICES THE IRS PROVIDES.....	1	2	3	4	5	6

Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results

10. (GROUP E SELF-RATINGS – ASK ALL:) FOLLOWING ARE SOME STATEMENTS CONCERNING YOUR VIEWS ON COMPLYING WITH THE TAX LAWS. AFTER I READ EACH STATEMENT, TELL ME HOW MUCH YOU AGREE OR DISAGREE WITH IT, USING A RATING SCALE OF: **STRONGLY AGREE, AGREE, NEITHER AGREE NOR DISAGREE, DISAGREE, OR STRONGLY DISAGREE.** HERE ARE THE STATEMENTS: (START WITH 1ST STATEMENT IN RANDOMIZED SET AND CONTINUE UNTIL ALL STATEMENTS HAVE BEEN RATED. NOTE: DO NOT OFFER “DON’T KNOW” AS A CHOICE, BUT CLICK IT IF RESPONDENT CANNOT CHOOSE A RATING POINT.)

	STRONGLY AGREE	AGREE	NEITHER AGREE NOR DISAGREE	DISAGREE	STRONGLY DISAGREE	DON'T KNOW
<input type="checkbox"/> (NORMS) MANY SMALL BUSINESSES DO NOT REPORT ALL OF THEIR INCOME	1	2	3	4	5	6
<input type="checkbox"/> (NORMS) MOST OF MY COMPETITORS REPORT ALL OF THEIR INCOME	1	2	3	4	5	6
<input type="checkbox"/> (NORMS) MOST SMALL BUSINESSES COULD NOT SURVIVE IF THEY REPORTED ALL OF THEIR INCOME	1	2	3	4	5	6
<input type="checkbox"/> (DETERRENCE) PEOPLE WHO DO NOT REPORT ALL OF THEIR INCOME ARE LIKELY TO END UP PAYING EVEN MORE IN PENALTIES AND INTEREST	1	2	3	4	5	6
<input type="checkbox"/> (TAX MORALE) EVERYONE SHOULD CORRECTLY REPORT ALL OF THEIR INCOME	1	2	3	4	5	6
<input type="checkbox"/> (TAX MORALE) I FEEL A MORAL OBLIGATION TO CORRECTLY REPORT ALL OF MY INCOME	1	2	3	4	5	6
<input type="checkbox"/> (TAX MORALE) IF OTHERS FOUND OUT I DID NOT REPORT ALL OF MY INCOME, I WOULD BE EMBARRASSED	1	2	3	4	5	6

(GROUP A QUESTIONS – ORGANIZATION AFFILIATION & NORMS) READ THIS SEGUE TO THE NEXT SECTION: THE NEXT SERIES OF QUESTIONS ARE ABOUT THE LOCAL ORGANIZATIONS IN WHICH YOU’RE INVOLVED AND YOUR PERCEPTION OF HOW MEMBERS OF THESE ORGANIZATIONS VIEW FEDERAL TAXES.

(PROGRAMMER: ROTATE THE GROUP “A” AFFILIATION AND NORMS QUESTION SERIES 11, 12, 13, 14, 15, AND 16, BUT ALWAYS LEAVE THE RELIGIOUS ORGANIZATIONS QUESTIONS (Qs 17a-b) AS THE LAST SERIES IN THIS ROTATION.)

11a. (BUSINESS ORGANIZATION AFFILIATION – ASK ALL:) DO YOU BELONG TO ANY LOCAL BUSINESS ORGANIZATIONS SUCH AS A LOCAL CHAMBER OF COMMERCE, BUSINESS LEAGUE, OR SIMILAR ORGANIZATION – FOR EXAMPLE, THE JAYCEES? (CLICK ANSWER AND FOLLOW INSTRUCTIONS.)

- Yes (CONTINUE WITH Qs 11b. – 11d.) 1
- No (SKIP TO Q12A.)..... 2
- (DO NOT OFFER AS A CHOICE, BUT CLICK IF:) PREFER NOT TO ANSWER (SKIP TO Q12A.)..... 3

11b. (IF YES TO Q11A, ASK:) THINK ABOUT THE ONE LOCAL BUSINESS ORGANIZATION THAT YOU ARE MOST CLOSELY ASSOCIATED WITH AND THEN TELL ME WHICH OF THE FOLLOWING BEST DESCRIBES HOW OFTEN YOU PARTICIPATE IN THIS ORGANIZATION’S ACTIVITIES. (READ CHOICES AND CLICK ANSWER.)

- ALWAYS 1
- USUALLY..... 2
- SOMETIMES..... 3
- RARELY 4

Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results

NEVER..... 5
 (DO NOT OFFER AS A CHOICE, BUT CLICK IF:) PREFER NOT TO ANSWER 6

11c. (IF YES TO Q11a, ASK:) WHICH OF THE FOLLOWING BEST DESCRIBES HOW OFTEN YOU SOCIALIZE WITH OTHER MEMBERS OF THIS ORGANIZATION? (READ CHOICES AND CLICK ANSWER.)

FREQUENTLY..... 1
 OCCASIONALLY..... 2
 RARELY 3
 NEVER..... 4
 (DO NOT OFFER AS A CHOICE, BUT CLICK IF:) PREFER NOT TO ANSWER 5

11d. (IF YES TO Q11a, ASK:) THINKING STILL ABOUT THE ONE LOCAL BUSINESS ORGANIZATION THAT YOU ARE MOST CLOSELY ASSOCIATED WITH, I'M GOING TO READ TWO STATEMENTS DESCRIBING THE ATTITUDES OF MEMBERS OF THIS ORGANIZATION TOWARD FEDERAL INCOME TAXES. AFTER I READ EACH STATEMENT, TELL ME HOW MUCH YOU AGREE OR DISAGREE WITH IT, USING A RATING SCALE OF: **STRONGLY AGREE, AGREE, NEITHER AGREE NOR DISAGREE, DISAGREE, OR STRONGLY DISAGREE.** HERE ARE THE STATEMENTS: (START WITH 1ST STATEMENT IN RANDOMIZED SET AND CONTINUE UNTIL ALL STATEMENTS HAVE BEEN RATED. NOTE: DO NOT OFFER "DON'T KNOW" AS A CHOICE, BUT CLICK IT IF RESPONDENT CANNOT CHOOSE A RATING POINT.)

	STRONGLY AGREE	AGREE	NEITHER AGREE NOR DISAGREE	DISAGREE	STRONGLY DISAGREE	DON'T KNOW
<input type="checkbox"/> MOST MEMBERS OF THIS ORGANIZATION BELIEVE THAT THE FEDERAL TAX LAWS ARE FAIR	1	2	3	4	5	6
<input type="checkbox"/> MOST MEMBERS OF THIS ORGANIZATION BELIEVE THE IRS TREATS TAXPAYERS FAIRLY.....	1	2	3	4	5	6

12a. (TRADE/LABOR/OCCUPATIONAL ORGANIZATION AFFILIATION – ASK ALL:) DO YOU BELONG TO ANY LOCAL TRADE ASSOCIATION, LABOR UNION, OR OTHER OCCUPATIONAL ORGANIZATIONS? (CLICK ANSWER AND FOLLOW INSTRUCTIONS.)

YES (CONTINUE WITH Qs 12b. – 12d.) 1
 NO (SKIP TO Q13a.)..... 2
 (DO NOT OFFER AS A CHOICE, BUT CLICK IF:) PREFER NOT TO ANSWER (SKIP TO Q13a.)..... 3

12b. (IF YES TO Q12a, ASK:) THINK ABOUT THE ONE LOCAL TRADE, LABOR, OR OCCUPATIONAL ORGANIZATION THAT YOU ARE MOST CLOSELY ASSOCIATED WITH AND THEN TELL ME WHICH OF THE FOLLOWING BEST DESCRIBES HOW OFTEN YOU PARTICIPATE IN THIS ORGANIZATION'S ACTIVITIES. (READ CHOICES AND CLICK ANSWER.)

ALWAYS 1
 USUALLY..... 2
 SOMETIMES..... 3
 RARELY 4
 NEVER..... 5
 (DO NOT OFFER AS A CHOICE, BUT CLICK IF:) PREFER NOT TO ANSWER 6

Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results

12c. (IF YES TO Q12a, ASK:) WHICH OF THE FOLLOWING BEST DESCRIBES HOW OFTEN YOU SOCIALIZE WITH OTHER MEMBERS OF THIS ORGANIZATION? (READ CHOICES AND CLICK ANSWER.)

- FREQUENTLY.....1
- OCCASIONALLY.....2
- RARELY3
- NEVER.....4
- (DO NOT OFFER AS A CHOICE, BUT CLICK IF:) PREFER NOT TO ANSWER.....5

12d. (IF YES TO Q12a, ASK:) THINKING STILL ABOUT THE ONE LOCAL TRADE, LABOR, OR OCCUPATIONAL ORGANIZATION THAT YOU ARE MOST CLOSELY ASSOCIATED WITH, I'M GOING TO READ TWO STATEMENTS DESCRIBING THE ATTITUDES OF MEMBERS OF THIS ORGANIZATION TOWARD FEDERAL INCOME TAXES. AFTER I READ EACH STATEMENT, TELL ME HOW MUCH YOU AGREE OR DISAGREE WITH IT, USING A RATING SCALE OF: *STRONGLY AGREE, AGREE, NEITHER AGREE NOR DISAGREE, DISAGREE, OR STRONGLY DISAGREE.* HERE ARE THE STATEMENTS: (START WITH 1ST STATEMENT IN RANDOMIZED SET AND CONTINUE UNTIL ALL STATEMENTS HAVE BEEN RATED. NOTE: DO NOT OFFER "DON'T KNOW" AS A CHOICE, BUT CLICK IT IF RESPONDENT CANNOT CHOOSE A RATING POINT.)

	STRONGLY AGREE	AGREE	NEITHER AGREE NOR DISAGREE	DISAGREE	STRONGLY DISAGREE	DON'T KNOW
<input type="checkbox"/> MOST MEMBERS OF THIS ORGANIZATION BELIEVE THAT THE FEDERAL TAX LAWS ARE FAIR	1	2	3	4	5	6
<input type="checkbox"/> MOST MEMBERS OF THIS ORGANIZATION BELIEVE THE IRS TREATS TAXPAYERS FAIRLY.....	1	2	3	4	5	6

13a. (CIVIC/COMMUNITY/FRATERNAL ORGANIZATION AFFILIATION – ASK ALL:) DO YOU BELONG TO ANY LOCAL CIVIC LEAGUE, COMMUNITY ORGANIZATION, FRATERNAL SOCIETY, OR SIMILAR CLUB – FOR EXAMPLE, THE ROTARY CLUB, OR THE VFW? (CLICK ANSWER AND FOLLOW INSTRUCTIONS.)

- Yes (CONTINUE WITH Qs 13b. – 13d.)1
- No (SKIP TO Q14a.).....2
- (DO NOT OFFER AS A CHOICE, BUT CLICK IF:) PREFER NOT TO ANSWER (SKIP TO Q14a.).....3

13b. (IF YES TO Q13a, ASK:) THINK ABOUT THE ONE LOCAL CIVIC, COMMUNITY, OR FRATERNAL ORGANIZATION THAT YOU ARE MOST CLOSELY ASSOCIATED WITH AND THEN TELL ME WHICH OF THE FOLLOWING BEST DESCRIBES HOW OFTEN YOU PARTICIPATE IN THIS ORGANIZATION'S ACTIVITIES. (READ CHOICES AND CLICK ANSWER.)

- ALWAYS1
- USUALLY.....2
- SOMETIMES.....3
- RARELY4
- NEVER.....5
- (DO NOT OFFER AS A CHOICE, BUT CLICK IF:) PREFER NOT TO ANSWER.....6

Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results

13c. (IF YES TO Q13a, ASK:) WHICH OF THE FOLLOWING BEST DESCRIBES HOW OFTEN YOU SOCIALIZE WITH OTHER MEMBERS OF THIS ORGANIZATION? (READ CHOICES AND CLICK ANSWER.)

- FREQUENTLY..... 1
- OCCASIONALLY..... 2
- RARELY 3
- NEVER..... 4
- (DO NOT OFFER AS A CHOICE, BUT CLICK IF:) PREFER NOT TO ANSWER 5

13d. (IF YES TO Q13a, ASK:) THINKING STILL ABOUT THE ONE LOCAL CIVIC, COMMUNITY, OR FRATERNAL ORGANIZATION THAT YOU ARE MOST CLOSELY ASSOCIATED WITH, I'M GOING TO READ TWO STATEMENTS DESCRIBING THE ATTITUDES OF MEMBERS OF THIS ORGANIZATION TOWARD FEDERAL INCOME TAXES. AFTER I READ EACH STATEMENT, TELL ME HOW MUCH YOU AGREE OR DISAGREE WITH IT, USING A RATING SCALE OF: STRONGLY AGREE, AGREE, NEITHER AGREE NOR DISAGREE, DISAGREE, OR STRONGLY DISAGREE. HERE ARE THE STATEMENTS: (START WITH 1ST STATEMENT IN RANDOMIZED SET AND CONTINUE UNTIL ALL STATEMENTS HAVE BEEN RATED. NOTE: DO NOT OFFER "DON'T KNOW" AS A CHOICE, BUT CLICK IT IF RESPONDENT CANNOT CHOOSE A RATING POINT.)

- | | STRONGLY
AGREE | AGREE | NEITHER
AGREE NOR
DISAGREE | DISAGREE | STRONGLY
DISAGREE | DON'T
KNOW |
|---|-------------------|-------|----------------------------------|----------|----------------------|---------------|
| <input type="checkbox"/> MOST MEMBERS OF THIS ORGANIZATION BELIEVE THAT THE FEDERAL TAX LAWS ARE FAIR | 1 | 2 | 3 | 4 | 5 | 6 |
| <input type="checkbox"/> MOST MEMBERS OF THIS ORGANIZATION BELIEVE THE IRS TREATS TAXPAYERS FAIRLY..... | 1 | 2 | 3 | 4 | 5 | 6 |

14a. (VOLUNTEER ORGANIZATION AFFILIATION – ASK ALL:) WHICH OF THE FOLLOWING BEST DESCRIBES HOW OFTEN YOU DO VOLUNTEER WORK FOR ANY LOCAL VOLUNTEER ORGANIZATION? (READ CHOICES, CLICK ANSWER AND FOLLOW INSTRUCTIONS.)

- NEVER (SKIP TO Q15a.) 1
- WEEKLY (ASK Q14b.)..... 2
- MONTHLY (ASK Q14b.) 3
- YEARLY (ASK Q14b.)..... 4
- (DO NOT OFFER AS A CHOICE, BUT CLICK IF:) PREFER NOT TO ANSWER (SKIP TO Q15a.)..... 5

14b. (IF WEEKLY/MONTHLY/YEARLY ABOVE, ASK:) THINK ABOUT THE ONE LOCAL VOLUNTEER ORGANIZATION THAT YOU ARE MOST CLOSELY ASSOCIATED WITH. I'M GOING TO READ TWO STATEMENTS DESCRIBING THE ATTITUDES OF MEMBERS OF THIS ORGANIZATION TOWARD FEDERAL INCOME TAXES. AFTER I READ EACH STATEMENT, TELL ME HOW MUCH YOU AGREE OR DISAGREE WITH IT, USING A RATING SCALE OF: STRONGLY AGREE, AGREE, NEITHER AGREE NOR DISAGREE, DISAGREE, OR STRONGLY DISAGREE. HERE ARE THE STATEMENTS: (START WITH 1ST STATEMENT IN RANDOMIZED SET AND CONTINUE UNTIL ALL STATEMENTS HAVE BEEN RATED. NOTE: DO NOT OFFER "DON'T KNOW" AS A CHOICE, BUT CLICK IT IF RESPONDENT CANNOT CHOOSE A RATING POINT.)

- | | STRONGLY
AGREE | AGREE | NEITHER
AGREE NOR
DISAGREE | DISAGREE | STRONGLY
DISAGREE | DON'T
KNOW |
|---|-------------------|-------|----------------------------------|----------|----------------------|---------------|
| <input type="checkbox"/> MOST MEMBERS OF THIS ORGANIZATION BELIEVE THAT THE FEDERAL TAX LAWS ARE FAIR | 1 | 2 | 3 | 4 | 5 | 6 |

Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results

MOST MEMBERS OF THIS ORGANIZATION BELIEVE THE IRS TREATS TAXPAYERS FAIRLY.....1 2 3 4 5 6

15A. (NORMS – ASK ALL:) DO YOU HAVE CHILDREN ATTENDING A LOCAL PUBLIC OR PRIVATE SCHOOL? (CLICK ANSWER AND FOLLOW INSTRUCTIONS.)

YES (ASK Q15b.).....1

NO (SKIP TO Q16a.).....2

(DO NOT OFFER AS A CHOICE, BUT CLICK IF:) PREFER NOT TO ANSWER (SKIP TO Q16a.).....5

15B. (IF YES TO Q15A, ASK:) THINK ABOUT THE PARENTS OF THE CHILDREN WITH WHOM YOUR CHILDREN PLAY OR ATTEND SCHOOL. I’M GOING TO READ TWO STATEMENTS DESCRIBING THE ATTITUDES OF THOSE PARENTS TOWARD FEDERAL INCOME TAXES. AFTER I READ EACH STATEMENT, TELL ME HOW MUCH YOU AGREE OR DISAGREE WITH IT, USING A RATING SCALE OF: *STRONGLY AGREE, AGREE, NEITHER AGREE NOR DISAGREE, DISAGREE, OR STRONGLY DISAGREE*. HERE ARE THE STATEMENTS: (START WITH 1ST STATEMENT IN RANDOMIZED SET AND CONTINUE UNTIL ALL STATEMENTS HAVE BEEN RATED. NOTE: DO NOT OFFER “DON’T KNOW” AS A CHOICE, BUT CLICK IT IF RESPONDENT CANNOT CHOOSE A RATING POINT.)

	STRONGLY AGREE	AGREE	NEITHER AGREE NOR DISAGREE	DISAGREE	STRONGLY DISAGREE	DON’T KNOW
--	-------------------	-------	----------------------------------	----------	----------------------	---------------

MOST PARENTS OF CHILDREN WITH WHOM YOUR CHILDREN PLAY OR ATTEND SCHOOL BELIEVE THAT THE FEDERAL TAX LAWS ARE FAIR1 2 3 4 5 6

MOST PARENTS OF CHILDREN WITH WHOM YOUR CHILDREN PLAY OR ATTEND SCHOOL BELIEVE THE IRS TREATS TAXPAYERS FAIRLY1 2 3 4 5 6

16A. (NORMS – ASK ALL:) WHICH OF THE FOLLOWING BEST DESCRIBES HOW REGULARLY YOU VOTE IN ELECTIONS FOR CONGRESS, MAYOR OR OTHER LOCAL ELECTED OFFICIALS? (READ CHOICES, CLICK ANSWER AND THEN ASK ALL Q16b.)

ALWAYS1

USUALLY.....2

SOMETIMES.....3

RARELY4

NEVER.....5

(DO NOT OFFER AS A CHOICE, BUT CLICK IF:) PREFER NOT TO ANSWER6

16B. (ASK ALL, REGARDLESS OF ANSWER TO Q16A.:) I’M GOING TO READ TWO STATEMENTS DESCRIBING THE ATTITUDES OF LOCAL OFFICIALS TOWARD FEDERAL INCOME TAXES. AFTER I READ EACH STATEMENT, TELL ME HOW MUCH YOU AGREE OR DISAGREE WITH IT, USING A RATING SCALE OF: *STRONGLY AGREE, AGREE, NEITHER AGREE NOR DISAGREE, DISAGREE, OR STRONGLY DISAGREE*. HERE ARE THE STATEMENTS: (START WITH 1ST STATEMENT IN RANDOMIZED SET AND CONTINUE UNTIL ALL STATEMENTS HAVE BEEN RATED. NOTE: DO NOT OFFER “DON’T KNOW” AS A CHOICE, BUT CLICK IT IF RESPONDENT CANNOT CHOOSE A RATING POINT.)

	STRONGLY AGREE	AGREE	NEITHER AGREE NOR DISAGREE	DISAGREE	STRONGLY DISAGREE	DON’T KNOW
--	-------------------	-------	----------------------------------	----------	----------------------	---------------

YOUR LOCAL OFFICIALS GENERALLY BELIEVE THAT THE FEDERAL TAX LAWS ARE FAIR1 2 3 4 5 6

Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results

YOUR LOCAL OFFICIALS GENERALLY BELIEVE THE IRS TREATS TAXPAYERS FAIRLY1 2 3 4 5 6

17A. (AFFILIATION – ASK ALL:) WHICH OF THE FOLLOWING BEST DESCRIBES HOW OFTEN YOU PARTICIPATE IN A CHURCH OR OTHER RELIGIOUS CONGREGATION? (READ CHOICES, CLICK ANSWER AND FOLLOW INSTRUCTIONS.)

- NEVER (SKIP TO Q18) 1
- WEEKLY (ASK Q17b.) 2
- MONTHLY (ASK Q17b.) 3
- YEARLY (ASK Q17b.) 4
- (DO NOT OFFER AS A CHOICE, BUT CLICK IF:) PREFER NOT TO ANSWER (SKIP TO Q18) 5

17B. (IF WEEKLY/MONTHLY/YEARLY ABOVE, ASK:) I’M GOING TO READ TWO STATEMENTS DESCRIBING THE ATTITUDES OF MEMBERS OF YOUR RELIGIOUS CONGREGATION. AFTER I READ EACH STATEMENT, TELL ME HOW MUCH YOU AGREE OR DISAGREE WITH IT, USING A RATING SCALE OF: STRONGLY AGREE, AGREE, NEITHER AGREE NOR DISAGREE, DISAGREE, OR STRONGLY DISAGREE. HERE ARE THE STATEMENTS: (START WITH 1ST STATEMENT IN RANDOMIZED SET AND CONTINUE UNTIL ALL STATEMENTS HAVE BEEN RATED. NOTE: DO NOT OFFER “DON’T KNOW” AS A CHOICE, BUT CLICK IT IF RESPONDENT CANNOT CHOOSE A RATING POINT.)

(PROGRAMMER: (ASK Qs 17a. & 17b. LAST IN THE GROUP A SERIES.)

STRONGLY
AGREE

AGREE

NEITHER
AGREE NOR
DISAGREE

DISAGREE

STRONGLY
DISAGREE

DON’T
KNOW

- MOST MEMBERS OF YOUR RELIGIOUS CONGREGATION BELIEVE THAT THE FEDERAL TAX LAWS ARE FAIR1 2 3 4 5 6
- MOST MEMBERS OF YOUR RELIGIOUS CONGREGATION BELIEVE THE IRS TREATS TAXPAYERS FAIRLY1 2 3 4 5 6

(GROUP F DEMOGRAPHICS – ASK ALL:) READ INTRO: FINALLY, I’M GOING TO ASK YOU SOME QUESTIONS ABOUT YOURSELF AND YOUR BACKGROUND. THESE QUESTIONS WILL HELP US BETTER UNDERSTAND HOW PEOPLE WITH DIFFERENT BACKGROUNDS FEEL ABOUT TAX ISSUES.

18. WHICH OF THE FOLLOWING BEST DESCRIBES THE LEVEL OF EDUCATION THAT YOU HAVE COMPLETED? (READ LIST & CLICK ONE ANSWER.)

- ELEMENTARY SCHOOL 1
- SOME HIGH SCHOOL 2
- HIGH SCHOOL GRADUATE 3
- SOME COLLEGE 4
- COLLEGE GRADUATE 5
- POST-GRADUATE WORK 6
- (CLICK IF:) PREFER NOT TO ANSWER 7

19. DO YOU SPEAK A LANGUAGE OTHER THAN ENGLISH AT HOME? (CLICK ANSWER.)

- Yes (ASK Q20 NEXT) 1
- No (SKIP TO CLOSING) 2
- (DON’T READ:) PREFER NOT TO ANSWER (SKIP TO CLOSING) 3

20. (IF "YES" TO Q19, ASK:) **WHAT IS THAT LANGUAGE?** (DO NOT READ CHOICES. CLICK ANSWER.)

- SPANISH..... 1
- CHINESE 2
- VIETNAMESE 3
- KOREAN 4
- RUSSIAN 5
- SOME OTHER LANGUAGE (SPECIFY) 6
- (DON'T READ BUT CLICK IF:) PREFER NOT TO ANSWER 7

CLOSING COMMENTS:

THAT COMPLETES THE SURVEY, WHICH IS A PART OF A NATIONAL RESEARCH STUDY BEING CONDUCTED BY THE TAXPAYER ADVOCATE SERVICE, AN INDEPENDENT ORGANIZATION WITHIN THE INTERNAL REVENUE SERVICE THAT HELPS TAXPAYERS RESOLVE PROBLEMS WITH THE IRS. THE PURPOSE OF THE STUDY IS TO IMPROVE THE ADMINISTRATION OF TAX COLLECTION ON BEHALF OF ALL TAXPAYERS. AS NOTED AT THE BEGINNING OF THE SURVEY, YOU CAN BE ASSURED OF COMPLETE ANONYMITY AND THAT YOUR PERSONAL ANSWERS AND OPINIONS FROM THIS SURVEY WILL NEVER BE SHARED WITH ANYONE – NOT EVEN WITH THE TAXPAYER ADVOCATE SERVICE OR THE IRS. INSTEAD, YOUR ANSWERS WILL BE ANALYZED ONLY IN COMBINATION WITH THOSE OF THOUSANDS OF OTHER TAXPAYERS.

IN ADDITION, WE ARE REQUIRED BY LAW TO PROVIDE YOU THE OMB (OFFICE OF MANAGEMENT AND BUDGET) CONTROL NUMBER FOR THIS PUBLIC INFORMATION REQUEST. THAT NUMBER IS 1545-1432. IN ADDITION, IF YOU HAVE ANY COMMENTS ABOUT THE TIME ESTIMATE TO COMPLETE THE SURVEY OR WAYS TO IMPROVE THE SURVEY, YOU MAY WRITE TO THE IRS. WOULD YOU LIKE THE ADDRESS? (IF YES, ADDRESS IS...) INTERNAL REVENUE SERVICE, TAX PRODUCTS COORDINATING COMMITTEE, SE:W:CAR:MP:T:T:SP, 1111 CONSTITUTION AVE. NW, WASHINGTON, DC 20224. INTERVIEWER: AFTER COMPLETING INTERVIEW, CROSS-CHECK COMPLETENESS AND ACCURATELY TRANSFER TO BOX ON PAGE 1 ANY APPLICABLE APPENDED DATA FOR THIS RESPONDENT.

Thank you for your time and help with the survey.

APPENDIX II: RUSSELL RESEARCH TOPLINE SUMMARY

TOPLINE SUMMARY

OF TAS STUDY OF FACTORS INFLUENCING COMPLIANCE

INTRODUCTION

Background/Overview

A principal goal of the Internal Revenue Service (IRS) is to maximize the rate at which taxpayers pay their tax obligations voluntarily. To maximize voluntary compliance, the IRS needs to understand why taxpayers comply. Research shows that a broad variety of factors motivate taxpayers' decisions to comply with income tax laws. For example, a survey of current research conducted for the Taxpayer Advocate Service (TAS) and published in Volume 2 of the National Taxpayer Advocate's 2007 Annual Report to Congress identified numerous factors driving taxpayer compliance decisions in addition to the expected likelihood and cost of getting caught underreporting (called "economic deterrence"). These factors include compliance norms, trust in the government and the tax administration process, complexity and the convenience of complying, and the influence of preparers. More research was needed, however, to allow the IRS to understand the extent to which each of these factors motivates taxpayer compliance decisions and how their influence varies for different segments of the taxpaying population. Thus, the study summarized here was undertaken by TAS.

This research focused on sole proprietors, *i.e.*, those who file Form 1040 Schedule C, *Profit or Loss from Business*. This segment of the taxpaying population is responsible for the largest portion of the tax gap (*i.e.*, the portion of total taxes due that are not voluntarily and timely paid). The IRS is least likely to be able to detect or deter noncompliance by this segment without expending significant enforcement resources because most sole proprietor income is not subject to third-party information reporting. Relatively inexpensive measures, such as document matching and correspondence examinations, cannot reliably detect income that is not subject to 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**.

Objectives Of This Study

TAS contracted Russell Research to help design and conduct a telephone-based survey to two different groups. The survey objectives included **identifying and quantifying the major factors that drive taxpayer compliance behavior**. The survey was administered to **a representative national sample of taxpayers who are sole proprietors**. It explored the factors potentially influencing compliance

behavior. The survey was also administered to a sample of high and low compliance communities. The communities research will enable TAS to better evaluate whether taxpayers' affiliations within their communities appear to influence compliance behavior. TAS will analyze data collected through this survey research to study the relationship between taxpayer attitudes with respect to the above-mentioned factors and taxpayer compliance behavior.

Sample Design & Methodology

In order to monitor taxpayer tax compliance, the IRS classifies tax returns into mutually exclusive groups called examination activity codes, and develops a separate compliance risk scoring algorithm (*i.e.*, DIF algorithm) for each activity code. For sole proprietors (*i.e.*, those who file tax returns that include a schedule C), the activity codes are defined in terms of the amount of gross receipts reported on the schedule C and the taxpayer's total positive income (which is essentially the taxpayer's income from all sources before adjusting for deductions and exemptions). The scores generated by the DIF algorithms are called DIF scores. TAS Research collected DIF scores from tax year 2009 returns for the population of taxpayers in the six activity codes included in the study. These activity codes included all sole proprietors residing in the United States, except low income taxpayers who claimed the earned income tax credit (EITC). The total population size (universe) for the study was about 16,000,000 taxpayers.

The DIF scores were sorted in ascending order by deciles within each of the six activity codes. TAS used the decile that each taxpayer's DIF score fell within as the indicator of the taxpayer's compliance level, *i.e.*, scores ranged from 1 to 10, with 1 representing taxpayers in the first decile, etc. The likelihood of noncompliance increases as the DIF score increases. So, those in the first decile have the lowest DIF scores and most compliant behavior.

The survey was administered to two groups of sole proprietor taxpayers: a representative national sample with 3,306 respondents — divided into high and low compliance strata within exam activity codes as shown below; and a "community" sample with 535 respondents — 173 in the high compliance community stratum and 362 in the low compliance community stratum. (Data collected from the community survey provides useful information in enabling TAS to better evaluate whether taxpayers' affiliations within their communities influence their compliance behavior, but is not data that can be generalized to the overall population.) The response rate during data collection by Russell Research was 56 percent for the national sample and 54 percent for the community sample.

Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results

National Sample Strata		Population	Sample
EAC 274	Deciles 1 - 2	2,053,331	350
EAC 274	Deciles 9 - 10	2,053,331	350
EAC 275	Deciles 1 - 2	571,075	351
EAC 275	Deciles 9 - 10	571,075	384
EACs 276, 277	Deciles 1 - 2	268,565	359
EACs 276, 277	Deciles 9 - 10	268,565	350
EACs 280, 281	Deciles 1 - 2	256,306	383
EACs 280, 281	Deciles 9 - 10	256,306	379
All EACs	Deciles 3 - 8	9,447,830	400
Total		15,745,384	3,306

Russell Research conducted all interviews via telephone from 1/03/12 to 4/19/12, using TAS-provided lists and then further randomly selecting (on an nth selection basis) respondents for each stratum/cell. All potential respondents initially contacted were re-contacted up to three times in order to properly dispose of the contact (including re-contact by more senior interviewers on refusals).

SUMMARY OF FINDINGS

Results from the **National Sample** indicated that compliance potentially correlates to a range of profiling characteristics as well as attitudes and organizational influences.

- In **profiling characteristics**, **high compliance taxpayers** were **significantly higher than low compliance taxpayers** in terms of being Self-Filers and more Female-skewed, and in having Smaller Companies with Lower Receipts and Lower Expenses.
- In terms of **attitudes**, **high compliance taxpayers** were less likely to be Risk-Takers, were less Anti-Government and Anti-Tax, and less cynical about the IRS.
- And in terms of **organizational influences**, **high compliance taxpayers** were less likely (than low compliance taxpayers) to be involved in Local Business Organizations, Trade/Labor/Occupational Organizations, and Churches/Congregations **and if they are members of those organizations**, they tended to be **less frequent participants** who were also **less cognizant of the attitudes toward taxes of other members** of the same groups (or less likely to perceive other members as having negative attitudes toward federal taxes). In addition, while high compliance taxpayers were equally likely (as low compliance taxpayers) to be members of Volunteer Organizations, Have Children In Schools, and Vote In Local Elections, they were again less cognizant of the attitudes toward Federal taxes of other Volunteers or their Local Public Officials.

Results from the **Communities Sample** showed that most differences between high and low compliance communities came in attitudes.

- First, there were few notable differences in the **profiling characteristics** of **high vs. low compliance communities** — mainly more high compliance taxpayers speaking a language other than English at home and some differences by segment in the types of industries represented.
- But in terms of **attitudes**, there were clear differences, with **high compliance communities** being more likely to follow tax instructions, check their return, and not underreport income because of hearing of those who were caught doing so. Yet, they were also more likely to say their preparer can creatively minimize taxes. In other attitudinal differences vs. low compliance communities, the high compliance communities indicated stronger belief in the benefits of, fairness, and fair sharing of federal taxes. They were also more likely to believe that the IRS treats everyone with respect and fairness and provides easy access to and high quality services. They were also more likely to approach paying taxes as a moral obligation.
- Finally, base sizes were generally too small for analysis of most **organizational influences** — though results did show that high compliance taxpayers are less likely to belong to Trade, Labor & Occupational groups, Volunteer organizations, are less likely to have Children in School, Vote, or Belong To Churches/Congregations.

SUMMARIZED TABULAR DATA FROM SURVEY

STATISTICAL NOTATION USED IN TABULAR SUMMARY

○ = data significantly higher than all comparative data point(s) at 95% confidence level. If arrow next to Circle, then data significantly lower than only the one comparative data point indicated by the arrow.

□ = data significantly lower than all comparative data point(s) at 95% confidence level. If arrow next to Box, then data significantly lower than only the one comparative data point indicated by the arrow.

* **IMPORTANT ANALYTICAL NOTE:** The statistical and analytical comparisons here are always between the High, Low and Moderate Compliance segments in the National Survey or between the High and Low Compliance communities in the Communities Survey. Results from the National versus Communities surveys have not been compared here.

Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results

FACTORS INFLUENCING SMALL BUSINESSES' COMPLIANCE WITH INCOME TAX LAWS

TABLE 1 – SCHEDULE C FILER PROFILING DATA

	-----NATIONAL SURVEY-----			---COMMUNITIES SURVEY---	
	HIGH COMPLIANCE (1443) %	LOW COMPLIANCE (1463) %	MODERATE COMPLIANCE (400) %	HIGH COMPLIANCE (173) %	LOW COMPLIANCE (362) %
TOTAL RESPONDENTS					
Q1 – GENDER					
MALE	59	← (65)	61	48	52
FEMALE	(41) →	35	39	52	48
Q2 – AGE: MEAN AGE	51	50	48	42	45
Q18 – EDUCATION: % WITH SOME COLLEGE	83	84	(77)	89	86
Q19 – LANGUAGE: % SPEAK NON-ENGLISH AT HOME	(7)	14	10	(22)	9
Q4 – # PEOPLE EMPLOYED BY COMPANY					
AVERAGE # EMPLOYEES	3.6	(6.6)	2.2	1.7	1.2
% WITH NO EMPLOYEES	(66) →	59	62	69	66
% WITH 1 EMPLOYEE	19	16	15	4	(12)
% WITH 2+ EMPLOYEES	(14)	24	23	26	21
NO Q – IRS AREA					
AREA 1	(21) →	17	20	(32)	1
AREA 2	26	23	24	(68)	45
AREA 3	19	21	19	-	5
AREA 4	18	18	18	-	36
AREA 5	17	20	19	-	12

Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results

TABLE 2 – SCHEDULE C FILER PROFILING DATA (CONT'D.)

	-----NATIONAL SURVEY-----			---COMMUNITIES SURVEY---	
	HIGH COMPLIANCE (1443) %	LOW COMPLIANCE (1463) %	MODERATE COMPLIANCE (400) %	HIGH COMPLIANCE (173) %	LOW COMPLIANCE (362) %
TOTAL RESPONDENTS					
Q5 – CUSTOMERS ARE PRIMARILY...					
LOCAL	78	77	83	85	82
NATIONAL	17	19	14	14	16
INTERNATIONAL	3	3	3	2	2
REFUSED	2	1	-	-	0
APPENDS – NAICS/NORTH AM. INDUSTRY CLASSIFICATION					
PROFESSIONAL, SCIENTIFIC, AND TECHNICAL SERVICES	26	17	16	11	22
OTHER SERVICES (EXCEPT PUBLIC ADMINISTRATION)	10	9	17	22	11
HEALTH CARE AND SOCIAL ASSISTANCE	7	4	7	5	8
ARTS, ENTERTAINMENT, AND RECREATION	7	5	4	5	1
RETAIL TRADE	7	8	7	13	5
FINANCE AND INSURANCE	6	5	2	1	5
CONSTRUCTION	4	9	9	3	7
REAL ESTATE AND RENTAL AND LEASING	4	9	2	2	5
ADMIN, SUPPORT, WM, REMEDIATION SVCS	3	4	6	11	7
EDUCATIONAL SERVICES	2	1	3	1	3
MANUFACTURING	2	2	1	1	0
TRANSPORTATION AND WAREHOUSING	2	3	3	1	3
WHOLESALE TRADE	1	2	2	1	0
INFORMATION	1	1	3	1	1
ACCOMMODATION AND FOOD SERVICES	1	2	3	1	0
AGRICULTURE, FORESTRY, FISHING AND HUNTING	1	2	2	0	0
MINING, QUARRYING, AND OIL AND GAS EXTRACTION	0	1	-	1	-
ALL OTHER/UNCLASSIFIED	17	17	14	20	18
APPENDS – RECEIPTS: MEAN	\$45,837	\$87,135	\$77,396	\$36,255	\$30,300
APPENDS – EXPENSES: MEAN	\$12,190	\$49,828	\$33,550	\$17,606	\$18,327
APPENDS – POSITIVE INCOME: MEAN	\$90,724	\$92,340	\$74,311	\$87,301	\$67,208
APPENDS – EXAM ACTIVITY: % WITH EXAM ACTIVITY	2	9	7	4	10
APPENDS – COLLECTION ACTIVITY: % W/COLLECTION ACT	1	3	1	1	7
APPENDS – BUSINESS OWNER TYPE					
PRIMARY	76	76	74	78	73
SECONDARY	24	24	26	22	27

Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results

TABLE 3 – WHO PREPARED MOST RECENT FEDERAL INCOME TAX RETURN

	-----NATIONAL SURVEY-----			---COMMUNITIES SURVEY---	
	HIGH COMPLIANCE (1443) %	LOW COMPLIANCE (1463) %	MODERATE COMPLIANCE (400) %	HIGH COMPLIANCE (173) %	LOW COMPLIANCE (362) %
TOTAL RESPONDENTS					
Q6 – WHO PREPARED MOST RECENT TAX RETURN					
COMPLETE IT YOURSELF	32	21	24	14	33
COMPLETE IT YOURSELF USING TAX SOFTWARE	25	15	18	11	28
COMPLETE IT YOURSELF WITHOUT USING TAX SOFTWARE	7	7	5	3	6
COMPLETELY BY TAX PREPARER/THIRD PARTY	68	78	74	86	65
HAVE IT COMPLETED BY A PAID TAX PREPARER	66	76	73	84	64
HAVE IT COMPLETED BY AN UNPAID THIRD PARTY	2	2	2	1	1
NONE OF THE ABOVE	0	0	1	-	2
REFUSED	0	0	1	-	-

Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results

TABLE 4 – ATTITUDES TOWARD PERSONAL FINANCES & PREPARING & FILING TAXES

	-----NATIONAL SURVEY-----			---COMMUNITIES SURVEY---	
	HIGH COMPLIANCE (1443) %	LOW COMPLIANCE (1463) %	MODERATE COMPLIANCE (400) %	HIGH COMPLIANCE (173) %	LOW COMPLIANCE (362) %
TOTAL RESPONDENTS					
Q7 – TOP-TWO BOX AGREEMENT RATING (STRONGLY AGREE/AGREE)					
I ALWAYS FOLLOW THE INSTRUCTIONS OR ADVICE FROM THE PERSON WHO PREPARES MY RETURN	96	90	95	98	89
ACHIEVING FINANCIAL SUCCESS IS IMPORTANT TO ME	85	88	90	96	93
I MAKE SURE THAT I UNDERSTAND EVERY ITEM THAT IS INCLUDED OR OMITTED FROM MY RETURN BEFORE SIGNING IT	80	79	79	91	84
THESE DAYS, IT IS DIFFICULT TO MAKE ENDS MEET	74	77	78	76	81
MY RECORD KEEPING SYSTEM MAKES IT EASY FOR ME TO COMPUTE THE AMOUNT OF INCOME TAX I NEED TO REPORT ON MY RETURN	74	76	72	74	79
THE RULES ABOUT WHAT TO REPORT AS INCOME ARE CLEAR	63	65	65	73	68
HEARING ABOUT PEOPLE WHO WERE CAUGHT NOT REPORTING THEIR TAXES MAKES ME TEND TO BE EVEN MORE CAREFUL WITH MY OWN TAXES	61	66	73	86	70
TAKING RISKS IS NECESSARY TO ACHIEVE FINANCIAL SUCCESS	61	68	65	70	67
THE PERSON WHO PREPARES MY RETURN FINDS CREATIVE WAYS TO MINIMIZE TAXES	35	28	36	47	35
EVEN THOUGH SOMEONE ELSE PREPARED MY RETURN, I KNOW THE FEDERAL TAX LAWS WELL ENOUGH TO PREPARE MY OWN TAX RETURN	23	23	19	28	27
A PERSON'S STATUS IN MY COMMUNITY DEPENDS ON THEIR FINANCIAL STATUS	23	27	27	41	35

Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results

TABLE 5 – ATTITUDES TOWARD FEDERAL GOVERNMENT & FEDERAL TAX LAWS

	-----NATIONAL SURVEY-----			---COMMUNITIES SURVEY---	
	HIGH COMPLIANCE (1443) %	LOW COMPLIANCE (1463) %	MODERATE COMPLIANCE (400) %	HIGH COMPLIANCE (173) %	LOW COMPLIANCE (362) %
TOTAL RESPONDENTS					
Q8 – TOP-TWO BOX AGREEMENT RATING (STRONGLY AGREE/AGREE)					
LARGE BUSINESSES HAVE LOOPHOLES TO REDUCE THEIR FEDERAL TAXES THAT SMALLER BUSINESSES DO NOT HAVE	77	75	76	71	80
THE WEALTHY HAVE WAYS OF MINIMIZING THEIR FEDERAL TAXES THAT ARE NOT AVAILABLE TO THE AVERAGE TAXPAYER	74	69	74	71	74
TAXES FUND IMPORTANT FEDERAL GOVERNMENT BENEFITS AND SERVICES	71	70	70	86	67
THE TAX RULES ARE SO COMPLICATED THAT IT IS VERY DIFFICULT TO GET A TAX RETURN EXACTLY RIGHT	62	58	54	64	63
THE FEDERAL GOVERNMENT IS INVOLVED IN AREAS BEST LEFT TO THE PRIVATE SECTOR	59	66	64	50	54
TAXPAYERS WOULD TOLERATE HIGHER TAXES IF IT MEANT IMPROVED FEDERAL GOVERNMENT SERVICES	37	30	37	54	37
THE FEDERAL TAX LAWS ARE FAIR	15	15	17	33	24
UNDER OUR FEDERAL TAX LAWS, EVERYONE PAYS THEIR FAIR SHARE OF TAXES	13	16	10	24	11
THE FEDERAL GOVERNMENT SPENDS TAX DOLLARS WISELY	8	6	7	22	11

Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results

TABLE 6 – ATTITUDES TOWARD IRS INTERACTION WITH TAXPAYERS

	-----NATIONAL SURVEY-----			---COMMUNITIES SURVEY---	
	HIGH COMPLIANCE (1443) %	LOW COMPLIANCE (1463) %	MODERATE COMPLIANCE (400) %	HIGH COMPLIANCE (173) %	LOW COMPLIANCE (362) %
TOTAL RESPONDENTS					
Q9 – TOP-TWO BOX AGREEMENT RATING (STRONGLY AGREE/AGREE)					
WEALTHY TAXPAYERS HAVE AN ADVANTAGE WHEN DEALING WITH THE IRS	58	59	63	52	62
THE IRS WILL WORK WITH YOU IF YOU HAVE DIFFICULTY PAYING YOUR TAXES	49	55	53	63	58
THE IRS TREATS TAXPAYERS WITH RESPECT	47	47	45	63	53
THE IRS TREATS TAXPAYERS FAIRLY	47	42	41	68	42
IT IS EASY FOR ME TO ACCESS THE FEDERAL TAX SERVICES THAT THE IRS PROVIDES	45	48	48	60	51
THE IRS OFFERS ALL OF THE FEDERAL TAX SERVICES I NEED	43	43	46	48	46
I AM SATISFIED WITH THE QUALITY OF THE FEDERAL TAX SERVICES THE IRS PROVIDES	40	39	41	68	42
THE IRS PROBABLY KNOWS WHEN PEOPLE DO NOT REPORT ALL OF THEIR INCOME	39	52	54	52	62
BECAUSE THE IRS TREATS TAXPAYERS FAIRLY, I ACCEPT ITS DECISIONS EVEN IF I DISAGREE WITH THEM	38	42	43	46	43
THE IRS IS MORE CONCERNED WITH COLLECTING AS MUCH AS IT CAN, THAN WITH COLLECTING THE CORRECT AMOUNT OF TAX	25	42	34	35	48

Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results

TABLE 7 – ATTITUDES TOWARD COMPLYING WITH TAX LAWS

	-----NATIONAL SURVEY-----			---COMMUNITIES SURVEY---	
	HIGH COMPLIANCE (1443) %	LOW COMPLIANCE (1463) %	MODERATE COMPLIANCE (400) %	HIGH COMPLIANCE (173) %	LOW COMPLIANCE (362) %
TOTAL RESPONDENTS					
Q10 – TOP-TWO BOX AGREEMENT RATING (STRONGLY AGREE/AGREE)					
I FEEL A MORAL OBLIGATION TO CORRECTLY REPORT ALL OF MY INCOME	96	96	93	98	92
EVERYONE SHOULD CORRECTLY REPORT ALL OF THEIR INCOME	94	97	96	98	95
IF OTHERS FOUND OUT I DID NOT REPORT ALL OF MY INCOME, I WOULD BE EMBARRASSED	78	79	75	90	76
PEOPLE WHO DO NOT REPORT ALL OF THEIR INCOME ARE LIKELY TO END UP PAYING EVEN MORE IN PENALTIES AND INTEREST	68	75	74	84	78
MANY SMALL BUSINESSES DO NOT REPORT ALL OF THEIR INCOME	26	27	28	27	33
MOST OF MY COMPETITORS REPORT ALL OF THEIR INCOME	22	31	28	35	27
MOST SMALL BUSINESSES COULD NOT SURVIVE IF THEY REPORTED ALL OF THEIR INCOME	12	15	12	23	16

Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results

TABLE 8 – MEMBERSHIP IN & ATTITUDES OF LOCAL BUSINESS ORGANIZATIONS

	-----NATIONAL SURVEY-----			---COMMUNITIES SURVEY---	
	HIGH COMPLIANCE (1443) %	LOW COMPLIANCE (1463) %	MODERATE COMPLIANCE (400) %	HIGH COMPLIANCE (173) %	LOW COMPLIANCE (362) %
TOTAL RESPONDENTS					
Q11A – WHETHER BELONG TO LOCAL BUSINESS ORGS.					
BELONG TO LOCAL BUSINESS ORGANIZATIONS	11	16	11	9	10
DO NOT BELONG TO LOCAL BUSINESS ORGANIZATIONS	89	84	89	89	90
REFUSED	0	0	0	1	0
<i>(NEW BASE: TOTAL BELONG TO LOCAL BUSINESS ORGANIZATIONS)</i>	<i>(188)</i>	<i>(307)</i>	<i>(47)</i>	<i>(28)</i>	<i>(45)</i>
FOR THE ONE LOCAL BUS ORG MOST CLOSELY ASSOCIATE WITH:					
Q11B – FREQ. OF PARTICIPATING IN ORG'S ACTIVITIES					
ALWAYS/USUALLY	30	50	26	31	20
SOMETIMES	45	27	42	36	36
RARELY/NEVER	25	22	31	33	44
Q11C – FREQUENCY OF SOCIALIZING W/MEMBERS OF ORG					
FREQUENTLY/OCCASIONALLY	75	69	65	83	44
RARELY/NEVER	25	31	35	17	55
Q11D – ATTITUDES OF MEMBERS TOWARD FEDERAL INCOME TAXES					
"MOST MEMBERS OF THIS ORGANIZATION BELIEVE FEDERAL TAX LAWS ARE FAIR"					
STRONGLY AGREE/AGREE	20	17	13	18	24
NEITHER AGREE NOR DISAGREE	23	13	18	14	29
DISAGREE/STRONGLY DISAGREE	28	48	38	65	36
DON'T KNOW	29	22	32	4	12
Q11D – ATTITUDES OF MEMBERS TOWARD FEDERAL INCOME TAXES					
"MOST MEMBERS OF THIS ORGANIZATION BELIEVE THE IRS TREATS TAXPAYERS FAIRLY"					
STRONGLY AGREE/AGREE	20	23	11	22	4
NEITHER AGREE NOR DISAGREE	19	14	16	20	29
DISAGREE/STRONGLY DISAGREE	21	37	32	48	57
DON'T KNOW	40	26	41	11	10

RED BOLD BASES = CAUTION: SMALL BASE OF <50 AND DATA BELOW IT HAVE NOT BEEN TESTED FOR STATISTICAL SIGNIFICANCE.

Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results

TABLE 9 – MEMBERSHIP IN & ATTITUDES OF LOCAL TRADE, LABOR & OCCUPATIONAL ORGANIZATIONS

	-----NATIONAL SURVEY-----			---COMMUNITIES SURVEY---	
	HIGH COMPLIANCE (1443) %	LOW COMPLIANCE (1463) %	MODERATE COMPLIANCE (400) %	HIGH COMPLIANCE (173) %	LOW COMPLIANCE (362) %
TOTAL RESPONDENTS					
Q12A – WHETHER BELONG TO ANY LOCAL TRADE, LABOR, OR OTHER OCCUPATIONAL ORGANIZATIONS					
BELONG TO LOCAL TRADE/LABOR/OCCUPATIONAL ORGS	15	18	13	10	20
DO NOT BELONG TO LOCAL TRADE/LABOR/OCCUP ORGS.	85	81	87	90	80
REFUSED	0	1	0	1	0
(TOTAL BELONG TO LOCAL TRADE/LABOR/OCCUPATIONAL ORGS)	(244)	(277)	(52)	(25)	(63)
FOR THE ONE LOCAL TRADE/LABOR/OCCUPATIONAL ORGANIZATION MOST CLOSELY ASSOCIATE WITH:					
Q12B – FREQ. OF PARTICIPATION IN ORG'S. ACTIVITIES					
ALWAYS/USUALLY	24	40	23	37	47
SOMETIMES	34	26	55	26	32
RARELY/NEVER	41	25	20	37	21
REFUSED	1	8	3	-	0
Q12C – FREQ. OF SOCIALIZING W/MEMBERS OF ORG.					
FREQUENTLY/OCCASIONALLY	71	65	70	63	75
RARELY/NEVER	28	26	28	37	25
REFUSED	0	9	2	-	-
Q12D – ATTITUDES OF MEMBERS TOWARD FEDERAL INCOME TAXES					
"MOST MEMBERS BELIEVE FEDERAL TAX LAWS ARE FAIR"					
STRONGLY AGREE/AGREE	23	26	14	18	26
NEITHER AGREE NOR DISAGREE	16 →	8	10	23	11
DISAGREE/STRONGLY DISAGREE	38	42	44	47	55
DON'T KNOW	23	24	31	11	8
Q12D – ATTITUDES OF MEMBERS TOWARD FEDERAL INCOME TAXES					
"MOST MEMBERS BELIEVE IRS TREATS TAXPAYERS FAIRLY"					
STRONGLY AGREE/AGREE	24	27	17	23	30
NEITHER AGREE NOR DISAGREE	23	10	12	31	15
DISAGREE/STRONGLY DISAGREE	28	← 46	40	36	46
DON'T KNOW	25	17	30	11	8

RED BOLD BASES = CAUTION: SMALL BASE OF <50 AND DATA BELOW IT HAVE NOT BEEN TESTED FOR STATISTICAL SIGNIFICANCE.

Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results

TABLE 10 – MEMBERSHIP IN & ATTITUDES OF LOCAL CIVIC, COMMUNITY & FRATERNAL ORGANIZATIONS

	-----NATIONAL SURVEY-----			---COMMUNITIES SURVEY---	
	HIGH COMPLIANCE (1443) %	LOW COMPLIANCE (1463) %	MODERATE COMPLIANCE (400) %	HIGH COMPLIANCE (173) %	LOW COMPLIANCE (362) %
TOTAL RESPONDENTS					
Q13A – WHETHER BELONG TO CIVIC/COMM/FRAT ORGS					
BELONG TO LOCAL COMMUNITY ORGANIZATIONS	11	13	13	15	14
DO NOT BELONG TO LOCAL COMMUNITY ORGANIZATIONS	88	86	86	83	86
REFUSED	1	1	0	1	0
(TOTAL BELONG TO LOCAL OCCUPATIONAL ORG)	(189)	(248)	(58)	(43)	(55)
FOR THE ONE LOCAL CIVIC/COMMUNITY/FRATERNAL ORGANIZATION MOST CLOSELY ASSOCIATE WITH:					
Q13B – FREQ. OF PARTICIPATION IN ORG'S ACTIVITIES					
ALWAYS/USUALLY	47	67	59	38	70
SOMETIMES	32	22	27	37	25
RARELY/NEVER	19	10	14	21	4
REFUSED	1	0	-	4	-
Q13C – FREQ. OF SOCIALIZING W/MEMBERS OF ORG.					
FREQUENTLY/OCCASIONALLY	83	85	82	80	91
RARELY/NEVER	15	15	18	16	9
REFUSED	2	-	-	4	-
Q13D – ATTITUDES OF MEMBERS TOWARD FEDERAL INCOME TAXES					
"MOST MEMBERS BELIEVE FEDERAL TAX LAWS ARE FAIR"					
STRONGLY AGREE/AGREE	13	17	16	28	29
NEITHER AGREE NOR DISAGREE	28	14	14	5	7
DISAGREE/STRONGLY DISAGREE	23	50	53	42	49
DON'T KNOW	37	19	17	25	15
Q13D – ATTITUDES OF MEMBERS TOWARD FEDERAL INCOME TAXES					
"MOST MEMBERS BELIEVE IRS TREATS TAXPAYERS FAIRLY"					
STRONGLY AGREE/AGREE	20	21	11	35	28
NEITHER AGREE NOR DISAGREE	25	17	14	5	7
DISAGREE/STRONGLY DISAGREE	18	36	57	31	49
DON'T KNOW	38	26	18	29	16

RED BOLD BASES = CAUTION: SMALL BASE OF <50 AND DATA BELOW IT HAVE NOT BEEN TESTED FOR STATISTICAL SIGNIFICANCE.

Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results

TABLE 11 – MEMBERSHIP IN & ATTITUDES OF LOCAL VOLUNTEER ORGANIZATIONS

	-----NATIONAL SURVEY-----			---COMMUNITIES SURVEY---	
	HIGH COMPLIANCE (1443) %	LOW COMPLIANCE (1463) %	MODERATE COMPLIANCE (400) %	HIGH COMPLIANCE (173) %	LOW COMPLIANCE (362) %
TOTAL RESPONDENTS					
Q14A – FREQ. OF VOLUNTEERING FOR LOCAL ORGS					
EVER VOLUNTEER	62	61	54	58	67
NEVER	34	35	43	40	32
REFUSED	4	4	3	2	1
(TOTAL EVER DO VOLUNTEER WORK)	(870)	(886)	(211)	(120)	(231)
FOR THE ONE LOCAL VOLUNTEER ORGANIZATION MOST CLOSELY ASSOCIATE WITH:					
Q14B – ATTITUDES OF MEMBERS TOWARD FEDERAL INCOME TAXES					
"MOST MEMBERS BELIEVE FEDERAL TAX LAWS ARE FAIR"					
STRONGLY AGREE/AGREE	15	20	18	15	25
NEITHER AGREE NOR DISAGREE	24	20	23	16	21
DISAGREE/STRONGLY DISAGREE	24	33	32	18	29
DON'T KNOW	36	27	27	51	26
Q14B – ATTITUDES OF MEMBERS TOWARD FEDERAL INCOME TAXES					
"MOST MEMBERS BELIEVE IRS TREATS TAXPAYERS FAIRLY"					
STRONGLY AGREE/AGREE	16	24	25	18	32
NEITHER AGREE NOR DISAGREE	22	23	24	16	20
DISAGREE/STRONGLY DISAGREE	19	24	21	15	25
DON'T KNOW	43	28	31	51	23

Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results

TABLE 12 – USE OF & ATTITUDES OF PARENTS IN LOCAL PUBLIC OR PRIVATE SCHOOLS

	-----NATIONAL SURVEY-----			---COMMUNITIES SURVEY---	
	HIGH COMPLIANCE	LOW COMPLIANCE	MODERATE COMPLIANCE	HIGH COMPLIANCE	LOW COMPLIANCE
TOTAL RESPONDENTS	(1443) %	(1463) %	(400) %	(173) %	(362) %
Q15A – WHETHER HAVE CHILDREN ATTENDING					
LOCAL PUBLIC/PRIVATE SCHOOL					
HAVE CHILDREN ATTENDING	33	32	36	37	52
DO NOT HAVE CHILDREN ATTENDING	67	67	64	63	47
REFUSED	1	1	0	1	0
<i>(TOTAL HAVE CHILDREN IN PUBLIC/PRIVATE SCHOOL)</i>	<i>(290)</i>	<i>(333)</i>	<i>(92)</i>	<i>(45)</i>	<i>(96)</i>
THINKING OF THE PARENTS OF CHILDREN WITH WHOM THEIR CHILDREN PLAY:					
Q15B – ATTITUDES OF PARENTS TOWARD FEDERAL INCOME TAXES					
“MOST PARENTS OF CHILDREN BELIEVE FEDERAL TAX LAWS ARE FAIR”					
STRONGLY AGREE/AGREE	11	15	17	37	27
NEITHER AGREE NOR DISAGREE	14	16	12	15	18
DISAGREE/STRONGLY DISAGREE	38	35	34	15	42
DON'T KNOW	37	33	38	33	13
Q15B – ATTITUDES OF PARENTS TOWARD FEDERAL INCOME TAXES					
“MOST PARENTS OF CHILDREN BELIEVE IRS TREATS TAXPAYERS FAIRLY”					
STRONGLY AGREE/AGREE	15	17	18	39	27
NEITHER AGREE NOR DISAGREE	19	16	13	17	22
DISAGREE/STRONGLY DISAGREE	29	30	29	9	37
DON'T KNOW	37	36	40	35	15

RED BOLD BASES = CAUTION: SMALL BASE OF <50 AND DATA BELOW IT HAVE NOT BEEN TESTED FOR STATISTICAL SIGNIFICANCE.

Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results

TABLE 13 – VOTING FOR & ATTITUDES OF LOCAL ELECTED OFFICIALS

	-----NATIONAL SURVEY-----			---COMMUNITIES SURVEY---	
	HIGH COMPLIANCE (1443) %	LOW COMPLIANCE (1463) %	MODERATE COMPLIANCE (400) %	HIGH COMPLIANCE (173) %	LOW COMPLIANCE (362) %
TOTAL RESPONDENTS					
Q16A – FREQUENCY OF VOTING IN ELECTIONS FOR CONGRESS, MAYOR OR OTHER LOCAL ELECTED OFFICIALS					
ALWAYS/USUALLY	83	81	74	64	73
SOMETIMES	6	8	11	10	12
RARELY/NEVER	9	10	12	23	12
REFUSED	2	1	3	3	3
Q16B – LOCAL OFFICIALS ATTITUDES TOWARD FEDERAL INCOME TAXES					
<i>"YOUR LOCAL OFFICIALS GENERALLY BELIEVE FEDERAL TAX LAWS ARE FAIR"</i>					
STRONGLY AGREE/AGREE	20	24	23	29	25
NEITHER AGREE NOR DISAGREE	23	21	24	25	17
DISAGREE/STRONGLY DISAGREE	19	23	19	14	29
DON'T KNOW	39	32	35	32	29
Q16B – LOCAL OFFICIALS ATTITUDES TOWARD FEDERAL INCOME TAXES					
<i>"YOUR LOCAL OFFICIALS GENERALLY BELIEVE IRS TREATS TAXPAYERS FAIRLY"</i>					
STRONGLY AGREE/AGREE	22	27	28	34	34
NEITHER AGREE NOR DISAGREE	26	21	19	24	17
DISAGREE/STRONGLY DISAGREE	10	18	17	9	20
DON'T KNOW	41	33	36	33	29

Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results

TABLE 14 – PARTICIPATION IN & ATTITUDES OF MEMBERS OF LOCAL CHURCH/OTHER RELIGIOUS CONGREGATIONS

	-----NATIONAL SURVEY-----			---COMMUNITIES SURVEY---	
	HIGH COMPLIANCE (1443) %	LOW COMPLIANCE (1463) %	MODERATE COMPLIANCE (400) %	HIGH COMPLIANCE (173) %	LOW COMPLIANCE (362) %
TOTAL RESPONDENTS					
Q17A – FREQUENCY OF PARTICIPATING IN CHURCH/ OTHER RELIGIOUS CONGREGATIONS					
EVER PARTICIPATE IN CHURCH/CONGREGATION	61	← 71	66	74	81
NEVER	34	27	29	22	15
REFUSED	5	3	6	4	4
(TOTAL PARTICIPATE IN CHURCH/RELIGIOUS CONGREGATIONS)	(920)	(989)	(269)	(125)	(278)
Q17B – ATTITUDES OF MEMBERS OF CHURCH/RELIGIOUS CONGREGATION TOWARD FEDERAL INCOME TAXES					
<i>“MOST MEMBERS BELIEVE FEDERAL TAX LAWS ARE FAIR”</i>					
STRONGLY AGREE/AGREE	16	← 22	15	33	29
NEITHER AGREE NOR DISAGREE	20	21	23	11	16
DISAGREE/STRONGLY DISAGREE	25	23	28	16	32
DON'T KNOW	39	34	35	40	23
Q17B – ATTITUDES OF MEMBERS OF CHURCH/RELIGIOUS CONGREGATION TOWARD FEDERAL INCOME TAXES					
<i>“MOST MEMBERS BELIEVE IRS TREATS TAXPAYERS FAIRLY”</i>					
STRONGLY AGREE/AGREE	20	22	20	35	35
NEITHER AGREE NOR DISAGREE	22	22	21	9	16
DISAGREE/STRONGLY DISAGREE	20	21	23	13	26
DON'T KNOW	39	35	36	43	23

**STUDY OF TAX COURT CASES IN
WHICH THE IRS CONCEDED THE
TAXPAYER WAS ENTITLED TO EARNED
INCOME TAX CREDIT (EITC)**

Study of Tax Court Cases In Which the IRS Conceded the Taxpayer was Entitled to Earned Income Tax Credit (EITC)¹

EXECUTIVE SUMMARY	74
INTRODUCTION	75
BACKGROUND	78
Most EITC Audits are Correspondence Exams, Highly Automated Audits that Generate Most Tax Court Cases	78
Eligibility for EITC is Especially Difficult for Transient Taxpayers to Substantiate	79
The IRS Applies the EITC Rules with Unnecessary Rigidity in Correspondence Exams	79
Most Taxpayers Do Not Dispute the Audit Results, and Those Who Do Almost Always Settle Their Cases Without Trial	81
RESEARCH QUESTIONS	84
METHODOLOGY	85
DATA COLLECTION	85
FINDINGS	86
Taxpayers Often Must Wait for Over a Year to Receive EITC Refunds Which Usually Represent More than a Quarter of Their Income	86
Taxpayers Call the IRS Repeatedly While There is Still Time to Resolve the Case Without Going to Tax Court	87
Taxpayers Can Substantiate their Claims, But Have Difficulty Doing So While Working With Examiners	88
Appeals Officers or Chief Counsel Attorneys Accept Documents Rejected by IRS Examiners in One-Fifth of the Cases	89
The Documents Examiners Reject Are Usually Listed in the IRM as Acceptable Substantiation, and Sometimes Examiners Deny EITC Because they Misapply the Law	89
Hazards of Litigation Is Rarely the Reason the IRS Concedes the Cases	90
Almost One-Fifth of the Cases Involved Duplicate EITC Claims for a Qualifying Child, and These Taxpayers May Need More Time to Provide Documents	91

¹ The principal author of this study is Jill MacNabb, Attorney-Advisor to the National Taxpayer Advocate.

Study of Tax Court Cases In Which the IRS Conceded the Taxpayer was Entitled to Earned Income Tax Credit (EITC)

CONCLUSION 92

RECOMMENDATIONS 92

APPENDIX A: Data Collection Instrument 94

APPENDIX B: Additional Questions Pertaining to Hazards of Litigation 96

APPENDIX C: Notice CP-75 Exam Initial Contact Letter – EIC – Refund Frozen 97

**APPENDIX D: Form 886-H-EIC, Documents You Need To Prove You Can Claim an Earned
Income Credit on the Basis of a Qualifying Child; Form 866-H-DEP, Supporting
Documents for Dependency Exemptions; Form 866-H-HOH, Supporting
Documents to Prove Head of Household Filing Status** 100

EXECUTIVE SUMMARY

When the IRS takes a “second look” at denied EITC claims, taxpayers often recover part or all of the credit. In the meantime, however, they are burdened by uncertainty, the cost of contesting the IRS’s position, and refund delays. The IRS in turn is burdened by the cost of handling contested cases through increasingly higher paid employees and interest charges on delayed refunds. The Taxpayer Advocate Service (TAS) undertook a study to examine a random sample of cases in which the taxpayer petitioned the Tax Court for review of IRS disallowance of the EITC and the IRS conceded the EITC issue in full without trial. The objective of the study is to identify impediments that prevent the IRS from conceding cases before the taxpayer filed the Tax Court petition.

The study found that taxpayers often had to wait almost a year and a half to receive the EITC refunds to which they were entitled. The average EITC claimed was \$3,479 and taxpayers’ average adjusted gross income was \$17,024. For more than half the taxpayers, the claimed EITC represented more than a quarter of their adjusted gross incomes. The government paid interest on delayed refunds in more than a third of the cases, amounting to about \$200 per return.

In most cases, taxpayers try to resolve their cases by repeatedly calling the IRS before they file their Tax Court petitions. They also submit documentation, but usually after petitioning Tax Court. However, taxpayers who submit their documents after petitioning the Tax Court have usually spoken with an IRS examiner beforehand, five times on average. Evidently, taxpayers do not receive from examiners adequate explanations of what documents are needed, but they do receive adequate explanations once they have exited the examination phase of the case. Only infrequently do taxpayers not speak to the IRS or submit any documentation until after they file their Tax Court petitions.

Even when taxpayers submit documentation before petitioning Tax Court, the case may be unnecessarily prolonged. In about a fifth of the cases, taxpayers submit documentation before filing a Tax Court petition that the examiner rejects but an Appeals Officer or Chief Counsel attorney later accepts. The documentation is usually listed in the Internal Revenue Manual (IRM) as acceptable substantiation of the claim. Moreover, examiners sometimes deny EITC because they misapply the law— this happened five percent of the time.

Appeals Officers and Chief Counsel attorneys do not often accept testimony as a substitute for documents, and the cases are rarely conceded due to the hazards of litigation.² The findings suggest that taxpayers are willing to talk with the IRS before they petition the Tax Court and are able to provide acceptable supporting documentation, but do not obtain the information about how to substantiate their claims from their conversations with examiners. Moreover, it appears that Appeals Officers and Chief Counsel employees are more

² As discussed below, “hazards of litigation” refers to the uncertainty of the outcome if the case were litigated.

Study of Tax Court Cases In Which the IRS Conceded the Taxpayer was Entitled to Earned Income Tax Credit (EITC)

adept at evaluating the documents taxpayers provide or more willing to elicit additional documentation as necessary, or both.

INTRODUCTION

The Earned Income Tax Credit (EITC) is an anti-poverty program consisting of a refundable tax credit available to certain low income working taxpayers and their families.³ Each year, the IRS audits the returns of approximately half a million taxpayers who claimed the EITC; EITC audits comprise about a third of all individual taxpayer audits.⁴ The statutory provisions are complex, and the IRS's automated process for evaluating EITC claims sometimes leads it to deny taxpayers the credit Congress intended them to have. When the IRS takes a "second look" at denied EITC claims, the taxpayer often recovers part or all of the credit.⁵ In the meantime, however, taxpayers are burdened by uncertainty, the cost of contesting the IRS's position, and refund delays. The IRS is burdened by the cost of handling contested cases through increasingly higher-paid employees and interest charges on delayed refunds.⁶ Thus, the National Taxpayer Advocate and the IRS have an interest in identifying obstacles that prevent early resolution of EITC cases.

Some taxpayers can overcome these hurdles and take their cases to court. The "family status" provisions in the Internal Revenue Code (IRC), including EITC, were among the top ten sources of court decisions each year from 2001 to 2010, resulting in their inclusion as Most Litigated Issues in the National Taxpayer Advocate's Annual Reports to Congress.⁷ Yet a discussion of litigated issues does not cover cases settled without litigation. In fact, only a small percentage of Tax Court cases (fewer than five percent for each of the past ten years) are closed as a result of a trial and decision. As Figure 1 shows, the largest category of closed cases, from 70 percent in fiscal year (FY) 2002 to 80 percent in FY 2011, consists of settlements.

³ Internal Revenue Code (IRC) § 32.

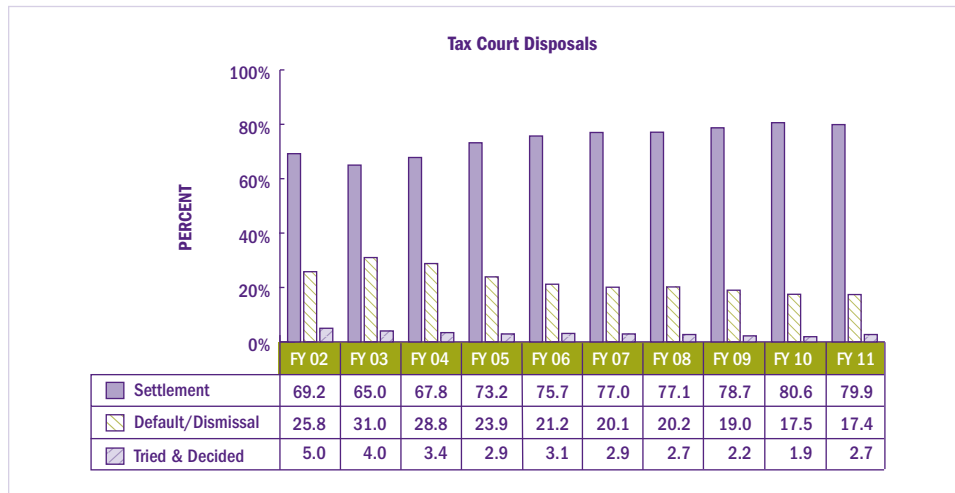
⁴ See National Taxpayer Advocate 2011 Annual Report to Congress 296, 300 (Most Serious Problem: *The IRS Should Reevaluate Earned Income Tax Credit Compliance and Take Steps to Improve Both Service and Compliance*), reporting that the IRS increased the number of EITC audits from 483,825 in fiscal year (FY) 2009 to 585,202 in FY 2010, or from approximately 34 to 37 percent, respectively, of all individual taxpayer audits.

⁵ In the 2004 EITC Audit Reconsideration study, TAS Research found that when enhanced communication techniques are employed in audit reconsiderations, 40 percent of EITC claimants working with IRS Exam employees, and 45 percent of those working with TAS, recovered EITC payments. The 2010 TAS *EITC No Relief, No Response Review* showed that on average, TAS obtains full or partial relief in approximately 48 percent of EITC cases. See TAS Business Performance Review, 2nd Qtr. 2011, 15 (Mar. 2011).

⁶ As discussed below, the first IRS employee assigned to an EITC audit is likely to be a Tax Examiner. A Tax Examiner may begin his or her IRS career as a Grade 5 employee. See National Taxpayer Advocate 2011 Annual Report to Congress vol. 2, 76 (*An Analysis of the IRS Examination Strategy: Suggestions to Maximize Compliance, Improve Credibility, and Respect Taxpayer Rights*). The 2012 base salary for a Grade 5 employee is \$17,803. U.S. Office of Personnel Management, 2012 General Schedule (Base), available at <http://www.opm.gov/oca/12tables/pdf/gs.pdf>. Once the taxpayer files a Tax Court petition, the case is handled by a Chief Counsel attorney. Newly-appointed Chief Counsel attorneys may begin their IRS careers as Grade 11, step 8 employees. See IRS Publ'n. 4063 (Rev. Apr. 2011). The 2012 base salary for a Grade 11 step 8 employee is \$62,019.

⁷ IRC § 7803(c)(2)(B)(ii)(x) requires the National Taxpayer Advocate to identify in her Annual Report to Congress the ten tax issues most litigated in federal courts. See Most Litigated Issues, *supra*. The "family status" provisions include IRC § 2, *Definitions and Special Rules*; IRC § 21, *Expenses for Household and Dependent Care Services Necessary for Gainful Employment*; IRC § 24, *Child Tax Credit*; IRC § 32, *Earned Income*; and IRC § 151, *Allowance of Deductions for Personal Exemptions*.

Study of Tax Court Cases In Which the IRS Conceded the Taxpayer was Entitled to Earned Income Tax Credit (EITC)

FIGURE 1, Tax Court Disposals, FY 2002–2011⁸

Thus, restricting an analysis of EITC cases to those that are litigated overlooks a great deal of activity and significant information.

More than half of all Tax Court cases (EITC and non-EITC) originate as campus correspondence exams, a highly automated type of audit that involves little or no person-to-person interaction with taxpayers.⁹ As the National Taxpayer Advocate has repeatedly pointed out, this efficiency effort is particularly ill-suited to the needs of low income taxpayers, who may face verbal and functional literacy challenges and are often transient.¹⁰ Members of this vulnerable population may lose EITC simply because they do not effectively navigate the audit process.

This study examines a sample of 256 Tax Court cases in which:

- The taxpayer claimed EITC that the IRS disallowed;
- The taxpayer petitioned the Tax Court for review of the disallowance; and
- The IRS conceded the EITC issue in full without trial.¹¹

⁸ The numbers do not include declaratory judgments (*i.e.*, review of certain IRS administrative determinations as provided by statute. For example, the Tax Court has jurisdiction under IRC § 7436 to review the IRS's determination of an individual's worker classification). Source: Counsel Automated Tracking System, TL-711, prepared by: CC:FM:PMD:MA.

⁹ For FY 2011, 17,800 out of 29,700 Tax Court cases (60 percent) came from a campus (or "Service Center"). Counsel Automated Tracking System, TL 708B, discussed *infra*.

¹⁰ National Taxpayer Advocate 2011 Annual Report to Congress 296, 304 (Most Serious Problem: *The IRS Should Reevaluate Earned Income Tax Credit Compliance and Take Steps to Improve Both Service and Compliance*); National Taxpayer Advocate 2009 Annual Report to Congress 110 (Most Serious Problem: *Beyond EITC: The Needs of Low Income Taxpayers Are Not Being Adequately Met*); National Taxpayer Advocate 2008 Annual Report to Congress 227-42 (Most Serious Problem: *Suitability of the Examination Process*).

¹¹ As discussed below, the 256 cases are a representative sample from a population of 734 fully-conceded Tax Court cases in which EITC was an issue. The sample, statistically valid at the 95 percent confidence level with a margin of error no greater than +/- 5 percent, allows study findings to be projected to the population.

Study of Tax Court Cases In Which the IRS Conceded the Taxpayer was Entitled to Earned Income Tax Credit (EITC)

The objective of the study is to identify impediments that prevented the IRS from conceding the cases before the taxpayer filed the Tax Court petition. The significant findings from this study are:

- For most taxpayers, EITC refunds ultimately allowed represent on average more than a quarter of their adjusted gross incomes;
- The average EITC claimed was \$3,479 and the average adjusted gross income was \$17,024;
- In many cases (99 out of 256 or almost 39 percent), taxpayers must wait an average of *almost a year and a half* to get the refunds they are entitled to;
- The IRS pays interest on delayed refunds in more than a third of the cases (90 out of 256), amounting to almost \$200 per affected return;
- In most cases (162 out of 256, or 63 percent), taxpayers try to resolve their problems by calling the IRS before they file their Tax Court petitions, calling five times on average;
- In most cases (201 out of 256, or 78 percent), taxpayers submit documentary evidence that the Appeals Officer or Chief Counsel attorney accepts as probative of the claim;
- Taxpayers who submit documents often do so (in 136 of 201 cases) only after petitioning the Tax Court, but these taxpayers have usually (in 83 out of the 136 cases) spoken with an IRS examiner beforehand;
- Only infrequently (33 out of 256 cases, or 13 percent) do taxpayers wait until after they file their Tax Court petitions to call the IRS and submit documents;
- In almost a fifth of all cases, (50 out of 256), taxpayers submit documentation, usually approved by the IRM, that the examiner rejects but an Appeals Officer or Chief Counsel attorney accepts; and
- Cases are rarely (13 out of 256 cases) settled based on hazards of litigation.¹²

The findings suggest that taxpayers are willing to talk with the IRS before they petition the Tax Court and can provide acceptable supporting documentation, but do not obtain the information necessary to enable them to substantiate their claims from their conversations with examiners. It appears that Appeals Officers and Chief Counsel attorneys are more adept at evaluating the documents taxpayers provide, or are more willing to elicit additional documentation as necessary, or both. Moreover, in five percent of the cases, the examiner denied EITC by misapplying the law. Not only did the IRS deny EITC to 13 taxpayers in our sample of 256 due to legal error, and we expect that the same is true for 37 taxpayers out of our population of 734, but this finding raises worrisome questions about legal errors in EITC audits generally.

¹² As discussed below, “hazards of litigation” refers to the uncertainty of the outcome if the case were litigated.

BACKGROUND

Most EITC Audits are Correspondence Exams, Highly Automated Audits that Generate Most Tax Court Cases.

Almost all (94 percent) of the cases we reviewed were campus correspondence exams.¹³ These audits commence when an IRS computer at a centralized processing center automatically generates an initial contact letter to the taxpayer informing him or her of the audit and requesting substantiation for claimed EITC.¹⁴ The initial contact letter may also advise the taxpayer that the IRS is holding the EITC portion of a refund pending the outcome of the audit.¹⁵ The letter does not provide the name of a specific employee with responsibility for handling the taxpayer's case, a matter of significant concern to the National Taxpayer Advocate.¹⁶

If the taxpayer telephones the IRS to discuss the examination, the call will be routed to the next available examiner (not necessarily the same examiner the taxpayer may already have spoken with or the one who will make a determination in the case). Taxpayers' reaction to call routing has been to "rightfully complain that they are frustrated about talking to tax examiners who do not have their files, having to resubmit paperwork, not having documentation acknowledged, having to repeat conversations, not receiving return calls, and not being able to get their cases resolved while on the phone."¹⁷ If the taxpayer does not respond to the initial contact letter, the IRS disallows the claimed EITC, and the same automated system that produced the initial contact letter ultimately generates a statutory notice of deficiency.¹⁸ As Figure 2 shows, most Tax Court cases (EITC and non-EITC) originate as campus (or "Service Center") correspondence exams.¹⁹

¹³ Of the 256 cases in our sample, 242 were correspondence exams.

¹⁴ See National Taxpayer Advocate 2011 Annual Report to Congress vol. 2, 70 (*An Analysis of the IRS Examination Strategy: Suggestions to Maximize Compliance, Improve Credibility, and Respect Taxpayer Rights*), describing correspondence examination procedures and reporting that during FY 2010, 86 percent of the examinations of individuals were performed by correspondence.

¹⁵ Notice CP-75 *Exam Initial Contact Letter – EIC – Refund Frozen*, shown in the Appendix; IRM 21.3.1.4.48 (Oct. 1, 2009).

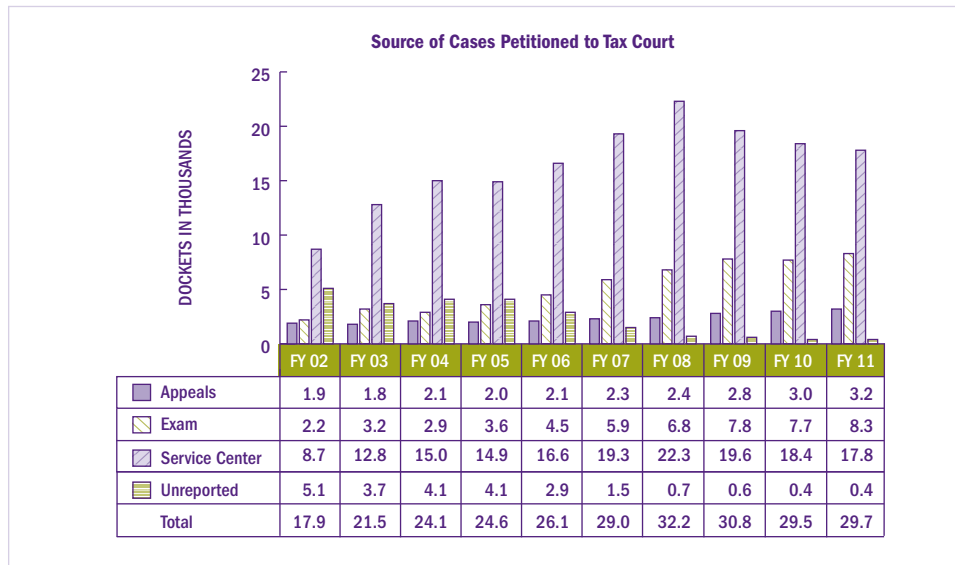
¹⁶ Only IRS correspondence that responds to correspondence from the taxpayer will identify a specific IRS employee to whom future inquiries may be directed. IRM 4.19.10.1.6(6) (Feb. 24, 2011). As a practical matter, not even this IRS correspondence will necessarily identify a specific employee as a point of contact. This is because the IRS, after reviewing the taxpayer's correspondence, may use Letter 565, *Acknowledgement and Request for Additional Information* or similar communication to request additional information. Letter 565, issued through an automated system, does not include any information identifying the employee who issued it. The National Taxpayer Advocate has significant concerns about this procedure because not only does it burden taxpayers, but it may also violate the requirement under § 3705(b) of the IRS Restructuring and Reform Act of 1998 that the IRS include in all manually-generated correspondence the name, telephone number, and unique identifying number of the employee the taxpayer may contact regarding correspondence. See Pub. L. No. 105-206, 112 Stat. 685, 777 (1998); National Taxpayer Advocate 2011 Annual Report to Congress vol. 2, 78, (*An Analysis of the IRS Examination Strategy: Suggestions to Maximize Compliance, Improve Credibility, and Respect Taxpayer Rights*); National Taxpayer Advocate Blog, *Are IRS Correspondence Audits Really Less Burdensome For Taxpayers?*, <http://www.taxpayeradvocate.irs.gov/Blog/are-irs-correspondence-audits-really-less-burdensome-for-taxpayers> (last visited Dec. 9, 2012).

¹⁷ National Taxpayer Advocate 2011 Annual Report to Congress vol. 2, 79 (*An Analysis of the IRS Examination Strategy: Suggestions to Maximize Compliance, Improve Credibility, and Respect Taxpayer Rights*).

¹⁸ For a detailed discussion of Automated Correspondence Examination (ACE), the software application that fully automates the initiation, aging, and closing of certain cases, see National Taxpayer Advocate 2011 Annual Report to Congress vol. 2, 70 (*An Analysis of the IRS Examination Strategy: Suggestions to Maximize Compliance, Improve Credibility, and Respect Taxpayer Rights*); IRM 4.19.20.1.6.1 (Apr. 16, 2008). As discussed below, the statutory notice of deficiency triggers the taxpayer's right to obtain Tax Court review of the IRS's determination.

¹⁹ When the Tax Court receives a petition, it assigns it a docket number. Rule 35, Tax Court Rules of Practice and Procedure. The case is then sometimes referred to as a docketed Tax Court case.

Study of Tax Court Cases In Which the IRS Conceded the Taxpayer was Entitled to Earned Income Tax Credit (EITC)

FIGURE 2, Source of Petitioned Cases²⁰**Eligibility for EITC is Especially Difficult for Transient Taxpayers to Substantiate.**

For eligible taxpayers whose incomes do not exceed certain amounts, IRC § 32 provides for a refundable credit, calculated as a function of the number of the taxpayer’s “qualifying children.”²¹ A “qualifying child” is a person who among other things meets age requirements, bears a specified relationship to the taxpayer, and has the same principal residence as the taxpayer for more than half the year.²² The last two components of EITC eligibility — relationship and residency — can be particularly difficult to substantiate.²³

The IRS Applies the EITC Rules with Unnecessary Rigidity in Correspondence Exams.

The IRS does not require Tax Examiners, the employees who handle correspondence exams, to possess more than a high school education (or GED certificate) or have a background in tax or accounting.²⁴ IRS publications, rather than primary sources of law, serve as the basis of Tax Examiners’ training, and their conclusions as to whether the EITC is allowable may be based on narrow “If - Then” reasoning, without a broader understanding

²⁰ The numbers include declaratory judgments. The unreported category includes cases where no statutory notice was attached to the petition. Source: Counsel Automated Tracking System, TL-708B, prepared by: CC:FM:PMD:MA.

²¹ IRC § 32(c)(1) sets out the definition of “eligible individual” and IRC § 32(b) contains the calculation of the amount of allowable credit. The credit is also available to taxpayers who do not have qualifying children. IRC § 32(b)(1)(A).

²² IRC §§ 32(c)(3); 152(c) (providing that a qualifying child is an individual who is the taxpayer’s son, daughter, stepchild, foster child, or a descendant of any of them (e.g., a grandchild), or a child who is a sibling, stepsibling, or half-sibling of the taxpayer, or a descendant of any of them).

²³ National Taxpayer Advocate 2011 Annual Report to Congress 296, 304 (Most Serious Problem: *The IRS Should Reevaluate Earned Income Tax Credit Compliance and Take Steps to Improve Both Service and Compliance*).

²⁴ National Taxpayer Advocate 2011 Annual Report to Congress vol. 2, 76 (*An Analysis of the IRS Examination Strategy: Suggestions to Maximize Compliance, Improve Credibility, and Respect Taxpayer Rights*).

Study of Tax Court Cases In Which the IRS Conceded the Taxpayer was Entitled to Earned Income Tax Credit (EITC)

of what the law actually says or what it intends to accomplish.²⁵ The applicable IRM provisions contain a link to Publication 501, *Exemptions, Standard Deduction, and Filing Information*, and a table in which one column identifies an EITC condition and another column displays the related “Acceptable Documentation.”

For example, “Acceptable Documentation” for the qualifying relationship condition is “Birth certificates or other official documents of birth; Marriage certificates that verify your relationship to the child; Letter from an authorized adoption agency; Letter from the authorized placement agency or applicable court document.”²⁶ “Acceptable Documentation” for the residency condition is “Photocopies of school (no report cards), medical, childcare provider (provider can’t be a relative), or social service records; A letter on official letterhead from a school, a health care provider, a social service agency, placement agency official, employer, Indian tribal official, landlord or property manager, or a place of worship that shows the name of child’s parent or guardian, child’s address and the dates that they lived with taxpayer.”²⁷

Lists of “acceptable documentation” in IRM provisions never include “other credible evidence” or allow for consideration of alternative records.²⁸ Tax Examiners generally do not accept the taxpayer’s own testimony to substantiate the relationship or residency components of the claim.

Recognizing the difficulties taxpayers face in substantiating their EITC claims in correspondence exams, in February 2012 the National Taxpayer Advocate issued interim guidance to TAS employees describing how to improve advocacy on EITC issues through:

- Better understanding of the legal requirements to qualify for the EITC;
- Greater consideration of the challenges eligible taxpayers may face trying to understand and navigate IRS requirements and correspondence;
- Research of information available through IRS systems;
- Awareness and pursuit of alternative documents to substantiate income or prove relationship and residency; and
- Increased efforts to contact taxpayers by phone to establish dialogue and rapport.

²⁵ National Taxpayer Advocate 2011 Annual Report to Congress vol. 2, 77 (*An Analysis of the IRS Examination Strategy: Suggestions to Maximize Compliance, Improve Credibility, and Respect Taxpayer Rights*), giving as an example of “If - Then” reasoning: “If a taxpayer has a birth certificate and full-year school record for their child, ‘Then’ the child meets the relationship and residency requirements for the Earned Income Tax Credit (EITC). ‘If a taxpayer has a birth certificate where the paternal information is blank and the child is too young to be in school or have a personal relationship with a pastor who could attest to residency, ‘Then’ the taxpayer is simply out of luck. Alternative sources of documentation are neither offered nor considered.”

²⁶ IRM 4.19.14.5.6(3) (Nov. 25, 2011).

²⁷ *Id.*

²⁸ As part of a three-year study that began in 2003, the IRS investigated the effectiveness of a pre-certification program that required EITC claimants either to pre-certify their eligibility or to submit documentation of eligibility with their tax returns. The IRS ultimately concluded that pre-certification should not be pursued because the “results of the pilot indicated that the pre-certification requirement decreased participation in the EITC and increased the cost and burden on taxpayers.” IRS, *Earned Income Tax Credit Initiative: Final Report to Congress* (Oct. 2005). See also IRM 4.19.14.7.3 (Nov. 25, 2011); *EITC Affidavit Study, supra/infra*.

Study of Tax Court Cases In Which the IRS Conceded the Taxpayer was Entitled to Earned Income Tax Credit (EITC)

The guidance includes a list of traditional and alternative documents that can substantiate entitlement to EITC.²⁹

Most Taxpayers Do Not Dispute the Audit Results, and Those Who Do Almost Always Settle Their Cases Without Trial.

If the IRS proposes to disallow claimed EITC, it issues a Notice of Proposed Adjustments, also known as a 30-day letter, which advises the taxpayer of the right to seek administrative review of the disallowance by IRS Appeals.³⁰ Taxpayers in correspondence exams almost never seek this administrative review in response to a 30-day letter, but as described below, they may nevertheless encounter an Appeals Officer later in Tax Court proceedings.³¹

IRS Appeals is the unit whose mission is to settle cases.³² Unlike Tax Examiners, Appeals Officers are authorized to consider “hazards of litigation” in evaluating how best to proceed.³³ A “hazards” settlement may result when there is “substantial uncertainty in the event of litigation as to: how the courts would interpret and apply the law; what facts the courts would find; or the admissibility of or weight that would be given to a specific item of evidence.”³⁴ Hazards include “whether the taxpayer will testify, what he or she will say, and what force and effect the court will give to the testimony.”³⁵ If the hazards of litigation are strongly in favor of the taxpayer, IRS Appeals may settle the case with a full concession.³⁶

Appeals Officers close a case by completing an Appeals Case Memorandum.³⁷ Form 5402, *Appeals Transmittal and Case Memo*, is part of every Appeals Case Memorandum and is sometimes all that is needed.³⁸ For more complex cases, the memorandum may also include a schedule of adjustments with a brief or more developed narrative.³⁹

²⁹ *Interim Guidance on Advocating for Taxpayers Claiming Earned Income Tax Credit (EITC) with Respect to a Qualifying Child*, Control No: TAS-13-0212-006 (Feb. 9, 2012), available at <http://www.irs.gov/pub/foia/ig/tas/tas-13-0212-006.pdf>.

³⁰ Treas. Reg. § 601.105(d)(1)(iv) authorizes the 30-day letter, which explains the proposed changes and advises the taxpayer of the liability and of the right to file a protest within 30 days to be considered by IRS Appeals. The IRS sometimes uses combination or “combo” letters which merge the initial contact letter with the 30-day letter. Because combo letters can confuse taxpayers, the National Taxpayer Advocate has consistently expressed concern about their use. See, e.g., National Taxpayer Advocate 2011 Annual Report to Congress vol. 2, 85 (*An Analysis of the IRS Examination Strategy: Suggestions to Maximize Compliance, Improve Credibility, and Respect Taxpayer Rights*).

³¹ National Taxpayer Advocate 2008 Annual Report to Congress 227, 234 (Most Serious Problem: *Suitability of the Examination Process*).

³² IRM 8.1.1.1 (Feb. 10, 2012) provides “The Appeals Mission is to resolve tax controversies, without litigation, on a basis which is fair and impartial to both the Government and the taxpayer and in a manner that will enhance voluntary compliance and public confidence in the integrity and efficiency of the Service.” This mission is accomplished by “considering protested cases, holding conferences, and negotiating settlements.”

³³ Treas. Reg. §601.106(f)(2) provides that “Appeals will ordinarily give serious consideration to an offer to settle a tax controversy on a basis which fairly reflects the relative merits of the opposing views in light of the hazards which would exist if the case were litigated;” *Hazards of Litigation-Settlement Practice*, Student Guide 3, IRS Training 22924-002 (May 2007).

³⁴ *Hazards of Litigation-Settlement Practice*, Student Guide 16, IRS Training 22924-002 (May 2007).

³⁵ *Id.* at 17.

³⁶ *Id.* at 27.

³⁷ IRM 8.6.2.1.2 (Mar. 21, 2012).

³⁸ IRM 8.6.2.1.2(1)(a) (Mar. 21, 2012).

³⁹ IRM 8.6.2.1.2(1)(b), (c) (Mar. 21, 2012).

Study of Tax Court Cases In Which the IRS Conceded the Taxpayer was Entitled to Earned Income Tax Credit (EITC)

Independently of the format, Appeals employees are required to indicate on the Appeals Case Memorandum whenever they settle a case on the basis of hazards of litigation.⁴⁰

In FY 2012, Appeals resolved over 67 percent of its non-docketed cases (*i.e.*, EITC and non-EITC cases in which the taxpayer requested Appeals review in response to the 30-day letter).⁴¹ If the case is not settled, then Appeals issues the statutory notice of deficiency authorized by IRC § 6212, which informs the taxpayer of the additional amount of tax the IRS believes he or she owes and advises of the right to petition the Tax Court for review of that determination. If the taxpayer did not seek Appeals review in response to the 30-day letter (and, as noted earlier, most do not), the IRS Examination function issues the statutory notice of deficiency.

IRC § 6213 provides that a taxpayer has 90 days after the IRS mails the statutory notice of deficiency (150 days, if the notice was addressed to a taxpayer outside the U.S.) to file a Tax Court petition. Taxpayers rarely petition the Tax Court, however.⁴² While the IRS Examination function issued more than 350,000 statutory notices of deficiency in FY 2012, for only half a percent of them did taxpayers file Tax Court petitions.⁴³ The \$60 Tax Court filing fee may be waived by the court “if the petitioner establishes to the satisfaction of the Court by an affidavit or a declaration containing specific financial information the inability to make such payment,” but taxpayers may not be aware of this possibility, particularly those not represented by counsel.⁴⁴ In any event, the most likely outcome in a correspondence exam in which the IRS proposes adjustments to the taxpayer’s account is that the taxpayer will not contest it.⁴⁵ The IRS then assesses the additional tax against the taxpayer by default.⁴⁶

For the relatively few taxpayers who petition the Tax Court, settlement opportunities continue; the cases we reviewed were all resolved at this stage. Tax Court cases not previously considered in Appeals are referred to Appeals for consideration of settlement.⁴⁷ In FY 2012, Appeals resolved over 54 percent of its docketed cases, but if the case remains

⁴⁰ IRM 8.6.2.1.1 (Mar. 21, 2012), *Four Major Sections of an Appeals Case Memo (ACM)* provides: “(1) Summary and Recommendation: The Summary and Recommendation is the first section of your narrative and is required in all ACMs. It briefly summarizes the issue and the recommendation. This section should contain enough information to cover all the most important matters, yet still be concise enough that the reader doesn’t feel bogged down in details. If the issue is simple, this section may be all that is needed. Include a summary and brief analysis of what the taxpayer and examiner did or said. Briefly state the rationale for the recommendation. *Include the litigating hazards facing the government and how these hazards affect the settlement.*” (emphasis added).

⁴¹ Response from IRS Appeals dated Dec. 3, 2012, on file with TAS.

⁴² National Taxpayer Advocate 2008 Annual Report to Congress 227, 234 (Most Serious Problem: *Suitability of the Examination Process*).

⁴³ In FY 2012, the IRS issued 352,043 statutory notices of deficiency. Taxpayers filed Tax Court petitions with respect to only 1,409 of these, about .04 percent. TAS Research, *Exam Statutory Notices of Deficiency by Disposal Code, FY 2012* (Dec. 7, 2012).

⁴⁴ Rule 20(d), Tax Court Rules of Practice and Procedure, as amended effective July 6, 2012. Prior to amendment, the reference to “a declaration” was not part of the rule. The Tax Court provides a form, *Application for Waiver of Filing Fee and Affidavit*, that may be used to request waiver of the filing fee.

⁴⁵ National Taxpayer Advocate 2008 Annual Report to Congress 227, 234 (Most Serious Problem: *Suitability of the Examination Process*).

⁴⁶ IRC § 6213(c) provides that if a taxpayer does not timely petition the Tax Court for review of a notice of deficiency, the IRS must assess the additional tax.

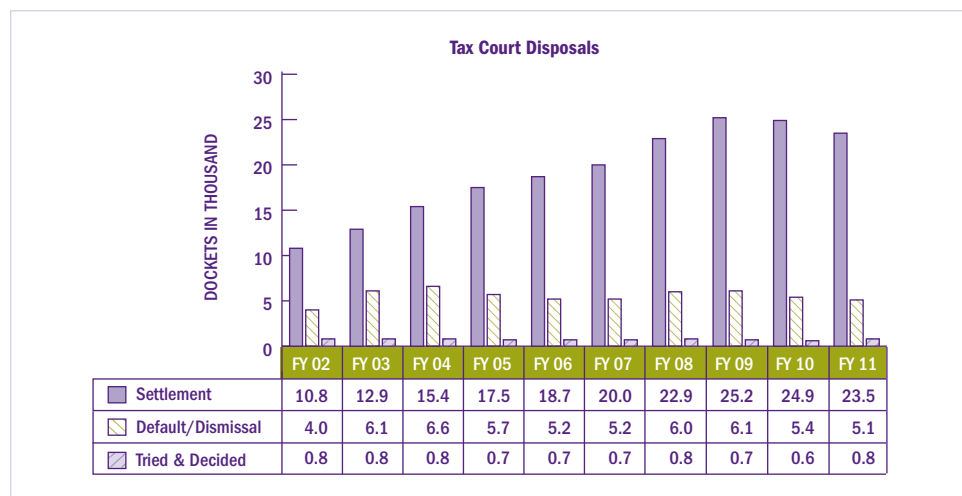
⁴⁷ National Taxpayer Advocate 2009 Annual Report to Congress (Most Serious Problem: *Appeals’ Efficiency Initiatives Have Not Improved Taxpayer Satisfaction or Confidence in Appeals*).

Study of Tax Court Cases In Which the IRS Conceded the Taxpayer was Entitled to Earned Income Tax Credit (EITC)

unresolved or was considered in Appeals before the Tax Court petition was filed, it is next considered by an attorney in the IRS Office of Chief Counsel (Counsel), who then decides whether to settle or proceed to trial.⁴⁸

Counsel's goals include settling cases "at the earliest possible date prior to the cases being calendared for trial."⁴⁹ Like an Appeals Officer, a Counsel attorney considers the hazards of litigation and in general "regards all cases as susceptible of settlement except those which involve negligible litigation hazards and cases designated for litigation."⁵⁰ The Counsel attorney prepares a Counsel Settlement Memorandum that explains the basis for the settlement, including any hazards of litigation.⁵¹ As Figure 3 shows, the majority of Tax Court cases (EITC and non-EITC) are settled.

FIGURE 3, Tax Court Disposals of Cases⁵²



When the case settlement results in an overpayment of tax by the taxpayer, the IRS refunds to the taxpayer any amounts still due, with interest as required by law.⁵³

⁴⁸ Response from IRS Appeals dated Dec. 3, 2012, on file with TAS. Rev. Proc. 87-24, 1987-1 C.B. 720, sets out the procedures for referring docketed Tax Court cases to Appeals and returning them to Counsel. Generally, deficiency cases of \$10,000 or less will be returned to Counsel after six months or by the month prior to the calendar call of the case (15 days, for small tax cases).

⁴⁹ Chief Counsel Directives Manual (C.C.D.M.) 35.5.1.3 (Aug. 11, 2004).

⁵⁰ C.C.D.M. 35.5.2.2 (Aug. 11, 2004). Cases that present recurring, significant legal issues affecting large numbers of taxpayers may be designated for litigation "in the interest of sound tax administration to establish judicial precedent, conserve resources, or reduce litigation costs for the Service and taxpayers." A case designated for litigation will not be resolved without a full concession by the taxpayer. C.C.D.M. 33.3.6 (Aug. 11, 2004). EITC is not an issue that was designated for litigation in the years involved in our sample.

⁵¹ C.C.D.M. 35.5.2.14(2) (Aug. 11, 2004) provides "The memorandum must justify the action taken in the case...*If an essential factor in the settlement is litigation hazards, such hazards should be set forth and explained*" (emphasis added).

⁵² These numbers do not include declaratory judgments. Source: Counsel Automated Tracking System, TL-711, prepared by: CC:FM:PMD:MA.

⁵³ See IRC § 6611, generally providing for interest on overpayments.

RESEARCH QUESTIONS

Our current study examines the EITC cases conceded in FY 2010. In the past, the National Taxpayer Advocate has studied the manner, in other settings and proceedings, in which the IRS processes and evaluates claims for EITC. For example, in 2004 TAS investigated the outcomes of audit reconsiderations for EITC claimants and found that about 45 percent of the taxpayers who received TAS assistance, and 40 percent who worked only with IRS examiners, received additional EITC as a result of the audit reconsideration.⁵⁴ In 2007, TAS studied the effect of representation in EITC audits in examinations and found that represented taxpayers are more likely to retain claimed EITC.⁵⁵ In 2011, TAS studied the IRS examination strategy and found, among other things, that greater emphasis on communication with taxpayers would protect taxpayers' rights, enhance compliance, and preserve IRS credibility.⁵⁶ This year's study extends the analysis beyond cases worked within the IRS and considers cases in which the taxpayer requested judicial review of the IRS's denial of claimed EITC, and the IRS conceded the case.

For the 256 conceded EITC Tax Court cases studied, we examined:

General characteristics of the cases:

- The amount of claimed EITC in relation to income, whether a refund was claimed, and the time that elapsed between return filing and refund dates;
- Whether the return was prepared by a paid preparer, and how frequently the taxpayer was represented during the audit or in Tax Court;
- Whether another taxpayer claimed the same person as a qualifying child; and
- The amount of time that elapsed between audit commencement and case closure.⁵⁷

How taxpayers communicated with the IRS before and after they filed their Tax Court petitions:

- How often, on average, taxpayers spoke with IRS employees by telephone or in person;
- Who usually initiated communications (the taxpayer or the IRS), and at what point in the process, and how many times on average they spoke;
- How often the taxpayer did not respond at all to the IRS; and
- How often taxpayers "dropped out" of the exam (*i.e.*, began to cooperate or correspond and then did not respond further to requests for information).

⁵⁴ National Taxpayer Advocate 2004 Annual Report to Congress, vol. 2, 9 (*Earned Income Tax Credit (EITC) Audit Reconsideration Study*).

⁵⁵ National Taxpayer Advocate 2007 Annual Report to Congress, vol. 2, 94 (*IRS Earned Income Credit Audits – A Challenge to Taxpayers*). The National Taxpayer Advocate also sponsored a study by a Carnegie Mellon University research team which found that the behavior of taxpayers claiming EITC could be simulated, which would allow better understanding of the impact of IRS activity on this population. National Taxpayer Advocate 2007 Annual Report to Congress, vol. 2, 118 (*Simulating EITC Filing Behaviors: The 2004 Hartford Case Study*).

⁵⁶ National Taxpayer Advocate 2011 Annual Report to Congress vol. 2, 70 (*An Analysis of the IRS Examination Strategy: Suggestions to Maximize Compliance, Improve Credibility, and Respect Taxpayer Rights*).

⁵⁷ We adopted a convention in which there are 360 days in the year and each month has 30 days.

How the IRS evaluated third-party written statements or other documentary substantiation of the claim before and after the taxpayer filed the Tax Court petition:

- Whether documents were received in time for the IRS to associate them with the file and consider them before issuing the notice of deficiency;
- Whether the substantiation later accepted by an Appeals Officer or Chief Counsel attorney was considered but deemed inadequate by an examiner, and if so, what the substantiation consisted of;
- Whether an Appeals Officer or Chief Counsel attorney accepted testimony as a substitute for documents;
- Whether an Appeals Officer or Chief Counsel attorney settled cases on the basis of hazards of litigation; and
- Whether an examiner misapplied the law in denying the taxpayer's claimed EITC.

METHODOLOGY

The IRS Office of Chief Counsel provided TAS Research a list of Tax Court cases in which EITC was an issue and that the IRS fully conceded in FY 2010. From a population of 734 cases, TAS Research selected a random sample of 256 cases in which the IRS conceded the case in full. The sample is statistically valid at the 95 percent confidence level with a margin of error no greater than +/-5 percent, which allows study findings to be projected to the population. The project lead, a TAS Attorney Advisor, ordered hardcopy IRS Examination or Chief Counsel case files from IRS storage facilities for each case in the sample and distributed the case files among three experienced TAS employees. The employees, all Internal Revenue Agent Technical Advisors, reviewed the case files containing a record of the examination process from the beginning of the audit until the case was closed.⁵⁸

DATA COLLECTION

The project team, with assistance from TAS Research, developed a scannable data collection instrument (DCI), which appears in Appendix A, to capture information about the original tax return, the original examination, and the IRS case actions. The reviewers completed the data collection instrument for each case file, augmenting information found in the hardcopy file with information from IRS databases as necessary. To minimize bias, case reviewers were thoroughly and consistently briefed on the purpose of the data collection and provided guidelines on proper completion of the DCI. The project lead reviewed ten cases from each team member for accuracy, and the team discussed ten additional cases as a group. TAS Research developed a database to compile the information collected on the DCIs and performed quality checks on the data after input. TAS Research collected additional data from return and examination databases, such as income level and the

⁵⁸ Internal Revenue Agent Technical Advisors in TAS provide expert advice on tax examination issues, research technical issues and apply tax law to facts, and access and analyze taxpayer returns and related documents, among other things. See IRS Standard Position Description No. 92548.

Study of Tax Court Cases In Which the IRS Conceded the Taxpayer was Entitled to Earned Income Tax Credit (EITC)

frequency and amount of refund claims, tax adjustments, notices, and examinations. TAS also reviewed information from Tax Court docket records.

In October 2012, TAS shared some preliminary results of the study with representatives of the IRS Wage and Investment (W&I) and Small Business/Self-Employed (SB/SE) operating divisions, who in collaboration with TAS are studying correspondence exam procedures.⁵⁹ The operating division representatives raised the issue of whether the cases in this study were settled based on hazards of litigation. Because the original data collection instrument did not capture this information, the team extracted additional information from the case files: the type of document that recorded the case closure (*e.g.*, Appeals Case Memorandum, Chief Counsel Settlement Memorandum), and whether the document indicated that hazards of litigation had been considered. The supplemental questions appear in Appendix B.

FINDINGS

Taxpayers Often Must Wait for Over a Year to Receive EITC Refunds Which Usually Represent More than a Quarter of Their Income, and Most Incur Litigation Costs in the Meantime.

Paid preparers prepared most returns in the cases we reviewed (180 out of 256, about 70 percent), but other than paid preparers shown on the returns, in 162 out of the 256 cases (63 percent), there was no indication of representation during the audit or in Tax Court. The average amount of EITC claimed on the return (and ultimately conceded by the IRS) was \$3,479 and taxpayers' average adjusted gross income was \$17,024. For more than half the taxpayers, the claimed EITC represented more than a quarter of their adjusted gross incomes. All but three of the returns were claims for refunds, with an average refund claim of \$3,880.

In 99 cases (or almost 39 percent), the taxpayers did not receive the claimed refunds until after the audits ended. From the time they filed their returns, these taxpayers had to wait on average *513 days, or 17 months*, to get their refunds. The IRS paid \$17,400 in interest on delayed refunds in 90 cases (an average of slightly less than \$200 per return). For all 256 cases, from the April 15 due date of the returns, it took about a year (366 days) on average for the IRS to audit the returns, the taxpayers to commence litigation, and the IRS to concede the cases and close them on its databases.⁶⁰ Most taxpayers (189 out of 256, or 74 percent) paid the \$60 Tax Court filing fee. In two thirds of these cases (127 of 189, or 67 percent) the taxpayer did not have representation at any point in the proceedings (other than having a paid preparer prepare the return, if that). In the 67 cases in which the filing fee was waived, the taxpayers were without representation only about half the time (34 of the 67 cases, or 51 percent).

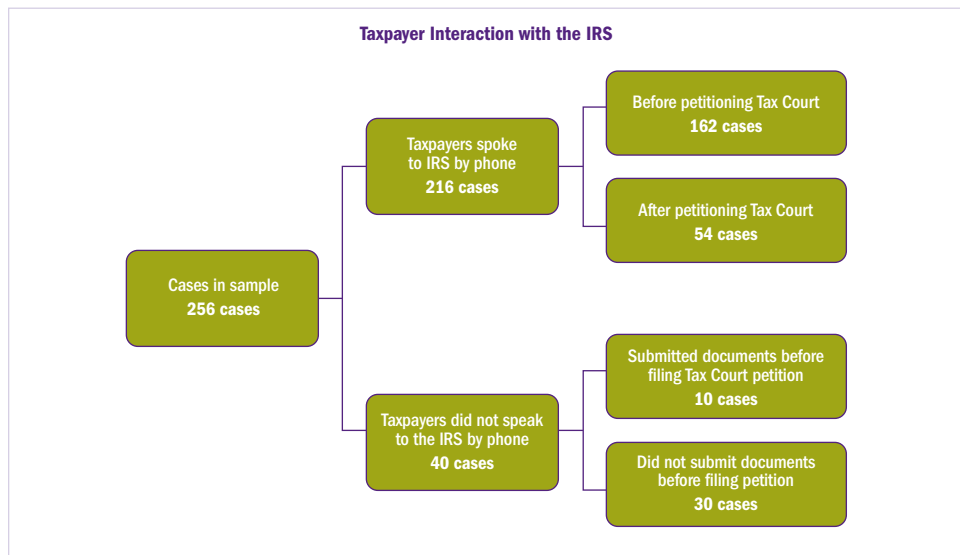
⁵⁹ The IRS Correspondence Examination Assessment Project (CEAP) includes representatives from TAS, W&I, and SB/SE. The project consists of internal reviews to evaluate how to continue, revise, or otherwise improve the IRS's Correspondence Examination program. CEAP Interim Report 1 (Sept. 28, 2012).

⁶⁰ We were unable to identify the disposal dates for seven of the cases.

Taxpayers Call the IRS Repeatedly While There is Still Time to Resolve the Case Without Going to Tax Court.

Once the audit began, taxpayers or their representatives spoke to an IRS employee by telephone in 216 of the 256 cases, or 84 percent of the time.⁶¹ Even when they did not speak to employees on the phone, they submitted documents to substantiate their claims. Figure 4 shows how taxpayers interacted with the IRS at various points during the audit process.

FIGURE 4, Taxpayer Interaction with the IRS

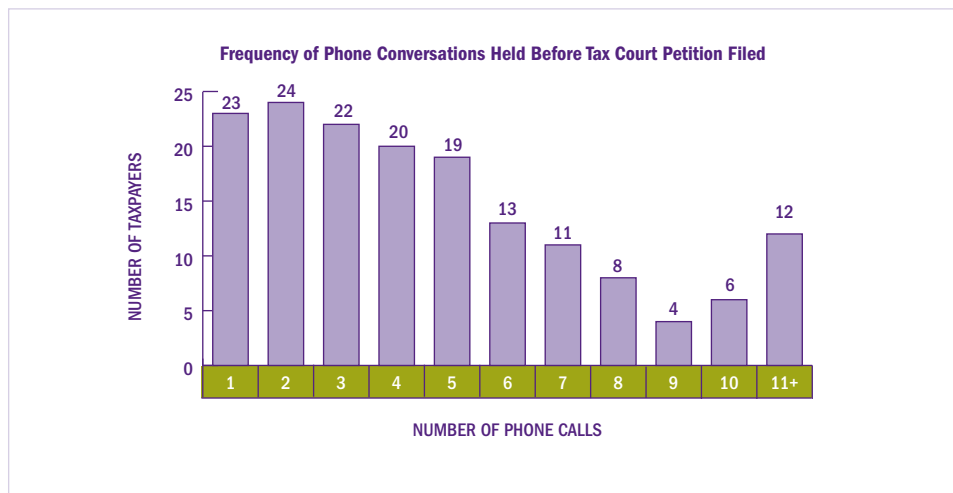


Taxpayers spoke to the IRS before filing their Tax Court petitions in 162 of the 256 cases, or 63 percent of the time. These 162 taxpayers continued to communicate, speaking to the IRS about five times on average. They called up to 21 times, with 61 calling between five and ten times.⁶² Figure 5 shows the frequency of the phone conversations for the 162 taxpayers who spoke to the IRS before they petitioned the Tax Court.

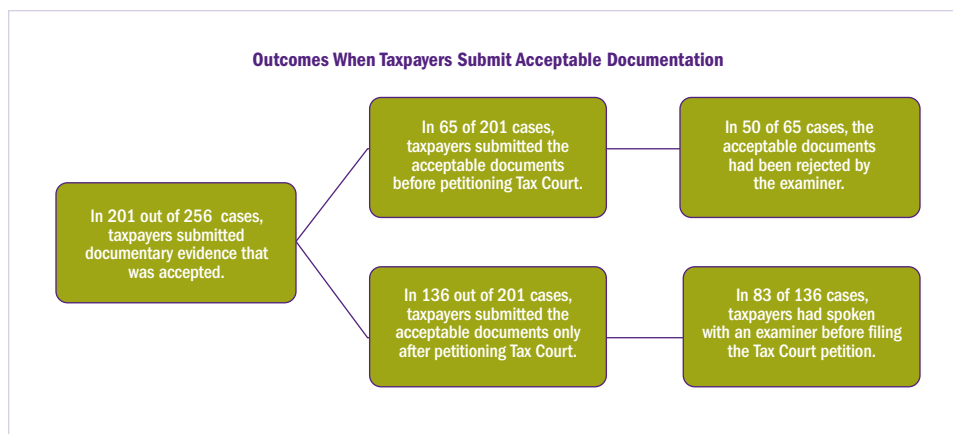
⁶¹ Of the 216 cases, the IRS initiated the first phone call in 46 cases, usually when the taxpayer had already filed the Tax Court petition. In 14 cases, the IRS made the first call before the Tax Court petition was filed. These 14 taxpayers spoke with the IRS three times on average. Taxpayers did not often meet with the IRS in person. In the 19 cases in which they did meet face-to-face, it was usually (in 12 cases) after the Tax Court petition was filed; in only three cases did more than one in-person meeting take place.

⁶² Only 23 of the 162 taxpayers spoke to the IRS only once: 66 of them called between two and four times, and 127 of them called between two and ten times.

Study of Tax Court Cases In Which the IRS Conceded the Taxpayer was Entitled to Earned Income Tax Credit (EITC)

FIGURE 5, Frequency of Taxpayer Phone Conversations with the IRS**Taxpayers Can Substantiate their Claims, But Have Difficulty Doing So While Working With Examiners.**

In 201 of the 256 cases, or 78 percent of the time, taxpayers submitted documentary evidence that the Appeals Officer or Chief Counsel attorney accepted as probative of the claim. However, in 136 of the 201 cases, they submitted these documents only after petitioning the Tax Court.⁶³ The various outcomes when taxpayers submitted documents later accepted in support of their claims are shown in Figure 6 below.

FIGURE 6, Outcomes When Taxpayers Submit Acceptable Substantiation

⁶³ In 28 of these 136 cases, the documentation was insufficient and the IRS accepted testimony as a substitute. As discussed below, 65 taxpayers submitted valid documentation before filing their Tax Court petitions. The examiner rejected the substantiation in 50 of these cases.

Of the 136 taxpayers who submitted documents only after petitioning Tax Court, 83 (61 percent) had spoken to the IRS before filing their Tax Court petition.⁶⁴ These 83 taxpayers called up to 21 times, five times on average. This shows that taxpayers who contact the IRS early in the process can provide valid documentation to support their claims, but often do not do so until they have exited the examination phase of the case. The most likely explanation for this behavior may be that when taxpayers call and speak to an examiner, they do not receive adequate explanations of what documents are needed, but do receive adequate explanations thereafter. We found only 33 cases in which the taxpayer called and submitted acceptable documentation only after filing the Tax Court petition.

Appeals Officers or Chief Counsel Attorneys Accept Documents Rejected by IRS Examiners in One-Fifth of the Cases.

As shown in Figure 6, above, in 50 cases in the sample (about 20 percent of the time), an Appeals Officer or Chief Counsel attorney accepted documents the examiner had considered but rejected.⁶⁵ In these 50 cases, the documentation that was unacceptable to the examiner but was later accepted by the Appeals Officer or Chief Counsel attorney most often included a birth certificate (in 28 cases), school records (in 24 cases), or statements by a health care provider (in 20 cases).⁶⁶ Other documents that the examiner and Appeals Officer or Chief Counsel attorney evaluated differently were Social Security cards (in 12 cases), a statement by a property owner or landlord (in 11 cases), and other third-party statements, such as those by a neighbor (in 12 cases). The taxpayers submitted these documents to establish relationship and residency, the components of EITC that present the most difficult proof problems for taxpayers.

Even if the documents submitted to the examiner were incomplete, the Appeals Officer or Chief Counsel attorney accepted testimony as a substitute for documents in only six of these 50 cases (12 percent of the time), meaning that taxpayers were almost always able to produce additional documents if necessary.⁶⁷ Only one of these 50 cases was settled on the basis of hazards of litigation.

⁶⁴ The IRS made the first phone call (calling before the petition was filed) in five of these cases.

⁶⁵ We found only three cases in which the taxpayer submitted documents that were not associated with the file in time for the examiner to consider them. We also found 15 cases in which the taxpayer “dropped out” of the examination process by initially responding to requests for information but then becoming nonresponsive. In eight of these 15 cases, the taxpayer submitted documents that the examiner rejected.

⁶⁶ Twelve cases involved all three of these documents.

⁶⁷ Testimony was accepted as a substitute for documents more frequently in the sample as a whole, occurring in 44 of the 256 cases (17 percent of the time).

The Documents Examiners Reject Are Usually Listed in the IRM as Acceptable Substantiation, and Sometimes Examiners Deny EITC Because they Misapply the Law.

In about 40 percent of the cases (18 out of 50) in which an examiner rejected a document that was later accepted, the document was not among those specified in the IRM.⁶⁸ Given the rigidity with which Tax Examiners are trained to evaluate EITC claims, it is perhaps unsurprising that a document not specifically mentioned as acceptable substantiation would be rejected. For the remaining 32 cases, however, the acceptable documents rejected by the examiner were listed in the IRM as acceptable. None of these 32 cases were settled on the basis of hazards of litigation, and in only three cases was testimony accepted as a substitute for documents. Therefore, it appears that examiners do not resolve cases on the basis of IRM-sanctioned documents that Appeals Officers and Chief Counsel attorneys later find sufficient.

Appeals Officers or Chief Counsel attorneys found that the examiner had misapplied the law in 13 cases, or about five percent of the total number of cases in the sample. All but one of these taxpayers spoke to the IRS before petitioning the Tax Court and in nine of these 13 cases submitted documents that the examiner rejected but the Appeals Officer or Chief Counsel attorney accepted. Projecting this error rate to our population of 734 taxpayers, we expect that 37 taxpayers were denied EITC, amounting to almost a quarter of their incomes, because the IRS examiner misapplied the law. The implications for EITC exams generally are worrisome.

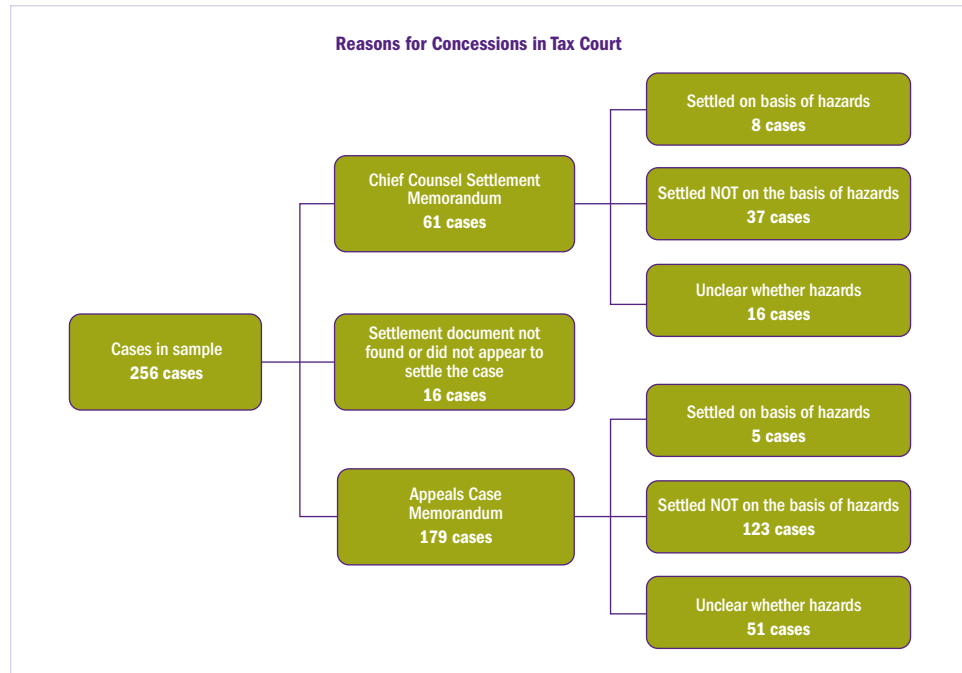
Hazards of Litigation Is Rarely the Reason the IRS Concedes the Cases.

Both IRS Appeals and Chief Counsel pursue the mission of settling cases whenever possible, and their authority to consider the hazards of litigation furthers that mission. As previously noted, an Appeals Officer who settles a case due to the hazards of litigation is expected to so indicate on the Appeals Case Memorandum. Of the 179 cases with an Appeals Settlement Memorandum explaining the disposal of the case, in only five was hazards of litigation given as a reason for conceding the case. Counsel attorneys are expected to indicate when they settle cases on the basis of hazards of litigation; of the 61 cases with a Counsel Settlement Memorandum, in only eight cases was hazards of litigation given as a reason for conceding. As Figure 7 shows, hazards of litigation does not explain the concessions.

⁶⁸ In 12 of these 18 cases, the additional document consisted of a third-party statement, in ten cases the additional document was another type of document not mentioned in the IRM, and four cases included documents in both categories.

Study of Tax Court Cases In Which the IRS Conceded the Taxpayer was Entitled to Earned Income Tax Credit (EITC)

FIGURE 7, Reasons for Concessions in Tax Court



It is clear in 160 cases (123 with Appeals Case Memoranda and 37 with Counsel Settlement Memoranda) that hazards of litigation was not the reason the case was conceded.⁶⁹

Almost One-Fifth of the Cases Involved Duplicate EITC Claims for a Qualifying Child, and These Taxpayers May Need More Time to Provide Documents.

We further examined the 47 cases in the sample in which another taxpayer claimed the same qualifying child, to test the hypothesis that it might be particularly difficult for taxpayers in these cases to obtain documentation early. For example, a disruptive event such as divorce or identity theft may have led to the duplicate claim and caused delay in obtaining acceptable documents. Taxpayers in the duplicate claim category exhibited the call-early-submit-documents-late behavior more frequently than taxpayers in the sample generally, so duplicate claims could explain that behavior, at least in part.⁷⁰

⁶⁹ The narrative in 160 cases makes clear that the case was not being conceded on the basis of hazards (e.g., because the taxpayer produced a document that had not previously been submitted which was sufficient to establish the validity of the claim). The narrative in the remaining cases was more general. For example, a narrative that often appeared on Form 5402 was "TP provided new facts and arguments and without involving exam, Appeals made a determination." In ten cases in the sample, the closing document could not be found or did not appear to dispose of the case.

⁷⁰ We found 18 duplicate claim cases in which the taxpayer called the IRS before filing the Tax Court petition but did not submit documents until afterward (18 out of 47 is 38 percent, compared to the 33 percent rate at which taxpayers in the sample overall exhibited this behavior).

CONCLUSION

This study adds to the National Taxpayer Advocate's body of research on EITC audits by considering post-audit events: the filing of a Tax Court petition followed by the IRS's full concession of the case. The correspondence audits in the study were initiated by a computer. Documents taxpayers submitted during the audit were considered by Tax Examiners trained to elicit and accept only certain types of substantiation without regard to whether other reliable evidence would demonstrate equally well that the statutory requirements had been met. Most taxpayers in the study responded to the IRS early in the audit process, but despite calling repeatedly, they were often able to substantiate their claims only after the IRS completed the audit.

Once their claims were considered by a specific Appeals Officer or Chief Counsel attorney, with more training and greater flexibility to judge the adequacy of their documentation and elicit additional information as necessary, taxpayers were able to satisfy the IRS that they were entitled to EITC. While Appeals employees and Chief Counsel attorneys are authorized to settle cases on the basis of the hazards of litigation, they rarely did so. Rather, they were able to elicit documents that the taxpayers had not previously submitted, or they accepted documents (often documents listed in the IRM as acceptable) the examiner had previously rejected. In about five percent of the cases, they corrected errors of law made at the audit stage. In the meantime, before the IRS conceded the case, almost 40 percent of the taxpayers were deprived of refunds to which they were entitled, usually amounting to about a quarter of their incomes, for almost a year and a half. This delay cost the government almost \$200 per affected return in interest payments.

Taxpayers attempt to understand what they must do to substantiate their EITC claims. If employees were trained on flexible approaches to evaluating whether taxpayers meet the statutory requirements for claiming the credit, they would be more likely to have meaningful conversations with taxpayers. If the IRS engaged taxpayers in meaningful conversations earlier in the process, more cases could be resolved earlier in the process. Fewer taxpayers with meritorious claims would be forced to resort to Tax Court to prove their claims, and the government would less often be required to pay interest on delayed refunds.

RECOMMENDATIONS


The National Taxpayer Advocate recommends that the IRS revise the IRM, incorporate rules similar to the interim guidance issued to TAS employees, and train Tax Examiners accordingly. Specifically, the IRS should train Tax Examiners to clearly explain to taxpayers why the IRS needs documents, to determine the type of records the taxpayer possesses that could corroborate the claim, and to consider whether alternative documentation might suffice when traditional records are not available. In cases in which two taxpayers claim the same qualifying child, the IRS should train examiners to consider allowing taxpayers more time to submit documents before issuing the statutory notice of deficiency.

Study of Tax Court Cases In Which the IRS Conceded the Taxpayer was Entitled to Earned Income Tax Credit (EITC)

Most importantly, the National Taxpayer Advocate calls upon the IRS to recognize that the EITC is a very complex statute, such that its employees must be trained in the *law*, not just “if-then” scenarios. Therefore, she recommends that the IRS use higher-graded employees with higher education requirements to handle these cases. As this study demonstrates, the minimal additional upfront costs of these recommendations will be more than offset by savings from the elimination of work downstream in the tax controversy process.

Study of Tax Court Cases In Which the IRS Conceded the Taxpayer was Entitled to Earned Income Tax Credit (EITC)

APPENDIX A, DATA COLLECTION INSTRUMENT


 18072

Docket # -

1. Does a paid preparer appear on the return? Yes No
2. Other than the return, does a POA appear for the taxpayer anywhere on any document, indicating that the taxpayer was represented at some point? Yes No
3. Was the case settled within two months after the petition was filed? Yes No
4. How many weeks elapsed from the date of initial contact letter until date of notice of deficiency (any part of a week equals a week).
5. Did the first telephone conversation take place before the notice of deficiency was issued? Yes No
6. Did the first telephone conversation take place after the notice of deficiency was issued but before the petition was filed? Yes No
7. Did the first telephone conversation take place only after the petition was filed? Yes No
8. Did the taxpayer (or the POA) initiate the first telephone conversation? Yes No
9. Did the taxpayer (or the POA) speak with the IRS on the phone more than once? Yes No
10. How many times did the taxpayer or the POA speak to the IRS on the telephone?
11. Did you find evidence of the conversation(s) in the paper file? Yes No
12. Did you find evidence of the conversation(s) in AMS? Yes No
13. Did you find evidence of the conversation(s) in CEAS? Yes No

In -Person Contact with IRS - complete this section only if the taxpayer or the POA spoke to the IRS in person.

14. Did the in person conversation take place before the notice of deficiency was issued? Yes No
15. Did the first in person conversation take place after the notice of deficiency was issued but before the petition was filed? Yes No
16. Did the first in person conversation take place only after the petition was filed? Yes No
17. Did the taxpayer (or the POA) initiate the first in person conversation? Yes No
18. Did the taxpayer (or the POA) speak with the IRS in person more than once? Yes No
19. How many in person conversations did the taxpayer (or the POA) have with the IRS?

Study of Tax Court Cases In Which the IRS Conceded the Taxpayer was Entitled to Earned Income Tax Credit (EITC)



18072

Case Characteristics

20. Did Counsel or Appeals explicitly accept testimony as a substitute for documents? (If not explicit, answer N) Yes No
21. Did the IRS state that another taxpayer had claimed the same person as a qualifying child? Yes No
22. Did Counsel or Appeals clearly state that the examiner misapplied the law in denying the taxpayer's claimed EITC? Yes No
23. Is there a no-change letter in the file? Yes No

Written third-party statements or other documents or receipts: Complete this section only if the taxpayer submitted at least one third-party statement or document in support of his or her position, which was clearly accepted by Counsel or Appeals (as shown in the Appeals Case Memorandum or Counsel Settlement Memorandum) as substantiation of the claim.

24. Was the written third-party statement or document or receipt stamped "received" by the IRS, or date stamped on a fax to the IRS, more than 15 days before the notice of deficiency was issued? If no, skip to question 25. Yes No

24a. Was the same written third-party statement or document or receipt clearly not associated with the file in time for Examiner to consider it? (Y or N) (examiner has a case until there's a notation in the case activity record that the exam is closed, submitted to manager, etc.) Yes No

24b. Was the same written third party statement or document or receipt clearly considered inadequate by Exam? Yes No

- | | | |
|---|---|--|
| <input type="radio"/> Birth Cert. | <input type="radio"/> Employer | <input type="radio"/> Signed 3rd Party Statement |
| <input type="radio"/> Marriage License | <input type="radio"/> Soc. or Gov't agency | <input type="radio"/> Sch. C Bus. Records |
| <input type="radio"/> SSN Card | <input type="radio"/> Court Order | |
| <input type="radio"/> Divorce Decree | <input type="radio"/> Health Care Provider | |
| <input type="radio"/> School Records | <input type="radio"/> Utility Bills | |
| <input type="radio"/> Prop. Mgr./Landlord | <input type="radio"/> Indian Tribal Council | |
| <input type="radio"/> Clergy | <input type="radio"/> Other | |

24c. Was the same written third part statement or document or receipt associated with the file but clearly not considered by Exam? Yes No

25. Was the written third-party statement or document or receipt received by the IRS after the statutory notice of deficiency was issued but before the petition was filed? Yes No

26. Was the written third party statement or document or receipt received by the IRS only after the petition was filed? Yes No

Taxpayer interaction with Exam

27. Did the taxpayer ever respond to any IRS notices? Yes No

28. Did the taxpayer "drop out" of the examination? i.e, did the taxpayer begin to cooperate/respond and then give up by not responding further to requests for information Yes No

APPENDIX B: ADDITIONAL QUESTIONS PERTAINING TO HAZARDS OF LITIGATION**29. What document did you consult for the explanation of why the case was conceded?**

1. Appeals Settlement Memorandum with narrative
2. Form 5402 only
3. Another document (other than Appeals Settlement Memorandum or Form 5402) or no document is found
4. Counsel Settlement Memorandum

30. Does the document identified in the previous question state that hazards of litigation were considered?

1. Yes. Hazards of litigation is given as the reason for the concession (a statement that the taxpayer is credible, or that testimony is being accepted as a substitute for documents, is not sufficient).
2. No. Hazards of litigation is not given as the reason for the concession, and the explanation in the closing document makes clear that the case was *not* settled on the basis of hazards of litigation (*e.g.*, the taxpayer provided documents for the first time and they were sufficient).
3. Hazards of litigation is not mentioned, and the explanation is general (*e.g.*, “TP provided new facts and arguments and without involving exam, Appeals made a determination”).

Study of Tax Court Cases In Which the IRS Conceded the Taxpayer was Entitled to Earned Income Tax Credit (EITC)

APPENDIX C: NOTICE CP-75 EXAM INITIAL CONTACT LETTER – EIC – REFUND FROZEN

B248939

60625

IRS USE ONLY

S B E

0 0 09

201041 CP: 75



Department of the Treasury
Internal Revenue Service
Examination Operations
5333 Getwell Rd. Stop 822
Memphis, TN 37501-0001

For assistance, call:
1-866-899-9085
Your Caller ID: 742026
Notice Number: CP75
Date: October 25, 2010

Taxpayer Identification Number:

Tax Form: 1040
Tax Year: December 31, 2009



001654

We're Auditing Your Tax Return And Delaying Part of Your Refund

Why We're Auditing Your Tax Return

We're auditing your tax return. This audit is why we've delayed sending you the earned income credit (EIC) part of your refund. The information below explains why we're auditing your return and the information you need to send us so we can make the right decision about your taxes.

Earned Income Credit - Your child must meet three tests to be your qualifying child for EIC. The enclosed *Form 886-H-EIC, Documents You Need to Prove You Can Claim an Earned Income Credit On the Basis of a Qualifying Child or Children*, explains the tests. It also explains the information you can send to us to show you've met the tests.

Dependents - You must meet five tests to claim a dependent. The enclosed *Form 886-H-DEP, Supporting Documents for Dependency Exemptions*, explains the tests. It also explains the information you can send to us to show you've met the tests.

Filing Status - If you claimed a Head of Household filing status on your tax return, you must meet three qualifying tests. The enclosed *Form 886-H-HOH, Supporting Documents To Prove Head of Household Filing Status* explains the qualifying tests. It also explains the information you can send to us to show you've met the tests.

Schedule C - You must have earned income to claim the EIC. Please complete and send us the enclosed *Form 11652, Questionnaire and Supporting Documentation, Form 1040 Schedule C (Profit or Loss from Business)* to help us determine if you have the right amount of earned income.

What You Need To Do Now

To get the EIC you deserve, please send us the above information within 30 days from this letter's date.

You can send us the information by mail, in the enclosed envelope, or by fax to 1-901-395-1600 (not toll-free).

Fill in and send us the stub on the last page of this letter. We'll use the stub to make sure your information gets to the right person and to make sure we can call you if we have any questions.

If you can't get all your information to us in time, call us at the above number to discuss what you can do.

Page 1

Study of Tax Court Cases In Which the IRS Conceded the Taxpayer was Entitled to Earned Income Tax Credit (EITC)

What We'll Do Once We Hear from You

We'll review the information you send us. If your information shows your return was correct, we won't make any changes to your tax return and we'll send you the EIC part of your refund. You won't need to do anything else.

If your information doesn't show your return was correct, we'll send you a report of changes we plan to make to your tax return and explain the tax you will owe. We'll also explain your right to appeal if you disagree.

Please allow us at least 30 days to review your information. After our review, we'll let you know by letter what we're going to do and explain your appeal rights, if we propose changes.

Any EIC refund you claimed will be delayed while we review your information.

What Happens If You Don't Reply

If we don't hear from you within 30 days you will not receive the EIC part of your refund. We'll send you a letter and a report disallowing the tax return items we've questioned. We'll explain how you can appeal if you disagree.

How to Get Help

You can only receive your EIC by mailing or faxing us the information we've requested.

However, we've enclosed *Publication 3498-A, The Examination Process*, to help you understand this audit and your appeal rights. It will explain your right to have someone help or represent you. Please visit our website at www.irs.gov/eitc to learn more about the examination process.

You can also call our toll-free number, 1-866-899-9085, with any questions you may have about this letter or the information we need.

Your local IRS office can provide free help. You can find your nearest IRS office listed in your local phone book or at www.irs.gov/localcontacts/index.html. If you have a significant hardship, you can contact the Taxpayer Advocate Service at 1-877-777-4778 (toll-free).

A Low Income Taxpayer Clinic may be able to offer you free help. The enclosed *Publication 4134, Low Income Taxpayer Clinic List*, lists the clinics' locations and their eligibility guidelines.

Follow These Steps
1. Read the enclosed forms and publications and call us if you have questions or need help.
2. Gather the information explained on the first page of this letter.
3. Make clear, readable copies of the information and keep the originals for your records.
4. Fill in your telephone numbers and the best time to call on the stub. (You can find the stub on the last page of this letter.)
5. You can send us your information in the enclosed envelope or you can use your own envelope. Be sure to enclose the stub. Send all information to us at the address on this letter.
6. You also can fax the stub with your documents to fax number 1-901-395-1600 (not toll-free).

Study of Tax Court Cases In Which the IRS Conceded the Taxpayer was Entitled to Earned Income Tax Credit (EITC)

EITC Tax Court Cases

B248939

CP: 75

Memphis Service Center

Tax Period: December 31, 2009

Remember: If you can't get all your information to us within the 30 days, call us at our toll-free number, 1-866-899-9085, to discuss what you need to do.

Enclosures:

- Form 886-H-DEP, Supporting Documents for Dependency Exemptions
- Form 886-H-HOH, Supporting Documents To Prove Head of Household Filing Status
- Form 886-H-EIC, Supporting Documents You Need to Prove You Can Claim an Earned Income Credit On the Basis of a Qualifying Child or Children
- Publication 3498-A, The Examination Process
- Publication 4134, Low Income Taxpayer Clinic List
- Form 11652, Questionnaire and Supporting Documents, Form 1040 Schedule C (Profit or Loss from Business)
- Return Envelope



001654



Return this voucher with your payment or correspondence.

Your Telephone Number: () - - - - - Best Time to Call: - - - - - AM - - - - - PM

Correspondence enclosed:

- Write your Taxpayer Identification Number, tax period and tax form number on your inquiry or correspondence

0623

SB 201041

75 Internal Revenue Service Examination Operations 5333 Getwell Rd Stop 822 Memphis, TN 37501-0001

Study of Tax Court Cases In Which the IRS Conceded the Taxpayer was Entitled to Earned Income Tax Credit (EITC)

APPENDIX D: FORM 886-H-EIC. DOCUMENTS YOU NEED TO PROVE YOU CAN CLAIM AN EARNED INCOME CREDIT ON THE BASIS OF A QUALIFYING CHILD; FORM 866-H-DEP, SUPPORTING DOCUMENTS FOR DEPENDENCY EXEMPTIONS; FORM 866-H-HOH, SUPPORTING DOCUMENTS TO PROVE HEAD OF HOUSEHOLD FILING STATUS

Form 886-H-EIC-2011
(January 2012)

Documents You Need to Prove You Can Claim an Earned Income Credit On the Basis of a Qualifying Child or Children

Usted puede conseguir una versión de esta forma en español llamando el número de teléfono en la primera página de la carta adjunta. You can get a Spanish version of this form, by calling the telephone number in the first page of the enclosed letter.

Your child must meet **relationship, age, and residency** requirements to qualify you for an Earned Income Credit (EIC). However, you may not need to claim a dependent child to qualify for a reduced EIC (see the reverse side of this form).

	If the Child Is	Then
Relationship Test	Your son or daughter (including an adopted child)	GO TO THE AGE and RESIDENCY TESTS. IRS will confirm the relationship; however, we may ask you later for additional information.
	Your grandchild or great grandchild, stepson, stepdaughter, step-grandchild or step-great grandchild, child pending adoption, brother, sister, stepbrother or stepsister or a descendant of any of them (such as a niece or nephew), eligible foster child (placed with you by an authorized placement agency)	Send us photocopies of documents that show evidence of the relationship, such as: <ul style="list-style-type: none"> • Birth certificates or other official documents of birth that verify your relationship • Marriage certificates that verify your relationship to the child • Letter from an authorized adoption agency • Letter from the authorized placement agency or applicable court document
Age Test	Under age 19 at the end of 2011	GO TO THE RESIDENCY TEST. IRS will confirm the age; however, we may ask you later for additional information.
	Under age 24 at the end of 2011 and a full-time student for at least five months of the year	Send us photocopies of official school records showing the child was a full-time student for at least five months of the tax year. The school records should show the dates of attendance. The months of attendance don't have to be consecutive.
	Any age and permanently and totally disabled at any time during 2011	Send us a letter from the child's doctor, other healthcare provider, or any social service program or agency verifying the child is permanently and totally disabled.
Residency Test	Related to you and lived with you in the United States for more than half of 2011	Send us photocopies of school (no report cards), medical, childcare provider (provider can't be a relative) or social service records or
	Any documents you submitted must reflect your actual street address. If you filed your tax return using a P.O. Box please submit a copy of the completed Form 1093 - P.O. Box Application - stamped by the post office.	Send us a letter on official letterhead from a school, a health care provider, a social service agency, placement agency official, employer, Indian tribal official, landlord or property manager, or a place of worship that shows the name of your child's parent or guardian, your child's address and the dates that they lived with you. You may need to send more than one document to prove your child lived with you for more than half of the year

Form **886-H-EIC-2011** (1-2012)

Cat No. 58202G

www.irs.gov

Department of the Treasury-Internal Revenue Service

Study of Tax Court Cases In Which the IRS Conceded the Taxpayer was Entitled to Earned Income Tax Credit (EITC)

EITC Tax Court Cases

Earned Income Credit for Taxpayers without a Qualifying Child

Stop here if you meet the test to claim an Earned Income Credit on the basis of a qualifying child or children as outlined on the other side. You do not need to complete this section.

You may qualify for a reduced earned income credit (EIC). The EITC Assistant link (found at irs.gov) can help you determine your eligibility and estimate the EIC amount that you may receive. Take the test below to see if you can qualify for a reduced EIC. (Note -- Your earned and adjusted gross income each must be less than \$13,660 (\$18,740 if married filing jointly).

TEST	YES	NO
You (or your spouse, if you filed a joint return) were at least age 25, but under age 65, on December 31, 2011	<input type="checkbox"/>	<input type="checkbox"/>
You (and your spouse, if you filed a joint return) cannot be claimed as a dependent on another person's return.	<input type="checkbox"/>	<input type="checkbox"/>
You (and your spouse, if you filed a joint return) lived in the United States for more than half of 2011.	<input type="checkbox"/>	<input type="checkbox"/>

If you checked **any of the "No" boxes**, you do **not** qualify for an EIC. You will receive a report, *Form 4549 or Form 4549-EZ, Income Tax Examination Changes*, reflecting our proposed adjustment.

If you checked **all of the "Yes" boxes**, you qualify for an EIC without a qualifying child. Please sign, date, and return this page in the enclosed envelope. **If you filed a joint return both you and your spouse must sign this form.** You will receive a report, *Form 4549 or Form 4549-EZ, Income Tax Examination Changes*, showing the amount of EIC you qualify for without a qualifying child.

Under penalties of perjury, I declare that I have examined this claim, and, to the best of my knowledge and belief, it is true, correct, and complete.

Print Name

Social Security Number

Signature

Date

Signature (For joint filed returns)

Date

Study of Tax Court Cases In Which the IRS Conceded the Taxpayer was Entitled to Earned Income Tax Credit (EITC)

Supporting Documents for Dependency Exemptions

If You Are:	And:	Then please send photocopies of the following documents:
Divorced, legally separated, or living apart from the other parent of the child claimed on your return.	Both parents (together) provided more than half of the child's total support for the tax year. and One or both parents have custody.	Entire divorce decree, separation agreement, decree of separate maintenance. If you are living apart from the child's other parent, but you are not divorced or legally separated, send proof that you did not live with the child's other parent for the last six months of the year. Current custody order, completed <i>Form 8332, Release of Claim to Exemption for Child of Divorced or Separated Parents</i> or a similar statement as applicable for 2011. You may need to send more than one document.
If the Person Is:	And:	Then please send photocopies of the following documents:
Your qualifying child	The child is: your son, daughter, adopted child, a child lawfully placed with you for legal adoption, stepson, stepdaughter, brother, sister, stepbrother, stepsister, foster child placed with you by an authorized placement agency or by court order, or a descendant of any such person (for example, a grandchild, a niece, or a nephew), and The child lived with you for more than half of 2011; (temporary absences away from home, such as the child going away to school, count as time lived at home), and The child did not provide half of his or her own support for 2011, and At the end of 2011, the child is under age 19, or a full time student under the age of 24, or permanently and totally disabled regardless of age.	Birth certificates or other official documents of birth, marriage certificates, letter from an authorized adoption agency, letter from the authorized placement agency, or applicable court document that verify your relationship to the child (send these documents only for a qualifying child who is not your natural or adopted child). To show both you and your child lived together at the same address or addresses for more than half of 2011, send either: • School, medical, daycare, or social service records. • A letter on the official letterhead from a school, medical provider, social service agency, or place of worship that shows names, common address and dates. (If you send a letter from a relative who provides your daycare, you MUST send at least one additional letter that provides proof.) You may need to send more than one document to show that the child lived with you for more than half of the year.
If the Person Is:	And:	Then please send photocopies of the following documents:
Your qualifying relative	Your relative is any of the relatives listed in the box above or any of the following: father or mother and their ancestors, step-father or step-mother, aunt or uncle, brother- in-law or sister in-law, and You provided over half of his or her support in 2011, (except for children of divorced or separated parents), and Can not be claimed as a qualifying child by any other person in 2011.	Birth and marriage certificates that verify your relationship to the qualifying relative. If you claim a non-blood related person as a qualifying relative, send proof the person has lived in your home for the entire 12 months of the year. To show both of you lived together at the same address or addresses for all of 2011, send either: • School, medical, daycare, or social service records. • A letter on the official letterhead from a school, medical provider, social service agency, or place of worship that shows names, common address and dates. (If you send a letter from a relative who provides your daycare, you MUST send at least one additional letter that provides proof.)

Form **886-H-DEP-2011** (1-2012)

Cat No. 58203R

www.irs.gov

Department of the Treasury-Internal Revenue Service

Study of Tax Court Cases In Which the IRS Conceded the Taxpayer was Entitled to Earned Income Tax Credit (EITC)

***** Note - Send Us Copies of the Following Documents as Proof You Provided More Than Half of Your Dependent's Total Support: *****

- A statement of account from a child support agency.
- A statement from any government agency verifying the amount and type of benefits you and/or your dependent received for the year.
- Rental agreements or a statement showing the fair rental value of your residence (proof of lodging cost).
- Utility and repair bills (proof of household expenses) with canceled checks or receipts.
- Daycare, school, medical records or bills (proof of child's support) with canceled checks or receipts.
- Clothing bills (proof of child's support) with canceled checks or receipts.

Study of Tax Court Cases In Which the IRS Conceded the Taxpayer was Entitled to Earned Income Tax Credit (EITC)

Supporting Documents To Prove Head of Household Filing Status

You may qualify for Head of Household filing status if you meet the following three tests:
Marriage Test, Qualifying Person Test, and Cost of Keeping up a Home Test.

	If You Are:		Then send photocopies of the following documents for tax year 2011
Marriage Test	Single		Go to the Qualifying Person Test and Cost of Keeping up a Home Test.
	Divorced or legally separated		Entire divorce decree, separate maintenance decree, or separation agreement.
	Married, but your spouse did not live with you during the last 6 months of tax year 2011		Documents verifying your spouse did not live with you during the last 6 months of the year, such as a lease agreement, utility bills, a letter from a clergy member, or a letter from social services.
Qualifying Person Test (If your relationship with the child is not in this listing, please see Publication 501, Exemptions, Standard Deduction, and Filing Information for more information).	If the Person Is:	And	Then send photocopies of the following documents for tax year 2011
	Your child (including an adopted child, or a pending adoption), Your brother or sister, stepbrother or stepsister, or any of their descendants (for example, grandchild, niece, or nephew), Your eligible foster child (a child placed in your home by an authorized placement agency or by a court order).	You can claim a dependency exemption for the child. The child lived in your home for more than half of 2011 (temporary absences away from home, such as time spent at school, count as time lived at home). Note-- A married child must be your dependent.	Birth certificates or other official documents of birth, marriage certificates, letter from an authorized adoption agency, letter from the authorized placement agency, or applicable court document that verify your relationship to the child (send these documents only for a qualifying child who is not your natural or adopted child). To show both you and your child lived together for more than half of 2011, send: <ul style="list-style-type: none">● School, medical, daycare, or social service records● A letter on the official letterhead from a school, medical provider, social service agency, or place of worship that shows names, common address and dates. (If you send a letter from a relative who provides your daycare, you MUST send at least one additional letter.) Send as many documents as necessary to show that the child lived with you for more than half of the year.
Cost of Keeping up a Home Test	If:	And	Then send photocopies of the following documents for tax year 2011
	You pass both the marriage test and the qualifying person test,	You paid more than half the cost of keeping up your home for 2011.	Rent receipts, utility bills, grocery receipts, property tax bills, mortgage interest statement, upkeep and repair bills, property insurance statement, and other household bills.

Form 886-H-HOH-2011 (1-2012)

Cat No. 58204C

www.irs.gov

Department of the Treasury-Internal Revenue Service

**INVESTIGATING THE IMPACT OF
LIENS ON TAXPAYER LIABILITIES
AND PAYMENT BEHAVIOR**

Investigating the Impact of Liens on Taxpayer Liabilities and Payment Behavior¹

EXECUTIVE SUMMARY	108
Introduction	108
Methodology	108
Findings	109
INTRODUCTION	111
BACKGROUND	112
OBJECTIVES	115
METHODOLOGY	115
Phase 1 – Data Set Construction	115
Phase 2 – Data Analysis	118
Limitations	119
FINDINGS	119
All Lien and Non-lien Taxpayers	119
IA Taxpayers and Non-IA Taxpayers	121
OIC Taxpayers and Non-OIC Taxpayers	122
CNC Hardship Taxpayers	123
CONCLUSIONS	124
APPENDIX A: IRM LIEN FILING REQUIREMENTS	126

¹ The principal authors of this study are Terry Ashley, Tom Beers, and Jeff Wilson of TAS Research and Analysis, and Mike Nestor of the IRS Human Capital Office (HCO) Engage & Research, on detail to TAS Research and Analysis.

Investigating the Impact of Liens on Taxpayer Liabilities and Payment Behavior

TABLE OF FIGURES

Figure 1, Total Payments - Lien vs. Non-Lien Taxpayers	109
Figure 2, Mean Entity Balance - Lien vs. Non-Lien Taxpayers	109
Figure 3, Mean Entity Balance - CNC Hardship Taxpayers with and without Liens	110
Figure 4, Total Payments - IA vs. Non-IA Taxpayers	110
Figure 5, Total Payments - CNC Hardship Taxpayers with and without OICs.....	110
Figure 6, Inflation-Adjusted Total Yield vs. Liens Issued	113
Figure 7, Criteria Captured in Model from IRM 5.12.1.13(2) & IRM 5.12.2.8(4) & (5).....	116
Figure 8, Criteria Captured in Model from IRM 5.19.4.5.2.....	116
Figure 9, Independent Variables for Propensity Scoring Model	117
Figure 10, Mean Entity Balance - Lien vs. Non-lien Taxpayers.....	120
Figure 11, Distribution of Entity Balances - Lien vs. Non-lien Taxpayers.....	120
Figure 12, Total Payments - Lien vs. Non-lien Taxpayers	120
Figure 13, Mean Entity Balance - IA vs. Non-IA Taxpayers	121
Figure 14, Distribution of Entity Balances - IA vs. Non-IA Taxpayers	121
Figure 15, Total Payments - IA vs. Non-IA Taxpayers	121
Figure 16, Mean Entity Balance - OIC vs. Non-OIC Taxpayers.....	122
Figure 17, Distribution of Entity Balances - OIC vs. Non-OIC Taxpayers.....	122
Figure 18, Total Payments - OIC vs. Non-OIC Taxpayers.....	123
Figure 19, Mean Entity Balance - CNC Hardship Taxpayers with and without Liens	123
Figure 20, Total Payments - CNC Hardship Taxpayers with and without OICs.....	123
Figure 21, Distribution of Entity Balances – CNC Hardship Taxpayers with and without OICs	124

EXECUTIVE SUMMARY

Introduction

Last year, TAS Research published its lien study, “Estimating the Impact of Liens on Taxpayer Compliance Behavior and Income,” in Volume 2 of the 2011 Annual Report to Congress.² TAS Research completed this study in response to the National Taxpayer Advocate’s concern that the IRS’s use of the Notice of Federal Tax Lien (NFTL) may be harming taxpayers, especially those experiencing economic hardships, while not significantly enhancing the IRS’s ability to collect liabilities.

The study examined the impact of lien filing on taxpayer compliance behavior and income. To conduct it, TAS Research analyzed a cohort of delinquent individual tax return filers (those who file Forms 1040, *U.S. Individual Income Tax Return*) in taxpayer delinquent account (TDA)³ status who incurred unpaid tax liabilities in 2002 and had no such liabilities at the beginning of 2002.⁴ We identified the subgroup of these taxpayers against whom IRS filed liens between 2002 and 2004, as well as a comparable subgroup against whom the IRS did not file liens.

In the current study, we analyze the impact of lien filing on the tax liabilities and revenue collected from these taxpayers and whether the installment agreement (IA) and offer in compromise (OIC) collection alternatives can improve these outcomes for both taxpayers and the IRS. We also update the 2011 propensity scoring model to incorporate some model enhancements.⁵

Methodology

This study employs a two-phase approach. In Phase 1, we construct our cohort of comparable lien and non-lien taxpayers from the initial population of delinquent taxpayers.⁶

In Phase 2, we use subsets of the study population created in Phase 1 to conduct our analyses. We look at the change in total tax liability of our various groups of taxpayers during the study period (2002 through 2010). We also look at the total dollars the IRS actually collected from these taxpayer groups.

² National Taxpayer Advocate 2011 Annual Report to Congress vol. 2, 91-111 (Research Study: *Estimating the Impact of Liens on Taxpayer Compliance Behavior and Income*).

³ Our cohort includes only the delinquent taxpayers who entered TDA status. These are delinquent taxpayers who did not resolve their liabilities in response to IRS notices.

⁴ The study also includes delinquent trust fund recovery penalty amounts. These are assessments against individual taxpayers who are generally officers of a corporation and who therefore have a fiduciary responsibility for unpaid employment tax amounts withheld from employees of that corporation.

⁵ The first stage of Phase 1 estimates the probability that a taxpayer will have a tax lien filed against his or her delinquent liability. The propensity score represents the probability that the IRS will file a lien against a taxpayer’s tax liability and ranges in value between 0 and 1. We used a logistic regression equation to estimate the propensity scores.

⁶ As discussed in the body of the report, TAS Research used a technique known as “propensity scoring” to identify a group of non-lien taxpayers comparable to the lien taxpayers in the study with respect to the characteristics the IRS uses to make lien filing determinations.

Investigating the Impact of Liens on Taxpayer Liabilities and Payment Behavior

Findings

Our results show that in general, and given the lien filing criteria in place during 2002–2004, lien filing was associated with unfavorable outcomes for both the IRS and the taxpayer, *i.e.*, the IRS collected significantly less revenue from lien taxpayers (see Figure 1 below) and the total tax liabilities of lien taxpayers increased more.

FIGURE 1, Total Payments – Lien vs. Non-Lien Taxpayers⁷

	Number of Taxpayers	Mean Balance at Time of Lien Filing	Mean Payments	Ratio Payments/Balance
Lien	65,249	\$37,486	\$25,845	0.69
No Lien⁸	65,249	\$34,813	\$38,477	1.11

As shown in Figure 2 below, however, both the lien and non-lien taxpayer groups had difficulty paying down their tax liabilities, and, on average, were in more debt to the IRS in 2010, the end of the study, than at the time of lien filing or proxy lien filing.⁹

FIGURE 2, Mean Entity¹⁰ Balance – Lien vs. Non-Lien Taxpayers

	Number of Taxpayers	Mean Balance at Time of Lien Filing	Mean Balance 2010	Ratio 2010/Lien Date
Lien	65,249	\$37,486	\$45,314	1.21
No Lien	65,249	\$34,813	\$38,635	1.11

This problem was most severe for currently not collectible (CNC) hardship taxpayers, who on average ended up owing about 50 percent more to the IRS in 2010 than at the time of lien (or proxy lien) filing (see Figure 3 below).

⁷ Our calculations of revenue collected do not include refund offsets, which are not taxpayer payments per se. Offsets are tax return refund amounts that the IRS uses to offset outstanding tax liabilities rather than refunding them to the taxpayer. During the study period, the mean amount of refund offsets from non-lien taxpayers was \$19,738. The mean amount of offsets from lien taxpayers was \$7,858.

⁸ As discussed in the Methodology section, some non-lien taxpayers were used twice during the matching process. We are showing the weighted counts of non-lien taxpayers throughout this report, since our calculations are based on the weighted counts. The actual number of non-lien taxpayers, excluding duplicates, was 44,563.

⁹ To compute a proxy lien filing date for our non-lien taxpayers, we first calculated the median days to lien filing from the date our lien taxpayers acquired their tax liability. For our non-lien taxpayers, we then added this number of days to the date they acquired their tax liability to determine the proxy lien filing date.

¹⁰ The entity balance is the total amount including penalty and interest of all outstanding individual tax liabilities owed by the taxpayer.

Investigating the Impact of Liens on Taxpayer Liabilities and Payment Behavior

FIGURE 3, Mean Entity Balance – CNC Hardship Taxpayers with and without Liens

	Number of Taxpayers	Mean Balance at Time of Lien Filing	Mean Balance 2010	Ratio 2010/Lien Date
CNC Lien	8,321	\$55,475	\$83,263	1.50
CNC No Lien	5,659	\$27,800	\$42,403	1.53

The subgroups with IA and OIC collection alternatives had better outcomes for taxpayers and the IRS. Over 50 percent of IA taxpayers and over 70 percent of OIC taxpayers were out of debt to the IRS at the end of the study period. Further, as shown in Figure 4 below, the IRS collected about 45 percent more tax revenue from IA taxpayers than from those without IAs, and almost twice as much in percentage terms based on the amount owed at the time of lien filing or proxy lien filing.

FIGURE 4, Total Payments – IA vs. Non-IA Taxpayers

	Number of Taxpayers	Mean Balance at Time of Lien Filing	Mean Payments	Ratio Payments/Balance
IA	10,531	\$27,017	\$44,989	1.67
No IA	119,967	\$36,951	\$31,035	0.84

While the IRS collected significantly less from taxpayers with approved OICs than from the other taxpayers included in this study, the accepted offer amount represents the full amount the IRS estimated it could collect from these taxpayers. Moreover, when we looked at CNC hardship taxpayers, the study group with the most unfavorable outcomes for both the taxpayer and the IRS,¹¹ we found that they paid considerably more to the IRS if they were granted OICs and were generally out of debt at the end of the study period (see Figure 5 below).¹²

FIGURE 5, Total Payments – CNC Hardship Taxpayers with and without OICs

	Number of Taxpayers	Mean Balance at Time of Lien Filing	Mean Payments	Ratio Payments/Balance
CNC with OICs	602	\$57,428	\$22,696	0.40
CNC without OICs	13,378	\$43,680	\$15,357	0.35

¹¹ On average, CNC hardship taxpayers paid the least to the IRS and had the greatest percentage increase in their total tax liabilities.

¹² About 80 percent of CNC hardship taxpayers with OICs were out of debt to the IRS at the end of the study period, compared to only about 20 percent of CNC hardship taxpayers who did not have OICs.

These study findings demonstrate the need for continued study of IRS lien filing criteria to maximize the benefits of lien filing to the IRS and minimize its adverse effects on taxpayers. Additionally, the findings underscore the benefits of active promotion and use of the IA and OIC collection alternatives and highlight the likely benefits to the IRS and taxpayers of increased use of OICs for CNC hardship taxpayers.

INTRODUCTION

Last year, TAS Research published its lien study, “Estimating the Impact of Liens on Taxpayer Compliance Behavior and Income,” in Volume 2 of the 2011 Annual Report to Congress.¹³ TAS Research completed this study in response to the National Taxpayer Advocate’s concern that the IRS’s use of the Notice of Federal Tax Lien (NFTL) may be harming taxpayers, especially those experiencing economic hardships, while not significantly enhancing the IRS’s ability to collect liabilities.

The study examined the impact of lien filing on taxpayer compliance behavior and income. To conduct it, TAS Research analyzed a cohort of delinquent individual tax return filers (those who file Forms 1040, *U.S. Individual Income Tax Return*) in taxpayer delinquent account status (TDA),¹⁴ who incurred unpaid tax liabilities in 2002 and had no such liabilities at the beginning of 2002.¹⁵ We identified the subgroup of these taxpayers against whom IRS filed liens between 2002 and 2004, as well as a comparable subgroup against whom the IRS did not file liens. We compared the payment and filing compliance behavior of these two groups from inception of the liability through 2010. Specifically, we explored four research questions:

1. Whether lien filing positively or negatively impacted taxpayers’ payment behavior with respect to the original liabilities they incurred in 2002;
2. Whether lien filing positively or negatively impacted taxpayer payment compliance in subsequent periods;
3. Whether lien filing positively or negatively impacted taxpayer filing behavior in subsequent periods; and
4. Whether lien filing positively or negatively impacted taxpayer income in subsequent periods.

Our study showed lien filing was associated with negative outcomes for payment compliance behavior on the taxpayers’ initial liabilities, negative filing compliance behavior, and negative outcomes for the amount of income earned by taxpayers in years subsequent to

¹³ National Taxpayer Advocate 2011 Annual Report to Congress vol. 2, 91-111 (Research Study: *Estimating the Impact of Liens on Taxpayer Compliance Behavior and Income*).

¹⁴ Our cohort includes only the delinquent taxpayers who entered TDA status. These are delinquent taxpayers who did not resolve their liabilities in response to IRS notices.

¹⁵ The study also includes delinquent trust fund recovery penalty amounts. These are assessments against individual taxpayers who are generally officers of a corporation and who therefore have a fiduciary responsibility for unpaid employment tax amounts withheld from employees of that corporation.

Investigating the Impact of Liens on Taxpayer Liabilities and Payment Behavior

the filing of the NFTL. Lien filing was associated with a positive outcome for taxpayer payment compliance behavior on liabilities subsequent to their original ones.

In the current study, we analyze the impact of lien filing on the tax liabilities and revenue collected from these taxpayers and whether the installment agreement and offer in compromise collection alternatives can improve these outcomes for both taxpayers and the IRS. We also update the 2011 propensity scoring model to incorporate some model enhancements.¹⁶

BACKGROUND

A federal tax lien (FTL) arises when the IRS assesses a tax liability, sends the taxpayer notice and demand for payment, and the taxpayer does not fully pay the debt within ten days.¹⁷ 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 those acquired by the taxpayer after that date.¹⁸ This lien continues against the taxpayer's property until the liability has been fully paid or is legally unenforceable.¹⁹ 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.²⁰

A lien filing determination is required for all balance due cases.²¹ The IRS IRM specifies various criteria for lien filings depending on the nature of the delinquency. The IRS is even supposed to file an NFTL on most accounts reported as CNC if the unpaid balance is at least \$10,000.²² Streamlined installment agreements do not usually require an NFTL filing.²³

¹⁶ The first stage of Phase I estimates the probability that a taxpayer will have a tax lien filed against his or her delinquent liability. The propensity score represents the probability that the IRS will file a lien against a taxpayer's tax liability and ranges in value between 0 and 1. We used a logistic regression equation to estimate the propensity scores.

¹⁷ 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.

¹⁸ See IRC § 6321; Internal Revenue Manual (IRM) 5.12.2.2 (May 20, 2005).

¹⁹ IRC § 6322.

²⁰ IRC § 6323(f); Treas. Reg. § 301.6323(f)-1; IRM 5.12.2.8 (Oct. 30, 2009).

²¹ IRM 5.12.2.4 (Mar. 8, 2012).

²² IRM 5.12.2.4.1 (Mar. 8, 2012). During our study period, the lien filing threshold was \$5,000. It was increased to \$10,000 as part of the IRS's "fresh start" initiative.

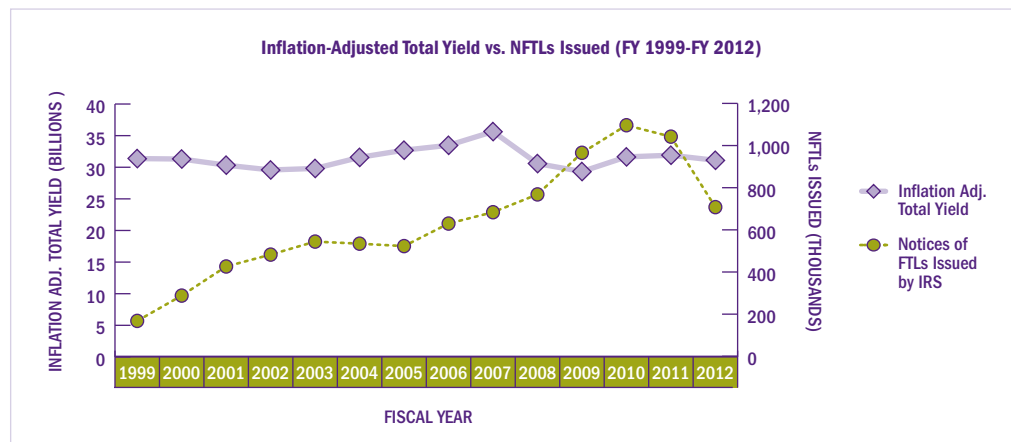
²³ IRM 5.14.5 (Mar. 11, 2011). Lien filing is not required for taxpayers entering into a streamlined installment agreement, but a lien may be filed at the discretion of the revenue officer. In January 2012, the IRS issued interim guidance which raised the threshold for obtaining a streamlined installment agreement (an agreement where the taxpayer does not have to supply the IRS with a financial statement) from \$25,000 to \$50,000. The maximum term for streamlined installment agreements was also raised to 72 months from the prior 60 month maximum. Small Business/Self Employed Division (SB/SE), Interim Guidance Memorandum, Control No. SBSE-05-0112-013 (Jan. 20, 2012).

Investigating the Impact of Liens on Taxpayer Liabilities and Payment Behavior

The IRS files more than a third of its NFTLs through the Automated Collection System (ACS), and files many of these without any significant employee review of the cases.²⁴ The National Taxpayer Advocate does not believe the IRS should be precluded from filing NFTLs, but rather that it should use this powerful collection tool judiciously as warranted by the circumstances of the delinquency.²⁵

While NFTL filings fell to an all-time low after the enactment of the IRS Restructuring and Reform Act of 1998, they have since increased, and rose precipitously between 2005 and 2010. Because of the IRS's "fresh start" changes in NFTL filing policies,²⁶ however, the number of NFTLs dropped about 32 percent from fiscal year (FY) 2011 to approximately 707,000 in FY 2012, as shown in Figure 6 below. The graphic illustrates the volume of IRS lien filings, and the total dollars collected since 1999.

FIGURE 6, Inflation-Adjusted Total Yield vs. Liens Issued²⁷



²⁴ IRS, Collection Report NO-5000-25 (Oct. 1, 2012). Of the 707,768 NFTLs filed in FY 2012, about 35 percent were filed by the ACS. An analysis TAS conducted prior to 2011 showed that about 58 percent of ACS liens were filed systemically and without significant employee review. See National Taxpayer Advocate 2010 Annual Report to Congress vol. 2, 93 (Status Update: *Estimating the Impact of Liens on Taxpayer Compliance Behavior, an Ongoing Research Initiative*). On February 24, 2011, the IRS increased the threshold for systemically filing liens to \$10,000 and raised it again to \$25,000 on April 15, 2011. See IRS response to information request (Oct. 12, 2011). TAS will continue to monitor IRS lien filing volumes to determine the impact of these lien filing threshold changes.

²⁵ For a detailed discussion of the National Taxpayer Advocate's concerns about IRS lien filing policies, see Most Serious Problem: *Although the IRS "Fresh Start" Initiative has reduced the Number of Lien Notices Filed, the IRS has Failed to Determine if its Lien Policies are Clearly Supported by either Increased Taxpayer Compliance or Revenue, infra*; Introduction: *Introduction to Collection Issues: The IRS "Fresh Start" Initiative Has Produced Significant Improvements in Some Collection Policies; However, Significantly More Emphasis on Service Delivery Is Necessary to Realize the Full Benefits of These Important Changes*; National Taxpayer Advocate 2011 Annual Report to Congress 109-128 (Most Serious Problem: *Changes to IRS Lien Filing Practices Are Needed to Improve Future Compliance, Increase Revenue Collection, and Minimize Economic Harm Inflicted on Financially Struggling Taxpayers*). See also National Taxpayer Advocate 2010 Annual Report to Congress 302-310 (Status Update: *The IRS Has Been Slow to Address the Adverse Impact of Its Lien-Filing Policies on Taxpayers and Future Tax Compliance*).

²⁶ The IRS began its fresh start Initiative in 2011 to help struggling taxpayers. It is discussed in more detail below.

²⁷ IRS, *IRS Data Book, Table 16, Delinquent Collection Activities, 1999-2011*; IRS, Collection Activity Report NO-5000-23 and 5000-25, *Collection Workload Indicators* (1999-2012).

Investigating the Impact of Liens on Taxpayer Liabilities and Payment Behavior

As shown above, overall inflation-adjusted collection revenue has not kept pace with the increase in lien filings.²⁸ While IRS and taxpayer activities, economic conditions, and other factors certainly affect the total collection yield, the fact that increased lien filings do not necessarily increase collections makes the practice of filing an NFTL questionable in various situations.

In response to the National Taxpayer Advocate's concerns and as a part of the 2011 "fresh start" initiative to help financially struggling taxpayers, the IRS has made changes to its lien filing criteria:

- The dollar threshold for filing most NFTLs has doubled from \$5,000 to \$10,000, resulting in fewer NFTLs;²⁹
- The IRS has changed procedures for NFTL withdrawals after lien releases;³⁰
- The IRS provides for NFTL withdrawal in most cases where a taxpayer enters into a Direct Debit Installment Agreement (DDIA);³¹ and
- The IRS set the minimum NFTL filing threshold on subsequent tax periods at \$2,500 or more.³²

The IRS also reprogrammed its ACS,³³ which files NFTLs systemically, as follows:

- On February 24, 2011, ACS's systemic NFTL filing threshold was increased from \$5,000 to \$10,000; and
- On April 15, 2011, the ACS NFTL filing threshold was further increased to \$25,000.³⁴

The data for FY 2012 show that lien filings are down about 32 percent from FY 2011.³⁵ The IRS continues to file most NFTLs based on a threshold amount of liability, however, rather than considering taxpayers' individual circumstances and financial situations.³⁶

²⁸ The inflation-adjusted totals reflect the yearly total collection yields adjusted to 2012 dollars using the U.S. Consumer Price Index-All Urban 2012, U.S. Bureau of Labor Statistics.

²⁹ IRM 5.12.2.4.1 (Mar. 8, 2012); IRM 5.12.2.4.2.3 (Mar. 8 2012). The Collection Process Study (CPS), in which TAS actively participated, recommended raising the threshold to \$50,000. IRS, CPS 122 (Sept. 30, 2010).

³⁰ SB/SE, Interim Guidance Memorandum, Control No. SBSE-05-0112-008 (Jan. 4, 2012).

³¹ SB/SE, Interim Guidance Memorandum, Control No. SBSE-05-0312-029 (Mar. 13, 2012).

³² IRM 5.12.2.4.1 (Mar. 8, 2012).

³³ IRMs for both Revenue Officers and ACS generally state that the NFTL may be filed if the unpaid balance of assessment is \$10,000 or more. IRM 5.12.2.4.1 (Mar. 8, 2012); IRM 5.19.4.5.2 (May 20, 2011).

³⁴ IRS response to TAS information request (Oct. 1, 2012).

³⁵ IRS Collection Report NO-5000-25 reported Total Liens/Refiles by Enterprise Collection FY 2012, Run 10/1/2012, at 707,768.

³⁶ IRS, Media Relations Office, IRS Announces New Effort to Help Struggling Taxpayers Get a Fresh Start; Major Changes to Lien Process, IR-2011-20 (Feb. 24, 2011).

OBJECTIVES

In this study, TAS Research sought to better understand the impact that lien filing has on taxpayer liabilities and IRS revenue collection. We also explore whether the IA and OIC collection alternatives can improve these outcomes for both taxpayers and the IRS. To analyze these impacts we constructed the following groups from our study population:

1. All taxpayers included in our study against whom the IRS filed liens and those against whom the IRS did not file liens;
2. Taxpayers who received IAs from the IRS and those who did not;
3. Taxpayers who received OICs from the IRS and those who did not; and
4. CNC hardship taxpayers who received OICs from the IRS and those who did not.

We then explored the following research questions:

1. Whether lien filing positively or negatively impacted the amount of payments taxpayers made against their total tax liabilities during the study period;
2. Whether lien filing positively or negatively impacted taxpayer total indebtedness to the IRS during the study period;
3. Whether IAs and OICs positively or negatively impacted the amount of payments taxpayers made against their total tax liabilities during the study period; and
4. Whether IAs and OICs positively or negatively impacted taxpayer total indebtedness to the IRS during the study period.

METHODOLOGY

In Phase 1 of this study, we use a two-step method to produce our cohort of comparable lien and non-lien taxpayers from the initial population of delinquent taxpayers. In Phase 2, we use subsets of the study population created in Phase 1 to conduct our analyses.

Phase 1 – Data Set Construction

The IRS criteria that determine when tax lien filings should occur³⁷ introduce a selection bias that must be addressed, or the estimation of the tax lien's impact in the second phase would produce biased results.³⁸

To overcome the selection bias arising from IRM criteria, we used 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.

³⁷ See IRM 5.12.1.13(2), IRM 5.12.2.8.1(4) & (5) and IRM 5.19.4.

³⁸ We note that a variety of circumstances prevent IRS employees from always consistently following the IRM lien filing criteria. For example, revenue officers in some geographic areas will work cases with lower balances due, while inventories will be so high in other areas that a case with a similar balance due will remain in the Collection queue and not be assigned to a Collection employee. In other words, the IRS treats two similar cases very differently.

Investigating the Impact of Liens on Taxpayer Liabilities and Payment Behavior

The propensity score we generate is an estimate of the probability that a taxpayer will have a tax lien filed against his or her delinquent liability. To determine this conditional probability we use a logistic regression equation, where the dependent variable is a binary variable (one indicates a lien has been filed and zero indicates a lien has not been filed).³⁹ The independent variables are the covariates that capture the underlying conditions for tax lien filing, which the IRM specifies.⁴⁰ Figures 7 and 8 report the lien filing criteria we identified in the IRS data and used to create our covariates. These criteria were in place at the time these delinquent taxpayers faced lien filing determinations (from 2002 to 2004).⁴¹ The use of this information permits the model to more closely reflect IRS practices.

FIGURE 7, Criteria Captured in Model from IRM 5.12.1.13(2) & IRM 5.12.2.8(4) & (5)

ID	IRM Provision
1	The aggregate unpaid balance of assessment (UBA) is \$5,000 or more.
2	If there is an UBA of any amount for an entity and the entity is not adhering to compliance requirements, such as Federal tax deposits, return filings, etc.
3	An installment agreement does not meet streamlined, guaranteed, or in-business trust fund express criteria.
4	An open account with an aggregate UBA of \$5,000 or more is being reported as currently not collectable.
5	The property is exempt by the Federal Bankruptcy Code or state insolvency proceeding.

Source: IRM 5.12.1.13(2) (July 31, 2001); IRM 5.12.2.8(4) & (5) (Mar. 1, 2004).

FIGURE 8, Criteria Captured in Model from IRM 5.19.4.5.2

ID	IRM Provision
1	Currently not collectable accounts, where the aggregate assessed balance is at or above \$5,000 and account is closed hardship (closing codes 24-32).
2	A lien has been filed and additional liabilities with aggregate assessed balance of \$2,000 or more are received.
3	Consider lien filing in any situation where taxpayer has: <ul style="list-style-type: none"> ♦ Broken a promise. ♦ Been warned of possible lien filing. ♦ An aggregate assessed balance at or above \$5,000. ♦ Employee believes filing the lien immediately will be helpful in collecting the balance due.

Source: IRM 5.19.4.5.2 (Aug. 30, 2001).

The model estimates the relationship between these criteria and the likelihood of lien filing to generate propensity scores. It generates a propensity score for each taxpayer based on the values the taxpayer has for each of these criteria. The higher the propensity score value, the greater the likelihood that the IRS will file an NFTL against the taxpayer under consideration.

³⁹ We actually model the dependent variable as a logit, which is the natural log of the odds derived from the dependent variable binary outcomes.

⁴⁰ Due to limitations in IRS data, we were not able to capture certain criteria for lien filings.

⁴¹ In IRM 5.12, *Federal Tax Lien*, we used IRM 5.12.1.13(2) with a revision date of 7/31/2001 and IRM 5.12.2.8.1(4) & (5) with a revision date of 3/1/2004. In the Enforcement Action chapter, IRM 5.19.4, we found additional guidance on lien filing determinations. Because our analysis focuses on tax lien filings in 2002 to 2004, we used IRM 5.19.4.5.2(2)-(7) with a revision date of 8/30/2001.

Investigating the Impact of Liens on Taxpayer Liabilities and Payment Behavior

The propensity scoring model we use in our study incorporates changes to the model we used in our 2011 study. In 2011, we defined our population of lien taxpayers as those who had received their lien between 2002 and 2004, and we excluded taxpayers who received their liens after 2004 from our dataset (we will refer to these taxpayers as late-lien taxpayers). Subsequently, we determined that these late-lien taxpayers should be included as part of the population of non-lien taxpayers during the Phase I propensity scoring and matching processes, since they were part of the population of delinquent taxpayers we were analyzing⁴² and were non-lien taxpayers prior to 2005.

We also made another change to the propensity scoring process. As discussed above, propensity scoring uses the values for the variables that drive the lien filing determination to calculate the probability that the IRS will file a lien against each taxpayer included in our dataset. These variables should therefore be set to their values at the time the lien filing determination was made. During our review of the Phase I propensity scoring process, TAS Research determined that four variables should be reconstructed to ensure that their values reflected their status at the time of lien filing. The affected variables appear in italics in Figure 9 below, along with a description of how we defined them. The figure describes all the variables used in the Phase I propensity scoring process.

FIGURE 9, Independent Variables for Propensity Scoring Model

Label	Variable Description
<i>aggbal5000</i>	A binary indicator where one indicates that an aggregate assessed balance equal to or greater than \$5,000 existed at the date of the lien filing for lien taxpayers or proxy lien filing for non-lien taxpayers. ⁴² Otherwise, it is zero.
<i>bnkrpty_ind</i>	A binary indicator where one indicates the taxpayer declared bankruptcy at or before the date of lien filing for lien taxpayers or proxy lien filing for non-lien taxpayers. Otherwise, it is zero.
<i>col_noncompl</i>	A binary indicator where one indicates the taxpayer failed to file a required return at or before the date of lien filing for lien taxpayers or proxy lien filing for non-lien taxpayers. Otherwise, it is zero.
<i>CNC_ind</i>	A binary indicator where one indicates the taxpayer was in CNC status at the date of lien filing for lien taxpayers or proxy lien filing for non-lien taxpayers. Otherwise, it is zero.
<i>default</i>	A binary indicator where one indicates the taxpayer defaulted on an installment agreement at or before the date of lien filing for lien taxpayers or proxy lien filing for non-lien taxpayers. Otherwise, it is zero.
<i>hardship_ind</i>	A binary indicator where one indicates the taxpayer was in CNC status due to economic hardship at the date of lien filing for lien taxpayers or proxy lien filing for non-lien taxpayers. Otherwise, it is zero.
<i>instlmt</i>	A binary indicator where one indicates the taxpayer was in installment agreement status at the date of lien filing for lien taxpayers or proxy lien filing for non-lien taxpayers. Otherwise, it is zero.
<i>ltnmodbal</i>	The logarithm of the dollar amount of the total balance of all delinquent modules at the time the IRS filed a lien (between 2002 and 2004) against the taxpayer's delinquencies. The proxy lien date was used for non-lien taxpayers. This variable is not in the IRM criteria, but significantly affected the lien filing determination.

⁴² TAS Research analyzed the population of delinquent individual tax return filers (*i.e.*, those who file Forms 1040, *U.S. Individual Income Tax Return*) in TDA status who incurred unpaid individual tax liabilities in 2002 and had no such liabilities at the beginning of that year. The study also includes delinquent trust fund recovery penalty amounts. These are assessments against individual taxpayers who are generally officers of a corporation and who therefore have a fiduciary responsibility for unpaid employment tax amounts withheld from employees of that corporation.

⁴³ To compute a proxy lien filing date for our non-lien taxpayers, we first calculated the median days to lien filing from the date our lien taxpayers acquired their tax liability. For our non-lien taxpayers, we then added this number of days to the date they acquired their tax liability to determine the proxy lien filing date.

We use the estimated propensity scores to create matched pairs of lien taxpayers with non-lien taxpayers. To ensure the best possible match between the lien and non-lien taxpayers, we matched taxpayers who were entering into CNC status at the time of lien filing against other non-lien taxpayers in CNC status. We matched the remaining lien taxpayers against the non-CNC population of delinquent non-lien taxpayers.

We used a propensity score matching technique known as the “nearest available neighbor” method.⁴⁴ The matched pairs allow the two groups (tax lien taxpayers and non-lien taxpayers) to be effectively identical over set covariates (observable characteristics pertaining to the IRS’s lien filing determinations). This condition in the sample allows the estimate of the event (tax lien filing) effect to be less biased.

In the nearest available neighbor matching method, both lien and non-lien groups are 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 selected as a match. This procedure is repeated for all the lien units. This method matches lien and non-lien cases within a certain distance of the propensity score set by the user (.01 in our case). While the propensity score for each pair member is an estimate and the matches may therefore be subject to some uncertainty, we believe the aggregate comparison between the lien and non-lien groups is valid, as any imprecision at the pair level balances out in the overall groups.

Phase 2 – Data Analysis

As discussed above, we used propensity scoring and a matching process to create matched pairs of lien and non-lien taxpayers. We then divided the pairs into comparable groups of lien and non-lien taxpayers. Finally, we analyzed these groups to create several subgroups of taxpayers:

- Those who were or were not recipients of installment agreements;
- Those who were or were not recipients of offers in compromise; and
- Those who entered into currently not collectible status due to economic hardship prior to or within 90 days after the time of lien filing or proxy lien filing (we broke out CNC hardship taxpayers who received OICs separately).

To determine the change in total tax liability for our various groups of taxpayers, we calculated the ratio of the 2010 ending entity balance (the balance including penalty and interest of all outstanding individual tax liabilities owed by the taxpayer) to the entity balance of the taxpayer at the time of lien filing or proxy lien filing.⁴⁵

⁴⁴ We used a nearest-neighbor technique for matching the lien units and non-lien units that is called the “greedy” matching technique and was developed by Jon Kosanke and Erik Bergstralh.

⁴⁵ To compute a proxy lien filing date for our non-lien taxpayers, we first calculated the median days to lien filing from the date our lien taxpayers acquired their tax liability. For our non-lien taxpayers, we then added this number of days to the date they acquired their tax liability to determine the proxy lien filing date.

We also looked at the total dollars the IRS actually collected from our various groups of taxpayers. We used the total payments from the Accounts Receivable Dollar Inventory (ARDI) module table to compute the amounts collected from these taxpayers between 2002 and 2010 and calculated a ratio, which compares the amount actually paid to the amount owed at the time of lien filing or proxy lien filing.⁴⁶

Limitations

We matched about 93 percent of all lien cases (taxpayers against whom the IRS filed liens between 2002 and 2004). We could not match many of the lien cases with propensity scores of .85 and higher, because fewer non-lien than lien cases had scores that high. Therefore, we excluded those cases from our dataset and this study does not pertain to those scores. We conducted two matches of lien cases against the population of non-lien cases to create more matches, so some non-lien cases were used twice and have a weight of two.⁴⁷

Also, although we believe that we captured the important characteristics that drive lien filing determinations, due to data limitations some characteristics that may influence lien filing behavior were not included in the propensity scoring process. Nevertheless, situations that could not be modeled such as when Collection personnel believe that NFTL filing will be beneficial should lead to favorable outcomes for the lien group. Therefore, results that show better outcomes for the non-lien group are conservative estimates. See Appendix A for an in-depth discussion of how we implemented the IRS's lien filing practices in the process.

To do our analyses, we needed to observe taxpayer behavior over an extended period of time (our study period runs from 2002 through 2010). In 2011, the IRS began its "fresh start" initiative and has made a number of changes to its lien filing criteria. Additional research is required to determine whether these changes will impact the outcomes we observed in our current study.

FINDINGS

All Lien and Non-lien Taxpayers

As shown in Figure 10 below, we found that on average, the total tax liabilities of both lien taxpayers and non-lien taxpayers was greater at the end of the study period than at the time of lien filing (or proxy lien filing for non-lien taxpayers), but that the liabilities of lien taxpayers grew more.

⁴⁶ Our calculations of revenue collected do not include refund offsets, which are not taxpayer payments *per se*. Offsets are tax return refund amounts that the IRS uses to offset outstanding tax liabilities rather than refunding them to the taxpayer. During the study period, the mean amount of refund offsets from non-lien taxpayers was \$19,738. The mean amount of offsets from lien taxpayers was \$7,858.

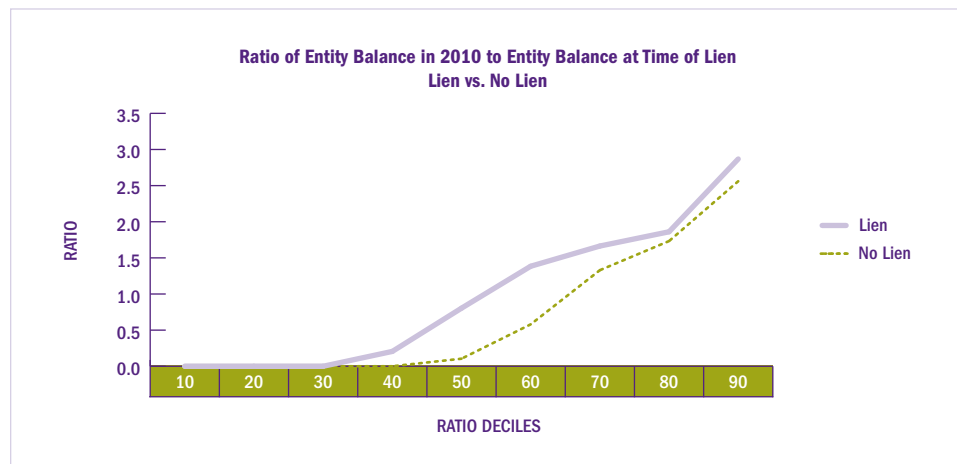
⁴⁷ We note that we also calculated the changes in taxpayers' entity balances excluding duplicates and found no significant differences from our reported results.

Investigating the Impact of Liens on Taxpayer Liabilities and Payment Behavior

FIGURE 10, Mean Entity Balance – Lien vs. Non-lien Taxpayers⁴⁸

	Number of Taxpayers	Mean Balance at Time of Lien Filing	Mean Balance 2010	Ratio 2010/Lien Date
Lien	65,249	\$37,486	\$45,314	1.21
No lien	65,249	\$34,813	\$38,635	1.11

When we looked at the distribution of taxpayer liabilities, we found that nearly 50 percent of lien taxpayers owed at least as much in 2010 as they did at the time of lien filing, and that nearly 40 percent owed at least 40 percent more.

FIGURE 11, Distribution of Entity Balances – Lien vs. Non-lien Taxpayers

We also found that lien taxpayers paid significantly less on average towards their total IRS liabilities than non-lien taxpayers (see Figure 12 below).

FIGURE 12, Total Payments – Lien vs. Non-lien Taxpayers

	Mean Balance at Time of Lien Filing	Mean Payments	Ratio Payments/Balance
Lien	\$37,486	\$25,845	0.69
No Lien	\$34,813	\$38,477	1.11

Concerned with the overall poor performance of both lien and non-lien taxpayers in paying down their tax liabilities, we then looked at whether the IA and OIC collection alternatives appeared to help taxpayers become current on their tax debts.

⁴⁸ As discussed in the Methodology section, some non-lien taxpayers were used twice during the matching process. We are showing the weighted counts of non-lien taxpayers throughout this report, since our calculations are based on the weighted counts. The actual number of non-lien taxpayers, excluding duplicates, was 44,563.

Investigating the Impact of Liens on Taxpayer Liabilities and Payment Behavior

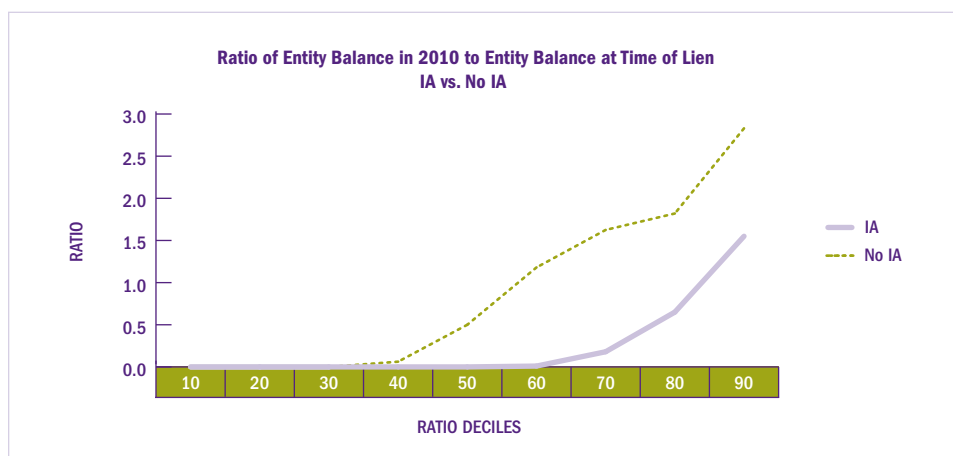
IA Taxpayers and Non-IA Taxpayers

As shown in Figure 13 below, we found that on average, taxpayers with IAs did significantly better than those without IAs in reducing their total indebtedness to the IRS.

FIGURE 13, Mean Entity Balance – IA vs. Non-IA Taxpayers

	Number of Taxpayers	Mean Balance at Time of Lien Filing	Mean Balance 2010	Ratio 2010/Lien Date
IA	10,531	\$27,017	\$15,270	0.57
No IA	119,967	\$36,951	\$44,319	1.20

When we looked at the distribution of taxpayer liabilities, we found that more than half of the taxpayers with IAs had fully paid off their tax liabilities by 2010.

FIGURE 14, Distribution of Entity Balances – IA vs. Non-IA Taxpayers

We also found that IA taxpayers paid significantly more on average towards their total IRS liabilities than non-IA taxpayers (see Figure 15 below).

FIGURE 15, Total Payments – IA vs. Non-IA Taxpayers

	Mean Balance at Time of Lien Filing	Mean Payments	Ratio Payments/Balance
IA	\$27,017	\$44,989	1.67
No IA	\$36,951	\$31,035	0.84

Investigating the Impact of Liens on Taxpayer Liabilities and Payment Behavior

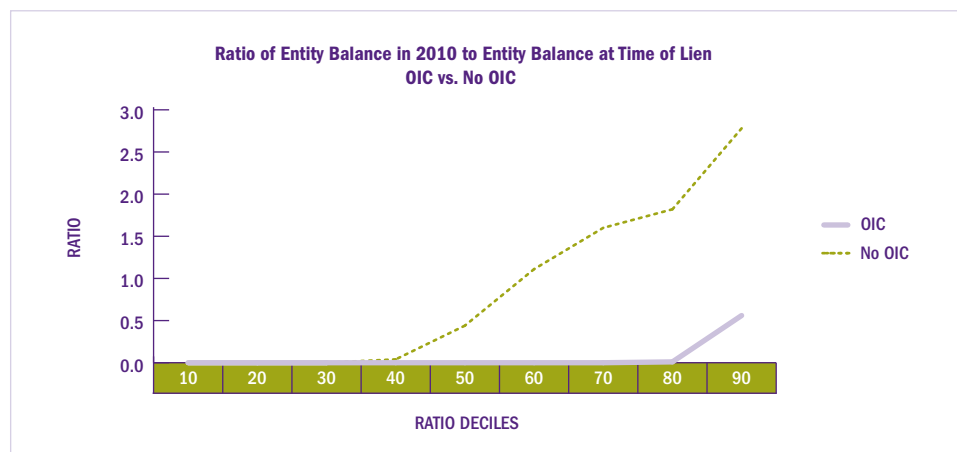
OIC Taxpayers and Non-OIC Taxpayers

As shown in Figure 16 below, we found that on average, taxpayers with OICs fared significantly better than those without OICs in reducing their total indebtedness to the IRS.

FIGURE 16, Mean Entity Balance – OIC vs. Non-OIC Taxpayers

	Number of Taxpayers	Mean Balance at Time of Lien Filing	Mean Balance 2010	Ratio 2010/Lien Date
OIC	4,026	\$68,917	\$8,763	0.13
No OIC	126,472	\$35,106	\$43,032	1.23

When we looked at the distribution of taxpayer liabilities, we found that more than 70 percent of the taxpayers with OICs had no tax liabilities in 2010.

FIGURE 17, Distribution of Entity Balances – OIC vs. Non-OIC Taxpayers

We found, however, that on average, OIC taxpayers paid significantly less than non-OIC taxpayers toward their tax liabilities, suggesting that their reductions in liabilities were primarily due to IRS write-downs based on reasonable collection potential (RCP) (see Figure 18 below).⁴⁹

⁴⁹ The IRS calculates RCP as an amount equal to the value of all of the taxpayer's equity in assets, plus future income (net of reasonable living expenses). See IRM 5.8.5 (Oct. 22, 2010). When the IRS calculates a taxpayer's reasonable collection potential, it will now look at only one year of future income for offers paid in five or fewer months, down from four years, and two years of future income for offers paid in six to 24 months, down from five years. All offers must be fully paid within 24 months of the date the offer is accepted. See IRS news release IR-2012-53, May 21, 2012.

Investigating the Impact of Liens on Taxpayer Liabilities and Payment Behavior

FIGURE 18, Total Payments – OIC vs. Non-OIC Taxpayers

	Mean Balance at Time of Lien Filing	Mean Payments	Ratio Payments/Balance
OIC	\$68,917	\$28,959	0.42
No OIC	\$35,106	\$32,263	0.92

We note, however, that in these cases the IRS has determined that OIC taxpayers have limited ability to pay. The accepted offer amount represents the full amount the IRS estimates it can collect from these taxpayers. We therefore decided to look at the impact of OICs on taxpayers that the IRS has identified as having limited ability to pay, *i.e.*, CNC hardship taxpayers.

CNC Hardship Taxpayers

We found that on average CNC hardship taxpayers ended up owing more relative to their liabilities at the time of lien filing or proxy lien filing than the other groups of taxpayers we studied (see Figure 19 below).

FIGURE 19, Mean Entity Balance – CNC Hardship Taxpayers with and without Liens

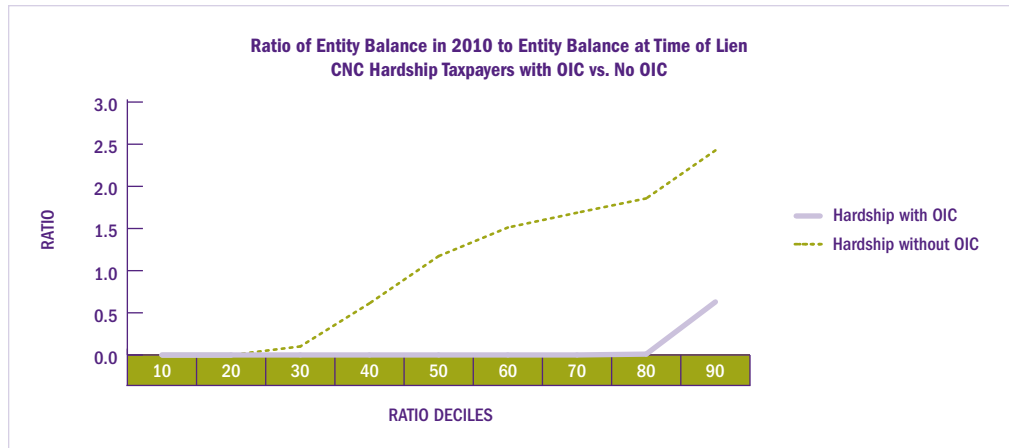
	Number of Taxpayers	Mean Balance at Time of Lien Filing	Mean Balance 2010	Ratio 2010/Lien Date
CNC Lien	8,321	\$55,475	\$83,263	1.50
CNC No Lien	5,659	\$27,800	\$42,403	1.53

We also determined that the IRS collected relatively little from CNC hardship taxpayers compared to the other groups discussed above, and that the IRS collected significantly more from CNC hardship taxpayers when they had accepted OICs (see Figure 20 below).

FIGURE 20, Total Payments – CNC Hardship Taxpayers with and without OICs

	Number of Taxpayers	Mean Balance at Time of Lien Filing	Mean Payments	Ratio Payments/Balance
CNC with OICs	602	\$57,428	\$22,696	0.40
CNC without OICs	13,378	\$43,680	\$15,357	0.35

When we looked at the distribution of taxpayer liabilities, we found that about 80 percent of the CNC hardship taxpayers with OICs had no tax liabilities in 2010, while only about 20 percent of CNC hardship taxpayers without OICs had zero balances.

FIGURE 21, Distribution of Entity Balances – CNC Hardship Taxpayers with and without OICs

CONCLUSIONS

Our study covers taxpayers against whom the IRS filed liens, and comparable non-lien taxpayers. For these taxpayers, our results show that in general, and given the lien filing criteria in place during 2002–2004, lien filing was associated with unfavorable outcomes for both the IRS and the taxpayer, *i.e.*, the IRS collected less revenue from lien taxpayers and the total tax liabilities of lien taxpayers increased more.

It is noteworthy, however, that both the lien and non-lien taxpayer groups had difficulty paying down their tax liabilities, and while non-lien taxpayers fared better, on average, both groups were in more debt to the IRS in 2010, the end of the study, than they were at the time of lien filing or proxy lien filing. This problem was most severe for CNC hardship taxpayers, who on average ended up owing about 50 percent more to the IRS in 2010 than they did at the time of lien filing or proxy lien filing.

The IA and OIC collection alternatives were associated with better outcomes for taxpayers and the IRS. Over 50 percent of IA taxpayers and over 70 percent of OIC taxpayers were out of debt to the IRS at the end of the study period. Furthermore, the IRS collected about 45 percent more tax revenue from IA taxpayers than from taxpayers without IAs, and almost twice as much in percentage terms based on the amount owed at the time of lien filing or proxy lien filing.⁵⁰

While the IRS collected significantly less from taxpayers with approved OICs than from the other taxpayers included in this study, the accepted offer amount represents the full amount the IRS estimated it could collect from these taxpayers. Moreover, when we looked

⁵⁰ As reported in the Findings section of this study, the IRS collected \$44,989 on average from IA taxpayers, which is about 167 percent of the amount they owed at the time of lien filing, and \$31,035 on average from taxpayers without IAs, which is about 84 percent of the amount these taxpayers owed at the time of lien filing.

at CNC hardship taxpayers, the study group with the most unfavorable outcomes for both the taxpayer and the IRS,⁵¹ we found that they paid considerably more to the IRS if they were granted OICs, and were generally out of debt at the end of the study period.⁵²

These study findings demonstrate the need for continued study of the lien filing criteria to maximize the benefits of lien filing to the IRS and minimize its adverse effects on taxpayers. Additionally, the findings underscore the benefits of active promotion and use of the IA and OIC collection alternatives, and highlight the likely benefits to the IRS and taxpayers of increased use of OICs for CNC hardship taxpayers.

⁵¹ On average, CNC hardship taxpayers paid the least to the IRS and had the greatest percentage increase in their total tax liabilities.

⁵² CNC hardship taxpayers with approved OICs paid \$22,696 on average, compared to \$15,357 for CNC hardship taxpayers who did not have OICs. About 80 percent of CNC hardship taxpayers with OICs were out of debt to the IRS at the end of the study period, compared to only about 20 percent of CNC hardship taxpayers who did not have OICs.

APPENDIX A: IRM LIEN FILING REQUIREMENTS

Our analysis focuses on tax lien filings from 2002 through 2004. Consequently, we used IRM 5.12.1.13(2) with a revision date of 7/31/2001 and IRM 5.12.2.8.1(4) & (5) with a revision date of 3/1/2004.⁵³ These IRM sections cover IRS lien filing requirements. The criteria covered in IRM 5.12.1.13(2), revision date 7/31/2001, provide the following situations for tax lien filing:⁵⁴

- The aggregate unpaid balance of assessment is \$5,000 or more. [file an NFTL]
- An IA is \$25,000 or more. [file an NFTL]
- An open account with an aggregate unpaid balance of assessment (UBA) of \$5,000 or more is being reported as CNC. [file an NFTL]
- A case involving both assessed and preassessed periods will be reported CNC. [The filing of an NFTL may be held up to include both periods on the NFTL.]
- The property is exempt by the Federal Bankruptcy Code or state insolvency proceeding. [file an NFTL]
- The party on which a levy is to be served is likely to file a priority claim under IRC § 6323(a) or (c). [file an NFTL even though there is no mandatory NFTL filing requirement prior to service of the notice of levy on wage, salaries, etc.]

The criteria covered in IRM 5.12.2.8.1(4) & (5), revision date 3/1/2004, provide the following situations for filing a tax lien:⁵⁵

- The aggregate UBA is \$5,000 or more. [file an NFTL]
- An installment agreement does not meet streamlined, guaranteed, or in-business trust fund express criteria. [file an NFTL]
- There are additional assessments of \$5,000 or more. [file an NFTL]
- An open account with an aggregate UBA of \$5,000 or more is being reported as currently not collectible. [file an NFTL]
- A case involving both assessed and unassessed periods will be reported CNC. [file an NFTL]
- The property is exempt by the Federal Bankruptcy Code or state insolvency proceeding. [file an NFTL]
- The taxpayer resides outside the U.S. and has known assets. [file an NFTL]

We looked at these criteria as the starting point regarding the filing of an NFTL. As we built the model for measuring the propensity for filing, we used these criteria as the

⁵³ The next revision to IRM 5.12.2.4.1 occurred May 5, 2005.

⁵⁴ IRM 5.12.1.13(2) (July 31, 2001).

⁵⁵ IRM 5.12.2.8.1(4) & (5) (Mar. 1, 2004).

Investigating the Impact of Liens on Taxpayer Liabilities and Payment Behavior

benchmark for building our variables from the data. Additional information for building our variables also came from the IRM Enforcement Action chapter.

The Enforcement Action chapter, IRM 5.19.4, provides additional guidance on the lien filing determination. Again, because our analysis focuses on filings in 2002 to 2004, we used IRM 5.19.4.5.2(2)-(7) with a revision date of 8/30/2001.⁵⁶ IRM 5.19.4.5.2(2)-(7) states that liens should be filed in these six situations, some of which overlap with IRM 5.12.2:⁵⁷

- Installment agreement: file a lien when both of the following conditions exist:
 - Aggregate assessed balance is at or above \$5,000.
 - A Collection Information Statement (CIS) is required.
- Currently not collectible: file a lien when both of the following conditions exist:
 - Aggregate assessed balance is at or above \$5,000.
 - Account is being closed under hardship provisions.
- R7 cases: these are older accounts with an aggregate assessed balance at or above \$5,000 that are reassigned for follow-up to a systemically issued ACS Letter 39.
- File an NFTL if collection is at risk, such as:
 - A creditor plans to seize the taxpayer's assets or the taxpayer is preparing to sell them.
 - The taxpayer is about to file bankruptcy.
- If a lien has been filed and additional liabilities with an aggregate assessed balance of \$2,000 or more are received, file an additional lien only if it significantly enhances the collectability of the account.
- The employee may consider lien filing in any situation where a taxpayer has:
 - Broken a promise;
 - Been warned of possible lien filing;
 - An aggregate assessed balance at or above \$5,000; and
 - The employee believes filing the lien immediately will be helpful in collecting the balance due.

The Enforcement Action guidance on tax lien filing appears to expand on the conditions for lien filing to allow Collection staff some discretion in filing the lien. We used this information to further enhance our understanding of IRS lien filing practices. We limited our modeling of filing determinations to information that could be captured on the criteria described above. Data limitations prevented us from capturing all of these situations for filing an NFTL, as detailed below.

⁵⁶ The next revision to IRM 5.19.4 occurred Aug. 1, 2005.

⁵⁷ IRM 5.19.4.5.2(2)-(7) (Aug. 30, 2001).

Investigating the Impact of Liens on Taxpayer Liabilities and Payment Behavior

Comparison of IRM NFTL Filing Criteria and Our NFTL Model

Data availability limited the IRM 5.12 section criteria that could be captured as covariates in our tax lien filing model. Table 1 shows the criteria that were captured.

TABLE 1, Variables Matched to IRM 5.12, Federal Tax Liens

ID	IRS IRM 5.12	In Model	Description of Variable in Model
1	Aggregate UBA is \$5,000 or more. [Appears for IRM 5.12.1.13 & IRM 5.12.2.8.1]	Yes	Indicator of aggregate assessed balance equal to or greater than \$5,000.
2	Installment agreement is \$25,000 or more. [Appears for IRM 5.12.1.13] Installment agreement does not meet streamlined, guaranteed, or in-business trust fund express criteria. [Appears for IRM 5.12.2.8.1]	Yes	Indicator of taxpayer having an installment agreement.
3	There are additional assessments of \$5,000 or more. [Appears for IRM 5.12.2.8.1]	No	Included in item 1.
4	An open account with an aggregate UBA of \$5,000 or more is being reported as currently not collectible. [Appears for IRM 5.12.1.13 & IRM 5.12.2.8.1]	Yes	Indicator of taxpayer having CNC modules and aggregate assessed balance equal to or greater than \$5,000.
5	A case involving both assessed and unassessed periods will be reported as currently not collectible. [Appears for IRM 5.12.1.13 & IRM 5.12.2.8.1]	No	NA
6	The property is exempt by the Federal Bankruptcy Code or State insolvency proceeding. [Appears for IRM 5.12.1.13 & IRM 5.12.2.8.1]	Yes	Indicator of taxpayer having a bankruptcy filing.
7	The party on which a levy is to be served is likely to file a priority claim under IRC 6323(a) or (c). [Appears for IRM 5.12.1.13]	No	NA
8	Taxpayer resides outside U.S. and has known assets. [Appears for IRM 5.12.2.8.1]	No	NA

Source: IRM 5.12.; NA=Not Available.

We augmented the variable list for our analysis with information from the Enforcement Action section, IRM 5.19.4.5.2 (2)-(7). This area of the IRM expanded the lien filing criteria to allow Collection staff to exercise judgment when making lien filing determinations. Due to data limitations, we were unable to model some of these criteria. Table 2 shows the criteria captured.

Investigating the Impact of Liens on Taxpayer Liabilities and Payment Behavior

TABLE 2, Variables Matched to IRM 5.19.4.5.2

ID	IRS IRM 5.19.4.5.2	In Model	Description of Variable in Model
1	Installment Agreement, where aggregate assessed balance is at or above \$5,000 and Collection Information Statement (CIS) is required.	No	Captured in prior variables.
2	CNC, where aggregate assessed balance is at or above \$5,000 and account is closed hardship (closing codes 24 through 32).	Yes	Indicator of hardship, TC530 with closing codes 24 to 32.
3	R7 cases, older accounts where aggregate assessed balance is at or above \$5,000.	No	NA
4	Collection is at risk, where creditor plans to seize the taxpayer's assets or the taxpayer is about to file bankruptcy.	No	NA
5	A lien has been filed and additional liabilities with aggregate assessed balance of \$2,000 or more are received.	Yes	Indicator that taxpayer is a repeater, <i>i.e.</i> , taxpayer incurred another balance due.
6	Consider lien filing in any situation where taxpayer has: <ul style="list-style-type: none"> ♦ Broken a promise; ♦ Been warned of possible lien filing; ♦ An aggregate assessed balance at or above \$5,000; or ♦ Where the employee believes filing the lien immediately will help collect the balance due. 	Yes	<ul style="list-style-type: none"> ♦ Indicator of default of installment agreement. ♦ Indicator of taxpayer noncompliance with a filing requirement.

Source: IRM 5.19.4.5.2; NA=Not Available.

We also allowed for the possible influence of the size of the liability on lien filing behavior by including a variable for the total module balance due. Although we were unable to capture some characteristics that influence lien filing determinations due to data limitations, situations that could not be modeled (such as when Collection personnel believe that NFTL filing will be beneficial) should lead to favorable outcomes for the lien group. Therefore, results that suggest better outcomes for the non-lien group are conservative estimates.

Investigating the Impact of Liens on Taxpayer Liabilities and Payment Behavior

This page intentionally left blank.

OPTIONS FOR EXPANDING THE
REMEDIES TO ADDRESS TAXPAYER
RIGHTS VIOLATIONS

Options for Expanding the Remedies to Address Taxpayer Rights Violations¹

EXECUTIVE SUMMARY	133
INTRODUCTION	133
Most people pay taxes voluntarily.	133
Taxpayer rights promote voluntary compliance.	133
Most taxpayers do not believe they have rights or do not know what they are.	134
Re-codifying existing taxpayer rights and responsibilities could help taxpayers remember them and improve compliance.	135
Providing adequate and accessible remedies could help taxpayers remember their rights and improve compliance.	136
DISCUSSION	138
Chile has potentially broad judicial remedies for the violation of taxpayer rights.	138
Australia and the U.K. have adopted “apology” payments (or equivalent) as a remedy for the violation of taxpayer rights.	139
CONCLUSION	140

¹ The principal author of this discussion is Eric LoPresti, Senior Attorney-Advisor to the National Taxpayer Advocate.

EXECUTIVE SUMMARY

Most U.S. taxpayers willingly meet their obligation to tell the government about their filing status, family structure, earnings, investments, expenses, and losses in an honest effort to pay the correct amount of tax. This willingness places a heavy responsibility on the IRS to treat these taxpayers fairly — in ways that comport with concepts of procedural justice. Failure to do so reduces our tax system to one based on compulsion alone, undermining our system of voluntary compliance. Moreover, survey results suggest that the perception that the IRS is fair promotes voluntary compliance. Thus, strengthening taxpayer rights could both make the tax system more fair and raise revenue.

While Congress has enacted various taxpayer rights, survey results suggest that less than 50 percent of taxpayers believe they have rights, and even fewer know what their rights are. Perhaps taxpayer rights are easy to forget because taxpayers feel they have no recourse when the IRS violates them. While remedies exist for some, they may be too costly or time consuming for many to pursue.

This study discusses ways to improve remedies available for the violation of taxpayer rights. One option adopted by the Republic of Chile is to expand the authority of the judiciary to quickly and efficiently remedy violations of taxpayer rights. Another option adopted by Australia and the United Kingdom is to empower the tax administrator — or the National Taxpayer Advocate — to make *de minimis* “apology” payments to those whose rights were violated, as previously recommended by the National Taxpayer Advocate.

INTRODUCTION

Most people pay taxes voluntarily.

Taxpayers paid about 83.1 percent of their taxes voluntarily and timely (\$2.21 trillion of the \$2.66 trillion due), and the IRS eventually collected another two percent through late payments or enforcement actions (\$65 billion out of \$2.66 trillion).² In other words, taxpayers voluntarily and timely paid about 34 times as much as the IRS will eventually collect through enforcement and voluntary late payments. Similarly, of the \$2.4 trillion in tax revenue received by the IRS in FY 2011, direct enforcement revenue accounted for only \$55.2 billion, or about two percent.³ The remaining 98 percent resulted from voluntary compliance.

Taxpayer rights promote voluntary compliance.

Some people may argue that compliance is not really “voluntary” if people comply only because of the risk of being caught and penalized if they do not (*i.e.*, because of “economic

² See IRS Research, Analysis & Statistics, *Federal Tax Compliance Research: Tax Year 2006 Tax Gap Estimation* (Mar. 2012), available at <http://www.irs.gov/pub/irs-soi/06rastg12workppr.pdf>.

³ Government Accountability Office, *GAO-12-165, IRS's Fiscal Years 2011 and 2010 Financial Statements 23* (Nov. 2011), available at http://cfo.fin.irs.gov/4all_docs/docs/gao_reports/financial_audits/gao12165.pdf.

Options for Expanding the Remedies to Address Taxpayer Rights Violations

deterrence”). However, scholars have concluded the probability of getting caught cheating is so remote that it is irrational to comply just to avoid being penalized.⁴

In response to the IRS Oversight Board’s annual survey, 89 percent of taxpayers responded that personal integrity influences their tax compliance whereas only 59 percent cited the fear of an audit — results are similar to those generated every year since 2004.⁵ These results are consistent with the notion that people voluntarily comply with tax laws for a variety of reasons other than economic deterrence.⁶

A recent TAS study found a correlation between voluntary compliance by small businesses and the perception that the IRS is fair.⁷ Thus, when taxpayers perceive the IRS is overreaching, they may lose faith in the system and voluntary compliance may decline. By contrast, when they perceive the IRS has fair procedures that embody taxpayer rights, those perceptions may increase the taxpayer’s willingness to reciprocate by voluntarily complying. At present, taxpayer rights show that the government respects taxpayers, and in response, taxpayers are more likely to show respect for the government by paying taxes. Thus, increasing the awareness of existing taxpayer rights could increase voluntary compliance.

Most taxpayers do not believe they have rights or do not know what they are.

In response to a nationwide survey of U.S. taxpayers, only 46 percent said they believed they had rights before the IRS.⁸ Further, when asked if they knew what their rights were, only 11 percent responded “Yes,” while 64 percent responded “No” or “Not Sure,” as shown by the table below.

⁴ 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 *PAGE L. REV.* 637, 640-642 (2009) [hereinafter *Lavoie 2009*] (summarizing tax compliance research). 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).

⁵ IRS Oversight Board, 2011 Taxpayer Attitudes Survey 5 (Jan. 2012), available at <http://www.treasury.gov/irsob/reports/2012/IRSOB-Taxpayer%20Attitude%20Survey%202012.pdf>.

⁶ See, e.g., National Taxpayer Advocate 2007 Annual Report to Congress vol. 2, 138-50 (Marjorie E. Kornhauser, *Normative and Cognitive Aspects of Tax Compliance*) [hereinafter *2007 Review*] (summarizing existing literature).

⁷ See *Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results*, *infra/supra* [hereinafter *Voluntary Compliance Study*]. This survey of Schedule C filers found that those in the “high-compliance” group expressed more positive views about the government, a preparer, and the IRS than those in the “low-compliance” group. Notably, less than half of all respondents agreed that the IRS treats taxpayers fairly (42 percent overall agreed or strongly agreed), but those in the high-compliance group were more likely to hold this view (47 percent agreed or strongly agreed vs. 42 percent for the low-compliance group). *Id.*

⁸ Forrester Research Omnibus Mail Survey for the Taxpayer Advocate Service (Sept. 17, 2012) [hereinafter *2012 Forrester Survey*].

Options for Expanding the Remedies to Address Taxpayer Rights Violations

TABLE 1, Views About Taxpayer Rights⁹

Responses (Percent)	Yes	No	Not Sure	No Answer
As a taxpayer, do you believe you have rights before the IRS?	46	9	20	25
Do you know what your rights are as a taxpayer when dealing with the IRS?	11	23	41	25

While Congress has enacted at least three “Taxpayer Bill of Rights” (TBOR) laws,¹⁰ these data show that less than 50 percent of taxpayers believe they have rights before the IRS and even fewer know what they are.¹¹

Re-codifying existing taxpayer rights and responsibilities could help taxpayers remember them and improve compliance.

Noting the wide variety of complicated taxpayer rights scattered throughout various laws, the National Taxpayer Advocate recommended that Congress enact another Taxpayer Bill of Rights (TBOR) to re-codify and summarize taxpayers’ existing rights and responsibilities by grouping them into the following simple, easy-to-understand categories:¹²

Taxpayer rights:¹³

- Right to be informed;
- Right to be assisted;
- Right to be heard;
- Right to pay no more than the correct amount of tax;
- Right to appeal;
- Right to certainty;
- Right to privacy;
- Right to confidentiality;
- Right to representation; and

⁹ 2012 Forrester Survey.

¹⁰ See, e.g., Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, 112 Stat. 685 (1998) [hereinafter *RRA 98*]; Taxpayer Bill of Rights, Pub. L. No. 104-168, 110 Stat. 1452 (1996); Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 102 Stat. 3342.

¹¹ 2012 Forrester Survey.

¹² For the proposal and a detailed analysis of each specific right, see National Taxpayer Advocate 2011 Annual Report to Congress 493-518 (Legislative Recommendation: *Enact the Recommendations of the National Taxpayer Advocate to Protect Taxpayer Rights*) and National Taxpayer Advocate 2007 Annual Report to Congress 478-489 (Legislative Recommendation: *Taxpayer Bill of Rights and De Minimis “Apology” Payments*). For legislative activity incorporating this recommendation in whole or in part, see Taxpayer Bill of Rights Act of 2010, S. 3215, 111th Cong., H.R. 5047, 111th Cong. (2010), H.R. 5716, 110th Cong. (2008).

¹³ These categories of taxpayer rights and responsibilities are very similar to those present in all tax systems surveyed by the Organization for Economic Co-operation and Development (OECD). See OECD Committee of Fiscal Affairs Forum on Tax Administration, Centre for Tax Policy and Administration, GAP002, *Taxpayers’ Rights and Obligations 3* (2003), available at <http://www.oecd.org/ctp/taxadministration/14990856.pdf> (analyzing survey results published in 1990); Adrian J. Sawyer, *A Comparison of New Zealand Taxpayers’ Rights with Selected Civil Law and Common Law Countries – Have New Zealand Taxpayers Been ‘Short-Changed’?* 32 *VAND. J. TRANSNAT’L L.* 1345 (1999).

Options for Expanding the Remedies to Address Taxpayer Rights Violations

- Right to fair and just tax system.

Taxpayer responsibilities:

- Obligation to be honest;
- Obligation to cooperate;
- Obligation to provide accurate information and documents on time;
- Obligation to keep records; and
- Obligation to pay taxes on time.

Restating taxpayer rights and responsibilities would also remind taxpayers that rights imply responsibilities. When the government establishes, communicates, and respects taxpayer rights, it also shows taxpayers that the government respects its citizens. Research suggests that some taxpayers are likely to respond by making an extra effort to pay their taxes voluntarily and timely.¹⁴

Providing adequate and accessible remedies could help taxpayers remember their rights and improve compliance.

It may be easy for taxpayers and the IRS to forget about taxpayer rights when Congress has not provided an adequate, easily available remedy for the violation of those rights. Some remedies may be inadequate because they penalize the IRS without directly addressing harm to the taxpayer. For example, an IRS employee may be terminated for certain violations of taxpayer rights.¹⁵ Other remedies may be adequate, but are not widely accessible because they are burdensome to pursue. For example, a taxpayer may recover actual civil damages in limited circumstances when the IRS violates certain privacy protections, fails to release a lien, or recklessly, intentionally, or negligently disregards the law or regulations in connection with the collection of federal tax.¹⁶ However, it can take years for a taxpayer to exhaust his or her administrative remedies and obtain actual damages in court.

There is no judicial remedy for the violation of administratively-created rights. For example, taxpayers generally have no recourse when the IRS fails to follow the Internal Revenue Manual (IRM) or other administrative guidance.¹⁷

¹⁴ See, e.g., *Voluntary Compliance Study*; Lavoie 2009.

¹⁵ RRA 98 § 1203(b) (the so-called “ten deadly sins”).

¹⁶ See, e.g., IRC §§ 7431 (damages for unauthorized disclosure of return information); 7432 (damages for failure to release lien); 7433 (damages for unauthorized collection actions by the IRS); 7433A (damages for unauthorized collection actions by contractors); 7435 (damages for unauthorized enticement of information disclosure); 7426 (actions brought by a person other than the taxpayer for unlawful levy actions). In limited circumstances, a taxpayer may be reimbursed for costs incurred by taxpayers protesting alleged IRS abuses or defending against IRS litigating positions that are not “substantially justified.” See IRC § 7430. Taxpayers who seek assistance from TAS may be eligible for the equitable remedy of a Taxpayer Assistance Order (TAO) under the authority granted to the National Taxpayer Advocate by IRC § 7811.

¹⁷ See, e.g., *Avers v. Comm’r*, T.C. Memo. 1988-176 *63 (“the I.R.M. requirements are merely directory rather than mandatory, and noncompliance does not render respondent’s actions invalid.”); *but see* IRC § 7811(a)(3) (“In cases where any Internal Revenue Service employee is not following applicable published administrative guidance (including the Internal Revenue Manual), the National Taxpayer Advocate shall construe the factors taken into account in determining whether to issue a Taxpayer Assistance Order in the manner most favorable to the taxpayer.”).

Options for Expanding the Remedies to Address Taxpayer Rights Violations

Similarly, taxpayers do not always have a remedy when the IRS violates taxpayer rights enacted by Congress. For example, they may not have an adequate remedy when the IRS sends a notice that proposes or determines a tax deficiency, but does not adequately describe the amount and basis for any tax, interest, and penalties due, as required by law.¹⁸ Nor do taxpayers have a remedy when the IRS sends manually-generated correspondence that does not include the name and telephone number of an employee that the taxpayer can contact, which is also required by law.¹⁹

In other cases, even judicial remedies may seem inadequate. For example, the IRS is required to notify taxpayers before contacting third parties who may have information necessary to determine the taxpayer's liability.²⁰ This approach provides the taxpayer the opportunity to submit the information first, and avoid the third-party contact and resulting damage to his or her reputation.²¹ If the IRS fails to do so, the taxpayer may seek to quash a third-party summons.²² However, failing to provide pre-contact notice may damage the taxpayer's reputation or business — damage that cannot be undone by quashing a summons.

Another example of an overly narrow remedy involves the taxpayer's right to appeal an IRS-determined deficiency to the U.S. Tax Court. A taxpayer generally has the right to petition the court within 90 days after the IRS mails a notice of deficiency (or "statutory notice").²³ When the IRS does not send a statutory notice timely, the period during which the taxpayer may file a petition is automatically extended (*i.e.*, the period remains 90 days from when the IRS mails the notice). This remedy may be overly narrow if the taxpayer is reasonably relying on a representative to respond and the IRS sends the notice to the taxpayer, but does not send it to the representative, as required.²⁴

¹⁸ IRC § 7522(a) ("An inadequate description ... shall not invalidate such notice"); *Shea v. Comm'r*, 112 T.C. 183 (1999) *nonacq.*, A.O.D. 2000-08 (shifting the burden of proof to the IRS when the notice fails to adequately describe the basis for the tax deficiency pursuant to IRC § 7522). Merely shifting the burden of proof will not always redress the harm resulting from the failure to explain the basis for the liability shown as due on certain notices, as most taxpayers do not seek review in the Tax Court, and those that do may not always seek to recover litigation costs.

¹⁹ RRA 98, Pub. L. No. 105-206, § 3705, 112 Stat. 685 (1998).

²⁰ IRC § 7602(c).

²¹ S. Rep. No. 105-174, at 77 (1998) ("taxpayers should have the opportunity to resolve issues and volunteer information before the IRS contacts third parties."). Commentators have argued that the IRS circumvented the purpose of this right by interpreting it to require merely sending "Publication 1," which contains a generic notice that the IRS may contact third parties in connection with an examination, at the beginning of the examination process, rather than informing the taxpayer that a specific contact is contemplated closer in time to when the contact will be made. See Kevan P. McLaughlin, State Bar of California Tax Section, *Balancing Privacy and Efficiency Under Section 7602: What Is "Reasonable Notice" and Changing IRS Procedures Related to Third Party Contacts* (2012).

²² See *e.g.*, *Gangi v. U.S.*, 107 A.F.T.R.2d 2011-1542 (D.N.J. 2011).

²³ IRC § 6213.

²⁴ See, *e.g.*, Form 2848, *Power of Attorney and Declaration of Representative* (2012) (providing a checkbox to indicate if the power of attorney is to receive copies of all correspondence); IRM 4.8.9.11.2 (June 14, 2011) (instructing IRS employees to send the statutory notice to those indicated on Form 2848). A broader remedy applies in New York where the period for filing an appeal is tolled if the taxpayer's representative is not served with the notice of deficiency. See, *e.g.*, *In re Hyatt Equities, LLC*, 2008 N.Y. Tax LEXIS 94, *13 (N.Y. Tax 2008) ("While the Tax Law does not specifically provide for the service of a statutory notice on a taxpayer's representative, we have held that the 90-day period for filing a petition or request for conciliation conference is tolled if the taxpayer's representative is not served with the statutory notice"); *In re Gurwin*, 2009 N.Y. Tax LEXIS 53, *14 (Apr. 30, 2009) ("Although not mandated by statute, case law has established that the 90-day period for filing a petition is tolled if the taxpayer's representative is not served with the statutory notice").

Options for Expanding the Remedies to Address Taxpayer Rights Violations

As these examples illustrate, existing remedies for violations of taxpayer rights are sometimes unavailable, inaccessible, or inadequate. Observing this deficiency, some have proposed a more general remedy for damages.²⁵ Moreover, there are no remedies for violations that cause frustration, confusion, anxiety, or wasted time, rather than actual damages. Thus, Congress should consider expanding these remedies to demonstrate that meaningful taxpayer rights actually exist.

DISCUSSION

Chile has potentially broad judicial remedies for the violation of taxpayer rights.

In 2010, Chile codified various taxpayer rights, which were similar to those recommended by the National Taxpayer Advocate in her 2011 annual report to congress, and provided a remedy to taxpayers whose rights are violated.²⁶ The legislation gave taxpayers the right to:

1. Be treated courteously, respectfully and considerately; to be informed and assisted by the Service about the exercise of their rights and compliance with their obligations;
2. Obtain complete and timely refunds prescribed by the tax laws, adjusted for inflation;
3. Receive information, at the initiation of every act of auditing, about the nature and scope to be reviewed, and to know at any moment their tax situation and the stage of the procedure;
4. Be informed about the identity and contact information of the functionaries of the Service under whose responsibility the matter at issue is proceeding;
5. Obtain copies, at their cost, or certification of the action taken or of the documents presented in the proceedings, under the terms prescribed by the law;
6. Be exempted from bringing documents that are not responsive to the proceeding or that already have been brought with them to the Service and to obtain, once the case is finalized, the return of the documents originally brought;
7. Have tax returns, save those in cases of legal exceptions, retain a confidential character, in the terms prescribed by the tax code;
8. Have the actions carried out without delay, unnecessary requirements or waiting, upon receipt of all the solicited records by the functionary in charge;
9. Formulate allegations and to present records within the parameters prescribed by the law and to have those records incorporated into the proceeding at issue and duly considered by the competent functionary; and

²⁵ See, e.g., Leandra Lederman, *Of Taxpayer Rights, Wrongs, and a Proposed Remedy* 87 Tax Notes 1133, 1142 (May 22, 2000) (concluding that “[a]lthough many provisions enacted by the three taxpayer bills of rights... may be beneficial to taxpayers involved in disputes with the IRS, these bills have not afforded remedies to the taxpayers they sought to protect” and proposing a general private right of action for damages for violations of the law, regulations, or internal procedures); Steve Johnson, *A Residual Damages Right Against the IRS: A Cure Worse Than the Disease*, 2000 TNT 137-88 (July 17, 2000) (critiquing the proposal); Leandra Lederman, *Taxpayer Rights In the Lurch: A Response To Professor Johnson*, 88 Tax Notes 1041 (Aug. 21, 2000) (responding to Professor Johnson).

²⁶ Cód. Trib., Tit. Preliminar, Pár. 4º, Art. 8º bis, as amended by Ley No. 20.420 (2010).

Options for Expanding the Remedies to Address Taxpayer Rights Violations

10. Raise, in a respectful and convenient form, suggestions and complaints about the actions of the Administration in which they have an interest or which affect them.

The remedy for a violation of these rights is relatively swift and widely accessible. Within 15 days of the violation, a taxpayer can bring the complaint in writing before the recently created Tax and Customs Court without an attorney.²⁷ The tax agency has ten days to respond.²⁸ Assuming there is an actual case or controversy, the Tax and Customs Court will open a probative term of ten days during which the parties must submit their proof in writing. The court then has ten days to render a judgment. According to the new law:

The decision will contain all the measures that the Court deems necessary to restore the rule of law and ensure the proper protection of the applicant, without prejudice to any other rights that may be asserted against the authorities or the courts.²⁹

The new law does not specify the scope of these “measures.”³⁰ However, the law has the potential to provide a quick and broad new remedy for any violation of taxpayer rights that could be considered for adoption by the U.S.

Australia and the U.K. have adopted “apology” payments (or equivalent) as a remedy for the violation of taxpayer rights.

As discussed in the National Taxpayer 2007 Annual Report to Congress, Australia and the United Kingdom have adopted “apology” payments (or an equivalent) as a remedy for the violation of taxpayer rights.³¹ The National Taxpayer Advocate included a recommendation in that report for Congress to adopt a similar system in the U.S. The proposal would grant non-delegable, discretionary authority to the National Taxpayer Advocate to make a payment of up to \$1,000 to a taxpayer where the action or inaction of the IRS caused excessive expense or undue burden, and the taxpayer experienced a “significant hardship” within the meaning of IRC § 7811.³²

The rationale for an apology payment is not to fully repay the taxpayer for his or her time and frustration, but to serve as a symbolic gesture to show that the government recognizes

²⁷ Cód. Trib., Libro Terº, Tit. III, Par. 2º, Art. 155 and 157.

²⁸ *Id.* Art. 156.

²⁹ *Id.*

³⁰ At least one decision under the new law is posted at www.tta.cl (last visited Oct. 31, 2012). See *Re Alvarez Escudero*, Tax & Customs Tribunal of Tarapaca (Oct. 25, 2011) (rejecting a taxpayer’s claim that the Chile Tax Service violated his rights in failing to pay a refund allegedly withheld by a third party, concluding that the claim was untimely and without merit).

³¹ National Taxpayer Advocate 2007 Annual Report to Congress 478-489 (Legislative Recommendation: *Taxpayer Bill of Rights and De Minimis “Apology” Payment*); Australian Tax Office, *Applying for Compensation*, available at <http://www.ato.gov.au/corporate/content.aspx?doc=/content/48904.htm> (generally called compensation for detriment caused by defective administration (“CDDA Scheme”) or “act of grace” payments); HMRC, *Complaints and Putting Things Right*, available at <http://www.hmrc.gov.uk/factsheets/complaints-factsheet.pdf> (called payments of “redress”). The UK’s “Adjudicator” recommended payments of redress by the HMRC of £299,872 during 2010-2011. Adjudicator’s Office Annual Report 12 (2011), available at <http://www.adjudicatorsoffice.gov.uk/publications.htm>.

³² National Taxpayer Advocate 2007 Annual Report to Congress 478-489 (Legislative Recommendation: *Taxpayer Bill of Rights and De Minimis “Apology” Payment*). The aggregate payments under this authority would be limited to \$1 million per year unless otherwise authorized by Congress. *Id.*

Options for Expanding the Remedies to Address Taxpayer Rights Violations

its mistake and the taxpayer's burden. These payments might enhance taxpayers' perception of the IRS and the tax system as just and fair. The National Taxpayer Advocate could also include a general description of apology payments authorized during the preceding year in her annual reports to Congress, which would keep Congress and the IRS apprised of the nature of significant IRS errors and highlight areas that might warrant attention by policymakers.

CONCLUSION

While remedies exist for the violation of some taxpayer rights, they may be too costly or time consuming to pursue. In any event, most taxpayers do not believe they have any rights before the IRS or do not know what they are, perhaps because existing remedies are inadequate or inaccessible. If Congress believes additional remedies are needed to make taxpayer rights more meaningful, one option, adopted by Chile, is to expand the authority of the Judiciary to quickly and efficiently remedy violations of taxpayer rights. Another option, adopted by Australia and the United Kingdom, is to empower the National Taxpayer Advocate to make *de minimis* "apology" payments to those whose rights are violated. These measures could improve voluntary compliance by showing taxpayers that the IRS and the tax system are fair.

RESEARCH PROSPECTUS:
COMPARING THE EFFECT OF
REVENUE OFFICERS AND THE
AUTOMATED COLLECTION
SYSTEM ON FUTURE COMPLIANCE

Research Prospectus: Comparing the Effect of Revenue Officers and the Automated Collection System on Future Compliance¹

EXECUTIVE SUMMARY	143
INTRODUCTION	144
When a taxpayer does not pay, the IRS may assign the case to a revenue officer (RO), Automated Collection System (ACS) employees, or the queue.....	144
It is difficult to compare ACS and RO productivity or long-term effectiveness.	145
ACS and ROs collect more by improving voluntary compliance than by collecting existing delinquencies.	145
DISCUSSION	146
IRS-wide measures assume that ACS is more effective than ROs.	146
The IRS does not measure the impact of ACS and ROs on future compliance.....	147
ROs can sometimes prevent future delinquencies better than ACS.	147
TAS Research will analyze the impact of ROs and ACS on future compliance.....	148
CONCLUSION	148

¹ The principal author of this discussion is Eric LoPresti, Senior Attorney-Advisor to the National Taxpayer Advocate.

EXECUTIVE SUMMARY

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

Direct comparisons between ACS employees and ROs present challenges. The IRS-wide measures — Collection Coverage and Collection Efficiency — assume that ACS is more effective than ROs because ACS generally works “fresh” cases, and closes them using fewer resources and lower-graded employees. These measures create an incentive for IRS executives to divert resources from the Cff to ACS, even though ROs could bring in more dollars by protecting revenue (*e.g.*, preventing future delinquencies) and increasing voluntary compliance.

The importance of voluntary compliance cannot be overstated. Taxpayers voluntarily and timely pay about 34 times as much as the IRS collects through enforcement and voluntary late payments.² Moreover, about 78 percent of all late payments come in voluntarily as the result of a notice or an installment agreement, meaning only about 22 percent of all late payments — less than one percent of all dollars collected — come in through less voluntary means of enforcement.³ For example, ROs work priority Federal Tax Deposit (FTD) Alerts — cases where employment tax deposits have inexplicably dropped. One recent IRS study found that ROs working these cases improved the likelihood that the taxpayer would become compliant by 12 percentage points (from 28 percent to 40 percent); increased future tax deposits by an average of \$1,832 per case over a 12-month period; and reduced the average penalties assessed against the taxpayer, as compared to priority Alerts that were not worked.⁴ It also concluded that every dollar spent on ROs working FTD Alerts brought in \$69 by preventing future FTD non-compliance.

ACS employees do not undertake similar proactive activities. Thus, the IRS needs to know the relative impact of ACS and ROs on voluntary compliance for different types of cases. Such information could help to improve both IRS “decision analytics” and “business rules” used to assign cases, as well as collection performance measures. Without it, the IRS’s collection function is operating based on unproven assumptions, assigning cases and allocating resources inefficiently, and potentially undermining long-term voluntary compliance.

² IRS, IR-2012-4, IRS Releases New Tax Gap Estimates, *Compliance Rates Remain Statistically Unchanged from Previous Study* (Jan. 6, 2012) (accompanying charts) (discussed below).

³ See Delinquent Accounts Receivable Yield, *Fiscal Year Comparison Cum. thru FY 2012* (Oct. 4, 2012) (discussed below). We say “less voluntary means of enforcement” because the IRS generally counts installment payments as “enforcement” revenue.

⁴ Small Business/Self Employed Division (SB/SE) Research, Federal Tax Deposit Alerts-P3 (*Do Alerts Impact Compliance?*) (Feb. 10, 2012); SB/SE Research, *Federal Tax Deposit Alerts-P2* (Cost and Benefit Evaluation) (Jan. 6, 2012).

Specifically, TAS Research plans to identify similar cases that were assigned to an RO, the ACS, or the queue, and then compare the collection results. Not only will this analysis compare direct collections, but also the revenue protected, penalties assessed, and future payment compliance by each group of taxpayers.

INTRODUCTION

When a taxpayer does not pay, the IRS may assign the case to a revenue officer (RO), Automated Collection System (ACS) employees, or the queue.

When a taxpayer fails to pay a liability, IRS computers send collection notices and offset refunds. If notices and offsets do not collect the balance due, most cases move to the Automated Collection System (ACS).⁵ While the IRS is beginning to implement Collection Decision Analytics (CDA) — a routing system that sends some cases directly to revenue officers (ROs) — it routes most cases to ACS first.⁶

ACS employees may review accounts, answer calls; respond to letters, receive payments, establish installment agreements, receive offer in compromise applications, file the Notice of Federal Tax Lien (NFTL); or levy assets.⁷ They do not make field calls to meet with taxpayers. They may call taxpayers, but they spend only about three percent or less of their direct time making outgoing calls.⁸ One recent IRS study found that to close a case, ACS most often sends a delinquency letter and then answers the taxpayer's call.⁹

If ACS does not resolve a tax delinquency, the IRS generally moves the account to the queue, where it ages unless or until assigned to an RO in the Collection Field function (Cff).¹⁰ ROs are higher-graded collection employees who can handle more complicated collection issues, physically observe local business conditions, and also meet with and educate taxpayers in the field.¹¹

⁵ Internal Revenue Manual (IRM) 5.19.5.2 (Dec. 1, 2007).

⁶ See, e.g., SB/SE Business Performance Review (Nov. 2011) (discussing the development of CDA); IRM Exhibits 5.19.5-9 and -10 (Dec. 1, 2007) (reflecting the few types of cases routed directly to revenue officers).

⁷ See generally IRM 5.19.1 (Nov. 3, 2010); IRM 5.19.5 (July 12, 2012); IRM 5.19.4 (Jan. 3, 2012); and IRM 5.19.9 (Oct. 1, 2010).

⁸ IRS response to TAS information request (Oct. 24, 2010) (indicating that for fiscal years 2010-2012, ACS employees spent 1 to 3 percent of their direct time making outgoing calls, 21 to 31 percent of their direct time working inventory, and 68 to 77 percent of their direct time answering incoming calls). For further discussion of challenges facing ACS, see Most Serious Problem: *The Automated Collection System Must Emphasize Taxpayer Service Initiatives to More Effectively Resolve Collection Workload*, supra. See also National Taxpayer Advocate 2010 Annual Report to Congress vol. 2, 39-70 (*An Analysis of the IRS Collection Strategy: Suggestions to Increase Revenue, Improve Taxpayer Service, and Further the IRS Mission*).

⁹ SB/SE Research, *Analyzing the Automated Collection System Closed Case Actions* (Aug. 24, 2012) (finding ACS closed nearly 70 percent of its cases: 42 percent were closed after answering the taxpayer's call, 15 percent were closed after releasing a levy on the taxpayer's assets, and 12 percent were closed after sending a delinquency notice).

¹⁰ See generally IRM 5.19.5 (July 12, 2012).

¹¹ For a more detailed discussion of the importance of ROs and challenges facing ACS, including the dollars uncollected and cases unresolved by ACS and referred to the queue or otherwise shelved, see Most Serious Problem: *The Diminishing Role of the Revenue Officer in IRS Collection Operations*, supra, and Most Serious Problem: *The Automated Collection System Must Emphasize Taxpayer Service Initiatives in Order to More Effectively Resolve Collection Workload*, supra.

It is difficult to compare ACS and RO productivity or long-term effectiveness.

It is difficult for the IRS to compare the productivity of ACS employees and ROs because the IRS generally assigns different types of cases to each operation, with ACS often receiving cases that are easier to collect because they have not aged.¹² Moreover, when comparing ACS to ROs, the unmeasured effect of each on long-term voluntary compliance is probably even more important than how much the IRS collects in the short run.

ACS and ROs collect more by improving voluntary compliance than by collecting existing delinquencies.

The IRS's Collection function plays an important role in addressing the "tax gap" (*i.e.*, tax not voluntarily and timely paid).¹³ In fiscal year (FY) 2012, it was responsible for over 60 percent of the IRS's direct enforcement revenue, and indirectly encouraged many more taxpayers to comply with the tax rules voluntarily.¹⁴

In fact, voluntary compliance brings in vastly more dollars than enforced collection. Taxpayers paid about 83.1 percent of their taxes voluntarily and timely (\$2.21 trillion of the \$2.66 trillion due) in tax year 2006, and the IRS projects it will eventually collect another two percent through late payments or enforcement (\$65 billion out of \$2.66 trillion).¹⁵ In other words, taxpayers voluntarily and timely pay about 34 times as much as the IRS collects through enforcement and voluntary late payments. Moreover, about 58 percent of those late payments come in voluntarily as the result of a notice and another 20 percent come in voluntarily as the result of installment agreements, meaning only about 22 percent of all late payments — less than one percent of all dollars collected — come in through less voluntary means of enforcement.¹⁶ As a result, the importance of an IRS collection strategy that promotes long-term *voluntary* compliance cannot be overstated. In addition, if the IRS prioritizes short-term collection dollars over long-term compliance, it may increase long-term enforcement costs if taxpayers do not learn to comply voluntarily, and it has to

¹² The collection industry estimates that the probability of collecting unpaid accounts falls to 70 percent after three months, 52 percent after six months, and 23 percent after a year. BANXQUOTE Rx, Business Debt Restructuring Solutions, www.banx.com/rx/ (last visited Sept. 12, 2012) (citing collectability statistics based on a survey conducted by the Commercial Collection Agency Association among its members, who collectively handle about 80 percent of all commercial debt claims placed for collection in the United States).

¹³ The gross tax gap — the difference between the taxes people owe and the amount they timely pay — is estimated at \$450 billion in 2006. See IRS, IR-2012-4, *IRS Releases New Tax Gap Estimates; Compliance Rates Remain Statistically Unchanged From Previous Study* (Jan. 6, 2012), <http://www.irs.gov/uac/IRS-Releases-New-Tax-Gap-Estimates;-Compliance-Rates-Remain-Statistically-Unchanged-From-Previous-Study>. The IRS estimates it will eventually collect \$65 billion through enforcement and late payments, leaving a net tax gap of \$385 billion. *Id.* These figures do not include unpaid tax on income from illegal activities.

¹⁴ IRS, Enforcement Revenue Information System, IRS Compliance Data Warehouse, *Total Enforcement Revenue Collected (TERC) by Revenue Collection Year and Major Category for FY 2012* (Dec. 10, 2012) (indicating collection accounted for \$30.4 billion of the \$50.2 billion total direct enforcement revenue for FY 2012).

¹⁵ IRS, IR-2012-4, *IRS Releases New Tax Gap Estimates; Compliance Rates Remain Statistically Unchanged from Previous Study* (Jan. 6, 2012) (accompanying charts).

¹⁶ Taxpayers voluntarily paid \$39.2 billion of the \$50.2 billion (78.1 percent) the IRS reported as "enforcement revenue" in FY 2012 after receiving a notice. Enforcement Revenue Information System, IRS Compliance Data Warehouse (Dec. 10, 2012). This amount includes \$10.2 billion (or 20.3 percent) voluntarily paid via installment agreements that year. Delinquent Accounts Receivable Yield, *Fiscal Year Comparison Cum. thru FY 2012* (Oct. 4, 2012).

use costly enforcement tools over and over again to collect dollars that taxpayers might otherwise pay voluntarily.

DISCUSSION

IRS-wide measures assume that ACS is more effective than ROs.

According to the government,

The IRS' core long-term goal, applicable to virtually all its enforcement programs, is the voluntary compliance rate (VCR) defined as the proportion of tax for a given year that is paid voluntarily and timely. Due to the time, expense and taxpayer burden involved in collecting data to measure voluntary compliance, IRS measures the effects of collection program activities on the VCR (which includes filing and payment compliance) through the long-term proxy measures of Collection Coverage and Collection Efficiency. . . . the effects of the Collection program on taxpayer behavior is also evidenced through deterrence, though the effect as such is not measured by the IRS.¹⁷

The government has not explained why Collection Coverage and Collection Efficiency are appropriate proxies for the effect of IRS collection program activities on the voluntary compliance rate. Moreover, these measures create incentives (described below) that could ultimately lead IRS executives to make business decisions that *erode* the voluntary compliance rate.¹⁸

Six years ago, the IRS's Future Field Collection Design study expressed similar concerns about the IRS's lack of good collection measures. It noted, "the CFf has not adopted a measure for compliance at any organizational level."¹⁹ It went on to recommend that "the CFf develop and implement an explicit compliance goal and measure," noting that adopting such a measure could "drive organizational behavior and performance that is consistent with CFf objectives to assure that Revenue Officer field presence and actions secure short- and long-term compliance."²⁰

Because ACS employees generally receive cases earlier than ROs, enabling them to close many of them with little effort, the IRS-wide measures (Collection Coverage and Collection Efficiency) essentially assume ACS is more effective in improving voluntary compliance.²¹ Thus, IRS measures establish an incentive for IRS executives to expand the IRS's use of

¹⁷ Office of Mgmt. & Budget, *Detailed Information on the Internal Revenue Service Tax Collection Assessment* § 2.1 (2008), <http://www.whitehouse.gov/sites/default/files/omb/assets/omb/expectmore/detail/10000424.2008.html> (last visited Nov. 29, 2012); see also IRS, *Management Discussion and Analysis For the Fiscal Year Ended* (Sept. 30, 2011).

¹⁸ For a discussion of problematic incentives that various IRS measures create, see National Taxpayer Advocate 2010 Annual Report to Congress 28 (Most Serious Problem: *IRS Performance Measures Provide Incentives that May Undermine the IRS Mission*).

¹⁹ IRS, FFCD Project Team, *Future Field Collection Design, Current State Design* 13 (Nov. 10, 2005).

²⁰ IRS, FFCD Project Team, *Future Field Collection Design, Future State Design - Final Report 2* (June 6, 2006).

²¹ Collection Coverage is the "volume of collection work disposed compared to the volume of collection work available." Collection Efficiency is the "volume of collection work disposed divided by total collection FTE." *MD&A* at 22.

ACS and reduce its use of ROs, even if ROs would be more efficient in collecting revenue and promoting voluntary compliance among the relatively “fresh” cases in ACS’s inventory or assigned to the queue.²² Moreover, in some cases, early intervention by an RO could be more effective than ACS in “protecting revenue” by preventing small delinquencies from turning into large ones and in promoting future compliance.²³

The IRS does not measure the impact of ACS and ROs on future compliance.

The IRS does not know whether early intervention by ACS or ROs has the greatest positive impact on voluntary compliance.²⁴ However, it is difficult for the IRS to formulate a reasonable collection strategy without this information.²⁵ While it is difficult to measure the full impact of an action on voluntary compliance (including, for example, reporting compliance by the delinquent taxpayer and other taxpayers), the IRS could measure and compare the effect of early intervention by an RO and ACS on the delinquent taxpayer’s future payment compliance.

ROs can sometimes prevent future delinquencies better than ACS.

The IRS has long known that ROs can prevent tax delinquencies from becoming more difficult to resolve by addressing them quickly — even before a return is due. For this reason, it sends its ROs on field calls to check on employers when their quarterly deposits inexplicably decline.²⁶ According to the Internal Revenue Manual, this Federal Tax Deposit Alert procedure provides an “early opportunity to assist and educate taxpayers before their liability pyramids and the growing debt becomes more difficult to resolve.”²⁷ One IRS study recently confirmed that when ROs worked priority FTD Alerts, they improved the likelihood that the taxpayer would become compliant by 12 percentage points (from 28 percent to 40 percent); increased future tax deposits by an average of \$1,832 per case over a 12-month period; and reduced the average penalties assessed against the taxpayer, as compared to priority Alerts that were not worked.²⁸ It also concluded that every dollar spent on ROs working FTD Alerts brought in \$69 by preventing future FTD non-compliance. However, this study did not directly compare ACS to ROs or the queue.

²² For further discussion of this problem, see *Most Serious Problem: The Diminishing Role of the Revenue Officer in IRS Collection Operations*, *supra*, and *Most Serious Problem: The Automated Collection System Must Emphasize Taxpayer Service Initiatives to More Effectively Resolve Collection Workload*, *supra*. See also National Taxpayer Advocate 2010 Annual Report to Congress vol. 2, 39-70 (*An Analysis of the IRS Collection Strategy: Suggestions to Increase Revenue, Improve Taxpayer Service, and Further the IRS Mission*).

²³ In addition, it may be helpful to consider whether ACS generates more rework than ROs (e.g., rework required to release an unnecessary lien or levy) and unnecessary damage to the taxpayer’s credit, which could prevent him or her from earning the revenue needed to repay the IRS.

²⁴ See, e.g., Alan H. Plumley, *The Impact of the IRS on Voluntary Tax Compliance: Preliminary Empirical Results*, Nat’l Tax Assoc., 95th Ann. Conf. on Tax’n 2 (Nov. 2002), <http://www.irs.gov/pub/irs-soi/irsvtc.pdf>.

²⁵ The Government Accountability Office has also recognized the challenges the IRS faces in achieving its goals without relevant data. See, e.g., Government Accountability Office, GAO-05-753, *Better Compliance Data and Long-term Goals Would Support a More Strategic IRS Approach to Reducing the Tax Gap* 22 (July 2005), <http://www.gao.gov/new.items/d05753.pdf>.

²⁶ IRM 5.7.1.1 (May 15, 2012).

²⁷ IRM 5.7.1.7 (May 15, 2012).

²⁸ SB/SE Research, *Federal Tax Deposit Alerts-P3 (Do Alerts Impact Compliance?)* (Feb. 10, 2012); SB/SE Research, *Federal Tax Deposit Alerts-P2 (Cost and Benefit Evaluation)* (Jan. 6, 2012).

TAS Research will analyze the impact of ROs and ACS on future compliance.

Because the primary determinant of IRS enforcement effectiveness is the maintenance or increase in voluntary compliance behavior, TAS plans to study this issue with respect to the IRS collection function. The objective of TAS's study is to compare the effect on compliance of assigning a "fresh" delinquency to an RO, ACS, or the queue. In undertaking this study, TAS plans to:

- Identify all taxpayers who had one or two unpaid employment tax delinquencies (called "taxpayer delinquency accounts" or TDAs) in a given year (or other appropriate period);²⁹
- Identify all such delinquencies that were assigned to an RO;
- Identify all such delinquencies of a similar kind and amount that were assigned to ACS or the queue; and
- Compare direct collections, revenue protected, penalties assessed, and future payment compliance by each group of taxpayers.

CONCLUSION

TAS plans to undertake research to compare the results of assigning a case to ACS or an RO when an employer first begins to fall behind on quarterly tax deposits. The IRS needs to be able to know the likely result of assigning similar cases (of the same age) to be worked by ACS and ROs, including both the short-collections and long-term voluntary compliance. Without such information, the IRS's collection function is operating based on unproven assumptions, assigning cases and allocating resources inefficiently, collecting delinquencies ineffectively, and potentially undermining long-term voluntary compliance. Such information could help the IRS to identify cases that it should assign to ROs immediately. It may also lead the IRS to improve its collection metrics. Better metrics could lead the IRS to allocate its resources between the Cff and ACS more effectively. Because metrics drive behavior, metrics that provide incentives to IRS executives to allocate resources to better promote long-term voluntary compliance will benefit both taxpayers and the government, as nobody benefits from noncompliance in the long run.

²⁹ These taxpayers may have other types of aged tax delinquencies, however.

**RESEARCH PROSPECTUS:
WHEN DO ACCURACY-RELATED
PENALTIES IMPROVE FUTURE
REPORTING COMPLIANCE BY
SCHEDULE C FILERS?**

Research Prospectus: When Do Accuracy-Related Penalties Improve Future Reporting Compliance by Schedule C Filers?

EXECUTIVE SUMMARY	151
INTRODUCTION	151
DISCUSSION	152
Underreported small business income represents the largest portion of the tax gap.....	152
Accuracy-related penalties provide an incentive to report income accurately.	153
Accuracy-related penalties may promote compliance by deterring noncompliance, setting expectations, influencing norms, and increasing the perceived fairness of the tax system.....	154
Reasonable cause penalty exceptions may also increase compliance, if properly applied.....	154
Accuracy-related penalties may not promote compliance when proposed automatically.	155
Accuracy-related penalties could have a different effect on voluntary compliance when applied incorrectly or appealed.....	156
TAS will analyze the impact of accuracy-related penalties on subsequent reporting compliance.	156
CONCLUSION	157

EXECUTIVE SUMMARY

The National Taxpayer Advocate and other stakeholders have long urged the IRS to research the effect of penalties on voluntary compliance. Given the large number of penalties, the likelihood that each one may affect different taxpayer groups in different ways, and IRS data limitations, TAS will focus on the taxpayers and penalties that could have the greatest impact on the tax gap: accuracy-related penalties applied to Schedule C filers.

One objective of this study is to determine if an accuracy-related penalty assessment improves reporting compliance by the taxpayer in the future.¹ In light of the IRS's increasing use of automated processes to assess penalties before communicating with the taxpayer, this study will also try to measure the effect of "default" penalty assessments, those appealed by the taxpayer (*i.e.*, through an audit reconsideration or the IRS Appeals function), and those that the IRS ultimately abates.

INTRODUCTION

Stakeholders have long urged the IRS to research the effect of penalties on voluntary compliance and the tax gap. According to Congress and the IRS, civil tax penalties should be used to enhance voluntary compliance with the Internal Revenue Code (IRC).² An IRS task force expressly rejected other purposes such as raising revenue, punishing noncompliant behavior, and reimbursing the government for the cost of compliance programs, because policies designed to fulfill other purposes may conflict with the primary goal of enhancing voluntary compliance.³

As early as 1989, Congress recommended that the IRS "develop better information concerning the administration and effects of penalties."⁴ In addition, the IRS's official policy is to collect information "to determine the effectiveness of penalties in promoting voluntary compliance... [and recommend] changes when the Internal Revenue Code or penalty administration does not effectively promote voluntary compliance"⁵

¹ Penalties may affect the future compliance of both the taxpayer in question and other taxpayers who learn about them. However, it is difficult to measure the effect of a penalty on other taxpayers, in part, because it is difficult to identify which other taxpayers are affected by the penalty.

² Both Congress and the IRS reached the same conclusion in the late 1980s after extensive study, research, and comment from the public. See, e.g., Executive Task Force for Internal Revenue Commissioner's Penalty Study, *A Philosophy of Civil Tax Penalties* (Discussion Draft), reprinted in 111 DTR L-1 1988, 9-10 (June 9, 1988) [hereinafter *IRS Task Force Report I*]; H.R. Rep. No. 101-386 at 661 (1989) (Conf. Rep.) (stating that, in connection with significant civil tax penalty reform, "the IRS should develop a policy statement emphasizing that civil tax penalties exist for the purpose of encouraging voluntary compliance"). Pursuant to IRS policy, "[P]enalties are used to enhance voluntary compliance." Policy Statement 20-1 (Formerly P-1-18), reprinted at IRM 1.2.20.1.1(1)-(2) (June 29, 2004).

³ See *IRS Task Force Report I* at 9-10.

⁴ H.R. Rep. No. 101-386, at 661 (1989) (Conf. Rep.).

⁵ Policy Statement 20-1 (June 29, 2004).

Similarly, IRS researchers have observed the need to examine the effect of IRS enforcement actions on compliance as follows:

IRS enforcement programs identify and collect some of the tax gap directly from the taxpayers they contact. That *direct effect* is observed and known. What we need to estimate is the extent to which those contacts (and even non-enforcement contacts) indirectly influence the voluntary compliance of the general population—both the subsequent compliance of those contacted, and the compliance of those who were not contacted. The mechanism of this *indirect effect* could be deterrence (*e.g.*, changing the public’s perceptions of the certainty, severity, and celerity of getting caught in noncompliance), but it could also involve education (clearing up misunderstandings) or shaping attitudes (*e.g.*, changing the public’s perceptions of the extent to which the law is applied and enforced fairly). Very few empirical studies have attempted to estimate the magnitude of these indirect effects....⁶

Observing that the IRS lacked any significant analysis or research concerning accuracy-related penalties, the National Taxpayer Advocate and others recommended that the IRS study the effect of penalties on voluntary compliance.⁷ Accordingly, TAS plans to initiate research in this area.

DISCUSSION

Underreported small business income represents the largest portion of the tax gap.

According to the IRS’s most recent estimate, the gross tax gap — the difference between the taxes people owe and the amount they timely pay — stood at \$450 billion in 2006.⁸ The largest portion of the tax gap is due to underreporting of business income by individuals (\$122 billion) (*i.e.*, self-employed individuals).⁹ Another significant amount is attributable to underreported self-employment tax (\$57 billion).¹⁰ Because underreporting by unincorporated businesses represents the largest portion of the tax gap, it is important to understand how so-called “accuracy-related” penalties, which target underreporting, can affect reporting compliance by Schedule C filers.

⁶ Alan H. Plumley, *The Impact of the IRS on Voluntary Tax Compliance: Preliminary Empirical Results*, Nat’l Tax Assoc., 95th Ann. Conf. on Tax’n 2 (Nov. 2002), <http://www.irs.gov/pub/irs-soi/irsvtc.pdf>.

⁷ See, *e.g.*, National Taxpayer Advocate 2008 Annual Report to Congress vol. 2, 2 (*A Framework for Reforming the Penalty Regime*).

⁸ See IRS Research, Analysis & Statistics, *Federal Tax Compliance Research: Tax Year 2006 Tax Gap Estimation 2* (Mar. 2012), <http://www.irs.gov/pub/irs-soi/06rastg12workprr.pdf>. The IRS computes the net tax gap by subtracting the \$65 billion that the IRS estimates it will eventually collect through enforcement and late payments from the \$450 billion gross tax gap—the difference between the taxes people owed and the amount they voluntarily and timely paid. *Id.*

⁹ *Id.*

¹⁰ See *id.* The percentage of income that goes unreported (or the net misreporting percentage) is lowest (at one percent) for income subject to information reporting and withholding, such as wages, and highest (at 56 percent) for income subject to little or no information reporting, such as cash receipts earned by sole proprietors. *Id.* at 3.

Accuracy-related penalties provide an incentive to report income accurately.

A taxpayer may be subject to a 20 percent accuracy-related penalty on the portion of any underpayment attributable to (1) the taxpayer's negligence or disregard of rules or regulations, or (2) a "substantial understatement" of income tax.¹¹ A taxpayer may be subject to the negligence penalty if he or she fails to make a reasonable attempt to comply with the internal revenue laws; does not exercise ordinary and reasonable care in preparing his or her tax return; or fails to keep adequate books and records or substantiate items properly.¹² In assessing a penalty, the IRS may also consider factors such as the taxpayer's compliance history; actions taken by the taxpayer to ensure the tax was correct and timely filed; and the taxpayer's explanation for any inaccuracies.¹³

An individual may be subject to a "substantial understatement" penalty if the understatement exceeds the greater of \$5,000 or ten percent of the tax required to be shown on the return.¹⁴ Generally, an "understatement" is the difference between (1) the correct amount of tax and (2) the amount reported on the return, reduced by any rebate.¹⁵ Understatements are usually reduced by any portion attributable to (1) an item for which the taxpayer had substantial authority; or (2) any item for which the taxpayer adequately disclosed the relevant facts affecting the item's tax treatment, provided the taxpayer had a reasonable basis for such treatment.¹⁶

A taxpayer generally is not subject to an accuracy-related penalty if he or she establishes a "reasonable cause" for the underpayment and acted in good faith.¹⁷ The most important factor in establishing reasonable cause is the extent of the taxpayer's effort to determine the correct tax liability.¹⁸ Thus, the combination of accuracy-related penalties and reasonable cause exceptions may provide an incentive for taxpayers to make reasonable and good faith efforts to report their income accurately.

¹¹ IRC § 6662(b)(1) (negligence or disregard of rules or regulations); IRC § 6662(b)(2) (substantial understatement). Although the IRS may assess more than one accuracy-related penalty, the total penalty rate cannot exceed 20 percent (or 40 percent in certain circumstances) because the penalties are not "stackable." Treas. Reg. § 1.6662-2(c). There are several accuracy-related penalties, but this discussion focuses on the accuracy-related penalties for negligence and substantial understatements because they are the most common.

¹² IRC § 6662(c); Treas. Reg. § 1.6662-3(b).

¹³ IRM 4.10.6.2.1 (May 14, 1999).

¹⁴ IRC §§ 6662(d)(1)(A)(i)-(ii). For corporations (other than S corporations or personal holding companies), an understatement is substantial if it exceeds the lesser of ten percent of the tax required to be shown on the return or \$10,000. IRC §§ 6662(d)(1)(B)(i)-(ii).

¹⁵ IRC § 6662(d)(2)(A).

¹⁶ IRC § 6662(d)(2)(B). No reduction is permitted, however, for any item attributable to a tax shelter. IRC § 6662(d)(2)(C)(i).

¹⁷ IRC § 6664(c)(1).

¹⁸ Treas. Reg. § 1.6664-4(b)(1).

Research Prospectus: When Do Accuracy-Related Penalties Improve Future Reporting Compliance by Schedule C Filers?

Accuracy-related penalties may promote compliance by deterring noncompliance, setting expectations, influencing norms, and increasing the perceived fairness of the tax system.

Penalties obviously “deter” some people from cheating,¹⁹ but others comply voluntarily for a variety of reasons other than deterrence.²⁰ Penalties may help taxpayers understand what compliance requires.²¹ So-called “tax morale” may play a role for those who value integrity, honesty, and the benefits of government; and “social norms” may play a role for those who want to comply only if they believe that other similar taxpayers do so. Those motivated by reciprocity may be influenced by their perception of whether the government or the IRS is respecting the basic elements of procedural justice by acting with impartiality, honesty, fairness, courtesy, and respect for taxpayer rights. The IRS generally acknowledges that such perceptions drive compliance and excessive or undeserved penalties can discourage it.²²

Reasonable cause penalty exceptions may also increase compliance, if properly applied.

As noted above, a penalty generally will not apply to a taxpayer who can show a good faith “reasonable cause” for the failure to comply.²³ To the extent that a reasonable cause exception reduces the perceived likelihood that noncompliance will trigger a penalty, it may reduce the incentive to comply. If properly applied, however, a reasonable cause exception should motivate taxpayers to use good faith efforts to comply with tax laws because it reassures them that their efforts will pay off (*i.e.*, a penalty will not apply so long as the taxpayer makes a reasonable good faith effort to comply, even if he or she fails). Properly applying the exception also promotes the perception that the penalties are fair.²⁴ Thus,

¹⁹ 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, 640-42 (2009) (summarizing research concerning tax compliance); Sarah B. Lawsky, *Probably? Understanding Tax Law's Uncertainty*, 157 U. Pa. L. Rev. 1017 (2009); Eric A. Posner, *Law and Social Norms: The Case of Tax Compliance*, 86 Va. L. Rev. 1781 (2000) (summarizing deterrence theory).

²⁰ See, e.g., National Taxpayer Advocate 2007 Annual Report to Congress vol. 2, 138-50 (Marjorie E. Kornhauser, *Normative and Cognitive Aspects of Tax Compliance: Literature Review and Recommendations for the IRS Regarding Individual Taxpayers*) (summarizing existing literature on “tax morale”); National Taxpayer Advocate 2010 Annual Report to Congress vol. 2, 71-89 (*Researching the Causes of Noncompliance: An Overview of Upcoming Studies*); Swedish Tax Agency, *Right from the Start: Research and Strategies* 6 (2005); Michael Doran, *Tax Penalties and Tax Compliance*, 46 HARV. J. ON LEGIS. 111, 113 (Winter 2009) (summarizing the “norms theory”) and [*Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results, supra/infra.*]

²¹ See *Internal Revenue Service Commissioner Lawrence Gibbs' Prepared Statement on Civil Tax Penalties, Including Executive Summary of Report by IRS Task Force on Civil Penalties, Hearing Before the House Ways and Means Oversight Subcommittee* (Feb. 21, 1989), reprinted in 34 DTR L-18, 1989 (Feb. 22, 1989). See also Michael Doran, *Tax Penalties and Tax Compliance*, 46 Harv. J. on Legis. 111, 113 (Winter 2009). Similarly, the IRS's 1998 Penalty Policy Statement acknowledged “the Service uses penalties to encourage voluntary compliance by ...helping taxpayers understand that compliant conduct is appropriate and that non-compliant conduct is not.” See Policy Statement P-1-18 (Aug. 20, 1998), superseded by Policy Statement 20-1 (June 29, 2004).

²² IRM 20.1.1.2.1(10) (Nov. 25, 2011) (“Penalties best aid voluntary compliance if they support belief in the fairness and effectiveness of the tax system.”); IRM 4.26.16.4(4)-(5) (July 1, 2008) (“examiners should consider whether the issuance of a warning letter and the securing of delinquent FBARS, rather than the assertion of a penalty, will achieve the desired result of improving compliance in the future ...[D]iscretion is necessary because the total amount of penalties that can be applied under the statute can greatly exceed an amount that would be appropriate in view of the violation.”); IRM 20.1.1.1.3(4) (Dec. 11, 2009) (“A wrong [penalty] decision, even though eventually corrected, has a negative impact on voluntary compliance.”).

²³ See, e.g., IRC § 6664(c).

²⁴ According to the IRM, “[v]oluntary compliance is achieved when a taxpayer makes a good faith effort to meet the tax obligations defined by the Internal Revenue Code.” IRM 20.1.1.2.1(6) (Nov. 25, 2011). If so, then penalizing taxpayers who have made a good faith effort does not promote voluntary compliance very effectively because it penalizes some who have done so.

the structure and application of a penalty may affect the extent to which it promotes or discourages voluntary compliance.

Accuracy-related penalties may not promote compliance when proposed automatically.

The IRS sometimes proposes penalties automatically, before performing a careful analysis of the relevant facts and circumstances.²⁵ As shown on the following table, the IRS may use different levels of effort to locate taxpayers and ascertain the reason for the apparent discrepancy, depending on the type of examination.

TABLE 1, Procedures for Proposing Accuracy-Related Penalties by Exam Program

Program	Address research?	Common letter used to propose a penalty	Examiner's contact information is on letter?	Examiner calls to solicit explanation for discrepancy?	Penalty assessed if taxpayer cannot be located?
Field Exam	Yes ²⁷	Letter 950 ²⁸	Yes ²⁹	Yes ³⁰	Not usually ³¹
Office Exam	Yes	Letter 915 ³²	Yes	Yes	Not usually
Correspondence Exam	No	Letter 525 ³³	No	No	Yes ³⁴

Automatic penalty assessments ignore direction from Congress that the IRS should “make a correct substantive decision in the first instance rather than mechanically assert penalties with the idea that they will be corrected later.”³⁴ Other stakeholders have expressed similar concerns.³⁵ Penalties that the IRS proposes automatically (as well as default assessments) do not take the taxpayer’s effort to comply into account — at least not before being

²⁵ See e.g., National Taxpayer Advocate 2007 Annual Report to Congress 275 (Most Serious Problem: *The Accuracy-Related Penalty in the Automated Under-reporter Units*); National Taxpayer Advocate 2010 Annual Report to Congress 198 (Most Serious Problem: *The IRS’s Over-Reliance on its “Reasonable Cause Assistant” Leads to Inaccurate Penalty Abatement Determinations*).

²⁶ IRM 4.10.2.7.2 (Apr. 2, 2010); IRM 4.10.2.7.2.7 (Apr. 2, 2010); Form 1900-B.

²⁷ IRM 4.10.8.11 (Aug. 11, 2006).

²⁸ IRM 4.19.10.1.6 (Feb. 24, 2011).

²⁹ IRM 4.10.6.3.5 (May 14, 1999); IRM 4.10.6.4(3) (May 14, 1999); IRM 4.10.6.8.3 (May 14, 1999).

³⁰ IRM 4.10.2.7.2.7 (Apr. 2, 2010) (penalty not assessed unless non-assessment would undermine compliance).

³¹ IRM 4.10.8.11 (Aug. 11, 2006).

³² IRM 4.19.10.1.6 (Feb. 24, 2011).

³³ IRM 20.1.5.7.1(5) (Jan. 24, 2012).

³⁴ H.R. Conf. Rep. No. 101-386, at 661 (1989).

³⁵ American Institute of Certified Public Accountants (AICPA), *Report on Civil Tax Penalties: The Need for Reform* (Aug. 28, 2009) (“[I]ncreasingly, penalties are assessed using automated processes . . . without the benefit of pre-assessment rights to pursue reasonable cause and other defenses. In many instances, taxpayers pay penalties even if they are unwarranted because it is so difficult and costly to challenge a penalty once it is assessed.”). American Bar Association (ABA) Tax Section, *Comments Concerning Possible Changes to Penalty Provisions of the Internal Revenue Code* (1999), http://www.americanbar.org/groups/taxation/policy/public_policy/provisions12.html (“Automatic assertion, followed by abatement, is far less satisfactory than assertion after inquiry, because taxpayers resent being penalized first and then having to prove compliance, and because many penalties that are asserted and paid probably should never have been assessed.”). Similarly, the IRS’s penalty handbook states, “[E]rroneous penalty assessments and incorrect calculations confuse taxpayers and misrepresent the overall competency of the IRS.” IRM 20.1.1.2.2(1)(b) (Nov. 25, 2011).

proposed — nor do they promote the sense that the tax system is fair, as other penalties do.³⁶ Thus, automatic penalty assessments may not have the same positive effect on voluntary compliance as other penalty assessments.³⁷

Accuracy-related penalties could have a different effect on voluntary compliance when applied incorrectly or appealed.

It is difficult for penalties to promote future compliance if imposed when the taxpayer has actually complied. Although some people might try to avoid further entanglement with the IRS by taking more conservative positions in the future, undeserved penalty assessments are probably more likely to discourage taxpayers from complying by communicating that the system is unfair and that they may be penalized even if they try to comply. Similarly, when a taxpayer appeals a penalty assessment or asks the IRS to reconsider it, he or she may also consider the penalty unfair. Accordingly, penalty assessments that result in reconsiderations or appeals may not have the same (positive) effect on voluntary compliance as other penalty assessments. Another possibility is that some taxpayers who ask the IRS to reconsider a penalty assessment or appeal it are less predisposed to trust the IRS or comply with the tax rules.³⁸ Any analysis of the impact of penalties on voluntary compliance should consider these factors.

TAS will analyze the impact of accuracy-related penalties on subsequent reporting compliance.

As noted above, TAS will try to determine if and how accuracy-related penalty assessments affect subsequent reporting compliance by Schedule C taxpayers. Because only some compliance can be measured directly, TAS will seek to gauge reporting compliance using the IRS's computer algorithms (called a Discriminant Index Function or "DIF" score) that estimate the likelihood that an audit of the taxpayer's return would produce an adjustment.³⁹ The study will use changes in the taxpayer's DIF score as a proxy for changes in voluntary compliance.

³⁶ Surveys consistently find that taxpayers report that personal integrity is the strongest factor influencing tax compliance. See, e.g., Roper ASW, *IRS Oversight Board 2011 Taxpayer Attitude Survey 5* (Jan. 2012), <http://www.treasury.gov/irsob/reports/2012/IRSOB-Taxpayer%20Attitude%20Survey%202012.pdf>.

³⁷ Some taxpayers may deliberately avoid contact with the IRS in an effort to avoid collection, however. It is unclear what impact a penalty would have on subsequent compliance by these taxpayers.

³⁸ For a discussion of the impact of trust on voluntary compliance, see *Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results*, [supra/infra].

³⁹ See, e.g., IRM 4.19.11.1.4 (Nov. 9, 2007). The IRS selects some returns for examination using the Discriminant Index Function (DIF) computer scoring system. IRM 4.1.1.2.6 (Oct. 24, 2006). It develops DIF score algorithms based on information obtained and periodically updated from National Research Program examinations. Returns with high DIF scores generally have a higher probability of being adjusted on audit than other returns of the same type. IRM Exhibit 4.1.7-1(12) (May 19, 1999). The IRS classifies tax returns into mutually exclusive groups called examination "activity codes" ("EAC"), and develops a separate compliance risk scoring algorithm (i.e., a DIF algorithm) for each activity code. For Schedule C filers, the activity codes reflect the amount of gross receipts reported on the Schedule C and the taxpayer's total positive income (TPI), which is the taxpayer's positive income (i.e., excluding negative income and losses) from all sources before adjusting for deductions and exemptions.

The study will identify two similar groups of Schedule C taxpayers who have been subject to an examination that uncovered a tax deficiency.⁴⁰ One group will include those who were assessed an accuracy-related penalty, and the other group will include those who were not.⁴¹

TAS will analyze the impact of the accuracy-related penalty on reporting compliance, as measured by changes to the taxpayer's DIF score. TAS will also try to estimate the extent to which the following factors affect the results:

1. Whether the penalty resulted from a default assessment (*i.e.*, one imposed before communicating with the taxpayer);
2. Whether the taxpayer requested an abatement (or reconsideration) of the penalty;⁴²
3. Whether the taxpayer appealed the penalty to Appeals;
4. Whether the penalty was ultimately abated; and
5. The amount of the tax understatement and proposed penalty (*e.g.*, so that TAS can determine if the penalty is for a substantial understatement or negligence and whether the penalty is 20 percent or 40 percent).

CONCLUSION

Accuracy-related penalties are meant to improve reporting compliance. This study will try to verify that accuracy-related penalty assessments do in fact improve subsequent reporting compliance among Schedule C filers.

The effect of such penalties on compliance may depend upon whether the IRS is perceived as applying them fairly. If automated penalty assessments, or those that are later appealed or abated, are more likely to be perceived as unfair, they may not have the same (positive) effect on voluntary compliance. Alternatively, such taxpayers' future compliance behavior may differ from the control group in other ways for different reasons. Thus, the study will also try to identify the impact of default penalty assessments, assessments appealed by the taxpayer (*i.e.*, through an audit reconsideration or the IRS Appeals function), and assessments that are ultimately abated.

⁴⁰ TAS will try to ensure the groups are balanced with respect to other factors that could influence compliance behavior, such as industry and previous compliance history.

⁴¹ To help reduce bias and improve the likelihood that the sample will represent all Schedule C taxpayers, TAS will stratify and/or weight the sample by DIF score and EAC, the industry listed as the source of the self-employed income, and whether the taxpayer was previously subject to collection or exam activity. TAS's ability to conduct this study will depend on its ability to find comparable groups of taxpayers.

⁴² At this preliminary stage, TAS anticipates that it may be difficult to identify some taxpayers who have requested reconsideration or abatement of the penalty.

Research Prospectus: When Do Accuracy-Related Penalties Improve Future Reporting Compliance by Schedule C Filers?

This page intentionally left blank.



www.TaxpayerAdvocate.irs.gov/2012AnnualReport

