

2007

The IRS Research Bulletin

Publication 1500

The IRS
Research
Bulletin

Proceedings of the 2007 IRS Research Conference

Research
Analysis
Statistics

The Obstacles of Voluntary Compliance from the Taxpayer's Perspective

Beanna J. Whitlock, The National Society of Tax Professionals

The National Society of Tax Professionals (NSTP) is a nonprofit organization founded in 1985, dedicated to “serving the tax professional.” With the goal of organizing the tax professional community, individuals in the business of tax, and assisting them to achieve a standard of recognition long overdue, the National Society of Tax Professionals reached out to certified public accountants, attorneys, enrolled agents, financial planners, and tax professionals/accountants.

The mission of NSTP is to serve tax professionals and the taxpaying public by promoting the highest standard of competency, ethics, and practice as a National Membership Organization.

In early February 2007, the members of NSTP were asked to be particularly alert when, during the 2007 filing season, they encountered taxpayers who were having difficulty in voluntarily complying with the Tax Code. Of the 5,000 members of NSTP, approximately 100 responded with anecdotes regarding specific taxpayers and their issues. Responses to the survey were received from April 18, 2007, through and including April 30, 2007.

On average, each tax professional member of NSTP prepares 650 tax returns. From the responses of 100 members, the total number of taxpayers included in the sampling would range from 130,000 if all were jointly filing taxpayers to 65,000 if all were single-filing taxpayers. Thus, approximately 100,000 individual taxpayers are estimated to be represented by the 100 preparers who provided feedback following the 2007 filing season.

Names and identifying numbers of taxpayers included in the survey were not made available, and every effort has been expended not to disclose the identities of taxpayers, as well as to ensure confidentiality between the tax professional and the client.

When reviewing case-specific data, it becomes clear that there is no single issue that is deemed to be an obstacle to voluntary compliance but rather an intricate set of roadblocks that take the taxpayer from the freeway of voluntary compliance to a detour which never leads back to the compliance highway. Some taxpayers deliberately exit the freeway of compliance, looking for an easier road to travel, while others simply take a side trip but eventually get back to the compliance freeway, having paid the price of penalty and interest for their divergence. Many taxpayers struggle desperately

to find a way back but have neither a good map nor someone to show them the way. In some instances, there appears to be no way to get back to the compliance highway. These taxpayers pose the greatest challenge.

While the data indicate that noncompliance is case-specific, the data reflect that taxpayers incur obstacles to voluntary compliance under the following general categories:

- Complexity of the tax law;
- Procedural difficulty with IRS, including communication;
- Burdensome reporting and tax filings;
- Unreasonable penalty and interest assessments;
- Insufficient encouragement to file and pay timely;
- Perceived lack of importance or priority; and
- Miscellaneous.

Complexity of the Tax Law

Twenty-one percent of preparers responded that their clients named complexity of the tax law as the obstacle to voluntary compliance.

Case examples include:

- Passive loss rules, particularly involving rental property and the phaseout of deductibility of passive losses based on the income of the taxpayer;
- Withholding on household workers, when to withhold, and alternatives based on earnings;
- Investment rules, various capital gain rates based on type of property sold, and length of time property held for investment;
- Retirement plan contributions, various limits, rules, and phaseout amounts;
- Threshold limitations, various limits of income eliminating deductions and credits; and
- Alternative Minimum Tax—AMT also surfaced as a major impairment to compliance, named by 21 percent of participating preparers. Cited as an example is the taxpayer who reduced W-2 withholding, taking advantage of the hybrid vehicle credit only to

be assessed AMT eliminating the credit, resulting in additional tax liability;

- Foreign taxpayers with H2B Visas are not aware that they can report business expenses on Form 2106, resulting in additional tax due;
- Basis, calculation, and the various methods based on acquisition manner;
- Earned Income Tax Credit, coupled with the change in the definition of “child,” makes regulations difficult to understand and examples in publications not applicable to the taxpayer’s set of complex circumstances;
- Various due dates for various reporting forms, such as 4/15 for partnership returns, makes late filing of 1040s almost certain;
- Payroll tax withholding, using rates for a single taxpayer, often results in insufficient tax withheld when there is a two-income earning family. Often, the taxpayer has no savings to make up the additional tax due, resulting in a collection problem for the taxpayer and IRS; and
- Complexity of the debt forgiveness rules, the choice of how to report a child’s investment income, as well as conflicts between Federal tax law and decisions of judges, particularly in the case of a divorce proceeding, are all cited as problematic to compliance by taxpayers.

Procedural Difficulty with IRS

Sixteen percent of responding preparers served taxpayers who named procedural difficulty with IRS as the top reason for difficulty with voluntary compliance.

Case examples include:

- Communications from IRS are not specific to the issue and often provide information that bears no relevance to the problem requiring resolve;
- Assistance in walk-in sites is grossly inadequate. The lack of Spanish-speaking assistors results in insufficient resolution of issues;

- IRS refuses to take responsibility when errors, including processing errors, are theirs. Procedure usually involves the IRS issuing a notice of deficiency rather than contacting the taxpayer about a mismatch with information documents or other similar matters;
- The Offer in Compromise (OIC) is no longer a viable means for a taxpayer returning to voluntary compliance. The procedural rule changes coupled with the centralized (Memphis and Brookhaven) working of OICs removes the revenue officer from the location near the taxpayer, producing realistic economic environment effects on the taxpayer; and
- A vast number of taxpayers encountering compliance and payment issues experience personal events so extraordinary that they are left unable to cope with circumstances of daily living let alone collection issues with IRS. The circumstances are such that, in the short-term, the problems created will result in long-term physical and economic disability. Some issues mentioned by taxpayers who reported to preparers participating in the survey are:
 - Alcoholism,
 - Drug abuse,
 - Depression,
 - Divorce,
 - Gambling,
 - Loss of a family member,
 - Lack of understanding, and
 - Others.

One percent of preparers, as an encouragement to voluntary compliance, cited the IRS Web site, www.irs.gov.

Burdensome Reporting and Tax Filings

Eleven percent of preparers indicated that burdensome reporting and tax filing requirements caused obstacles for voluntary compliance for their clients.

Examples include:

- The various number of codes on Forms W-2 and 1099 when new forms are needed to clarify the income reported;

- As many major brokerage firms corrected 1099 reporting of dividends, qualified dividends, and interest earned multiple times during the filing season, taxpayers were required to file amended tax returns or delay filing until brokerages were confident their 1099 filings were correct. Additionally, taxpayers remarked that, often, the “corrected” 1099 was formatted much like their monthly brokerage statements and the taxpayer was unaware that a return was incorrect until notified by an IRS CP2000 notice;
- Taxpayers purchasing hybrid automobiles, entitled to the energy credit, were not provided documentation by the automobile dealerships. Without proof of purchase, taxpayers who had relied on the energy credit subsequently owed tax. A simplified reporting form would insure that taxpayers received the credit and that IRS had a matching document; and
- Many tax professionals remarked on the growing problem of taxpayers who were previously W-2 employees being converted to 1099 employees, remaining in the same job and working for the same employer. The net result is that the taxpayer often does not understand the need to make estimated tax payments, both for Federal income tax, as well as for self-employment tax. Greater education and enforcement against participating employers are required to alleviate this impairment to compliance.

Unreasonable Penalty and Interest Assessments

Eleven percent of participating preparers indicated that taxpayers could pay outstanding tax assessments, but the penalty and interest were prohibitive. Taxpayers cited that payments made over the remaining collection statute would retire the debt but not all of the interest and penalty. IRS, in many instances, was unwilling to accept an installment agreement that would not retire all the outstanding debt, including interest and penalty.

Taxpayers repeatedly cited examples of the tax liability being created, either through capital gains or other unusual income production. Further examples included those of taxpayers whose incomes had been substantially reduced from the year the liability was incurred. In both cases, IRS application of penalty and interest was not an incentive to pay but a deterrent as it made the liability unrealistic for the taxpayer to resolve.

Responding taxpayers overwhelmingly indicated their willingness to pay the tax liability in full with a reasonable penalty for late payment.

Insufficient Encouragement to File and Pay Timely

Webster's New Collegiate Dictionary defines "taxpayer" as one who pays or is liable to pay a tax. In 1950, 53,060,098 taxpayers filed Form 1040. In 2005, 134,462,537 taxpayers filed Form 1040, representing an increase of 81,402,439 or 153 percent. In 1950, 6,865,387 taxpayers filed as sole proprietorships, including farmers. In 2005, 22,712,150 filed as sole proprietorships, including farmers, representing an increase of 15,846,763 or 231 percent. Proportionately, in 1950, 13 percent of American taxpayers were self-employed. In 2005, 17 percent of American taxpayers reported being self-employed, while the population of reporting taxpayers increased by 153 percent. Without question, the taxpayer of 1950 is a vastly different taxpayer from that of 2005 or 2007. Eight percent of preparers responding to the survey served taxpayers who indicated that the lack of incentive to file and pay taxes was an obstacle to voluntary compliance. One taxpayer remarked that, while he owed no Federal income tax, self-employment tax was too prohibitive. He cited that, on \$8,000 of net income, while no Federal income tax was due, \$1,224 in self-employment tax were assessed. Taxpayers responding to the survey question also remarked that there should be an incentive to file and pay timely as other merchants provide.

Among the suggestions:

- Provide a \$5 e-file incentive;
- Provide a \$5 direct deposit incentive;
- Provide a credit for timely filing and paying;
- Provide an IRS EZ file, online, which automatically prepares the taxpayer's return; and
- Provide a reduction in penalty and interest if taxpayers begin payment before IRS contacts them.

Perceived Lack of Importance or Priority

Perhaps among the most troubling of information from the survey is the number of preparers participating, 6 percent, who had clients who felt there was no need to timely file or pay their taxes. There was knowledge of what was required. The willful and deliberate attempt to avoid compliance was not believed to be important, and they would get to it when other more important issues no longer took priority.

Examples of such lack of compliance include:

- Filing of tax returns, including Form 1099s and W-2s which undoubtedly affect other taxpayers wishing to be compliant.
- Paying of tax obligations, estimated tax payments, as well as penalty and interest.
- Reporting and payment of taxes by non-US citizens who see no benefit in the filing and payment of tax.
- The most troubling comment from a taxpayer interviewed was “that cheating on taxes was not anything bad.” It should be noted that the taxpayer was only correcting prior-year tax return filings in order to meet the demands of his fiancé.

Miscellaneous

Demographic results of the survey indicate problems with voluntary compliance in primarily Hispanic communities. Stemming from “lack of trust,” Spanish-speaking taxpayers with English as a second language suffer from an insufficient number of Spanish-speaking tax professionals. Additionally, illegal aliens who want to file and pay their taxes are often deterred from filing for fear that filing a tax return will result in being contacted by Immigration.

Similarly, taxpayers with “occupations,” listed on page 2 of the 1040, which may be unlawful in their States, are discouraged from filing Federal income tax returns. If there was no “occupation” to complete, these individuals would have greater confidence in timely reporting and paying of their taxes. Estimated Tax Payments are a compliance issue separate from filing and paying tax liability. Three percent of preparers participating in the survey remarked that the obstacle for filing estimated tax payments would be removed if:

1. The first quarter estimate was not set on the same date as the 1040 tax liability for the prior year; and
2. The estimated tax payments were set on evenly calculated quarters.

One taxpayer remarked that the State of California provides a statement showing the estimated tax payments made by the taxpayer. A similar statement sent by IRS would promote correct filing of payments.

The obstacles to voluntary compliance from the taxpayer’s perspective are important as Congress, the Internal Revenue Service, and the tax profes-

sional community struggle to reconcile the Tax Gap. Studies and projects will be funded and analysis performed on the numbers, but no information can be as vital to the resolution of the Tax Gap as all in the business of tax to know, from the taxpayers' perspective, what taxpayers find most problematic.

The tax professional community understands all too well that taxpayers have changed their attitudes about filing and paying taxes since 1950. Tax professionals have to work harder to get the same taxpayers to come in and file taxes than they did 50 years ago. Tax professionals have to constantly remind taxpayers about the importance of filing and paying, including estimated tax payments. Most importantly, the tax professional, the trusted advisor of taxpayers, must be ever-vigilant to keep taxpayers from straying into the Tax Gap.

In the world of compliance—if a taxpayer believes it, it is so!

The tax professional community is encouraged that the Internal Revenue Service is willing to add to their research about taxpayers the experiences of tax professionals who live out their research by assisting taxpayers.

Acknowledgments

Members of the National Society of Tax Professionals and the taxpayers who participated in the survey.