

Real Time Tax System Initiative

Comments of T. Keith Fogg, Director, Villanova Law School Federal Tax Clinic

Introduction

The concept of having more information available during the filing season which serves to reduce errors prior to issuance of a refund check or prior to accumulation of significant interest and penalties serves many good purposes. In some ways this concept draws on historical roots. Beginning in the civil war with the imposition of the income tax and leading up to World War I shortly after the reimposition of the income tax, the Service audited returns prior to assessment. Returning to a partial pre-assessment review of returns based on technological advances brings back many of the benefits that existed in the original practice.¹

While getting the return right the first time will save the IRS significant resources spent in correcting the amount of the liability freeing up those resources for more productive endeavors, even greater savings may exist when viewing the initiative from a collection perspective since the subsequently assessed dollars make difficult collection cases. For many low income taxpayers any refunds received generate immediate expenditure of the funds – often to cover basic necessities. Once spent, recovering these funds from low income taxpayers presents quite a challenge for the Service and quite a burden to the low income taxpayer. Building a system which avoids the anxiety of ten year assessment would enhance the quality of life of those stuck with a tax bill they have little or no ability to pay.

For those taxpayers filing early in the filing season, the ability to correct their returns prior to the due date allows them to avoid interest and penalty charges since corrections prior to the due date do not create amended returns but rather refinements of the original return.² Early resolution of mismatches between data provided to the Service and data in the hands of taxpayers allows a fix before the data necessary for the taxpayer to prevail becomes difficult to obtain. The normal point at which the Service contacts the taxpayer through the Automated Underreport (AUR) program creates difficulties for taxpayers with poor recordkeeping systems. Low income taxpayers suffer disproportionately in this system due to both their recordkeeping systems and their communications capabilities.

Details of implementation can make the difference in the success of the proposal. The impact of the proposed changes on low income taxpayers will be the focus of my comments.

¹ For a detailed discussion of early practices see Bryan Camp, Theory and Practice in Tax Administration, 29 Virginia Tax Review 229 (2009)

² For a brief discussion of the distinction of corrections prior to and after the filing due date of a return see T. Keith Fogg and Calvin Johnson, Imposing a Duty to Correct Material Mistakes – Amended Returns, Tax Notes, September 8, 2008

Use of data when mismatch occurs

The fact that the Service identifies a mismatch during the filing process only begins an effort to correct the return. Identifying a mismatch at an earlier point than the current AUR process does not itself save time in resolving the issue. How will the early detection of a potential problem turn into a savings for the system and the taxpayer?

Low income taxpayers do not respond readily to contacts from the Service. The Service has recently piloted a program in correspondence examinations that might work well as a means of increasing the responsiveness of low income taxpayers to the preassessment contacts required by Real Time processing.

The correspondence examination program piloted this year seeks to call taxpayers subjected to a correspondence exam concerning the earned income tax credit (EITC) instead of just relying on correspondence. This pilot was championed by the National Taxpayer Advocate. Studies showed that a high percentage of requests for audit reconsideration of correspondence examinations of the EITC issue resulted in abatement of the tax. This suggests that the claim of the EITC was correct when made but the taxpayer failed to respond to the correspondence examination request for information and only became responsive during the post-assessment or collection phase of the case. If this pilot proves successful in obtaining more responses from the EITC taxpayers during the examination phase, it should serve as a model for reaching out to make corrections during the Real Time phase of a case.³

Unlike taxpayers with high dollar returns, low income taxpayers have their cases worked by the Service, both at the examination and collection phases of their case, by a pool of employees rather than a single Service employee assigned to the case of the taxpayer.⁴ Low income taxpayers almost never speak twice to the same person from the Service who is working their case. In the examination phase they rarely talk to a person. Low income taxpayers must process the information received by correspondence or by phone with someone who has no continuity with them or their situation. The generally low responsiveness of low income taxpayers to contacts from examination or collection pools of employees prevents low income taxpayers from early resolution of their problems causing assessment of liabilities that should reach resolution or the filing of a notice of federal tax lien on a collection account that should have an installment agreement.

To make the contact work effectively following a Real Time identification of a mismatch, the Service needs to adopt a strategy that will work to effectively engage low income taxpayers.

The idea of Real Time includes quick resolution of the issue. The quickest way to reach a taxpayer is by phone. To reach a taxpayer by phone, the Service needs to know the taxpayer's phone number. To obtain the phone number, the Service could request it on the return as several states already do. Of course, not every taxpayer will fill in that information and not every number called will result in an

³ Any program involving telephonic contact from the Service needs to insure that it cannot be duplicated by scam artist seeking to obtain information and funds from taxpayers.

⁴ For a discussion of how this system works in the context of filing a federal tax lien see T. Keith Fogg, Systemic Problems with Low-Dollar Lien Filing, 133 Tax Notes 88 (October 3, 2011)

answer but phone contact to discuss the issue of the mismatch will provide the taxpayer the chance to engage in a dialogue and potentially reach quick resolution.

Assigning a taxpayer's case to one individual allows the taxpayer who must make more than one contact to resolve the issue to have the luxury of not having to start all over again each time the conversation starts back up. The Service employee can gain knowledge about the taxpayer and the account that can inform the decision on proper resolution.

Many low income taxpayers use preparers because of a lack of knowledge or discomfort with the federal tax system. Keeping the preparer engaged in the discussion of mismatch on the return would allow a person with some knowledge of the tax system to continue to advise the taxpayer and might also keep engaged a party who the Service can more easily reach. Education of low income taxpayers and their preparers on the benefit of allowing the Service to contact the preparer might make the election to allow preparer contact more likely. If this election is made, the Service obtains the benefit of talking with a tax professional about the mismatch and the taxpayer receives the benefit of a trusted interpreter of the problem.⁵

Based on the experience of the Villanova Federal Tax Clinic working with low income taxpayers engaged in a controversy matter with the Service, communicating with low income taxpayers provides challenges not present in communication with individuals in other social strata. Many barriers⁶ exist that prevent these taxpayers from responding as one might expect in a normal business model. Recognition of these barriers needs to occur at the outset of this endeavor so that the best possible plans are applied to reaching a solution.

Alternatively, providing the data prior to return preparation

Because of the problem of reaching low income taxpayers after the filing of the return – whether immediately thereafter in Real Time or 12 months later in an AUR process, another possible use of the Real Time data exists.⁷ The other possibility is allowing tax return preparers or taxpayers themselves to view the data in the Service's records prior to filing the tax return. If a return preparer, using e-Services, could see the information return data as return preparation occurs, the preparer could ask the taxpayer about discrepancies between the data on file with the government and the data presented by the taxpayer. The taxpayer, sitting across the desk from the preparer, could quickly respond to inquiries

⁵ The newly adopted system of preparer regulation should bring to the situation a better informed preparer who is motivated to see the matter through to the correct result.

⁶ Low income taxpayers live in less traditional settings and move more frequently making their home address more difficult to ascertain. Low income taxpayers do not always have phone service or internet service. Low income taxpayers have more language and cultural differences than taxpayers in other social strata making communication difficult even if the proper address or phone number exists.

⁷ In addition to my proposal, Real Time data also brings out the possibility of the Service using the data to prepare draft returns similar to the California Ready Return system or systems that exist in Europe. I know that is not the focus of the Real Time discussion nor is it the focus of my alternative proposal. For a discussion of pros and cons of such a proposal see Joseph Cordes and Arlene Holen, "Should the Government Prepare Individual Income Tax Returns?" Technology Policy Institute, September 2010 or Joseph Bankman, "Using Technology to Simplify Individual Tax Filing" LXI National Tax Journal 773 (2008)

about sources of additional information. The problem of the Service trying to track down the taxpayer two weeks later when the taxpayer has moved on to other life tasks would not exist.

Preparers could include in the originally filed return income sources previously overlooked because the Real Time data would provide access to that information at a point when the preparer has access to the taxpayer who could provide an explanation. Taxpayers could immediately acknowledge income sources left out of the information initially provided to the preparer and immediately begin to challenge income returns showing up on their account incorrectly. This would all happen while the taxpayers still had the assistance of a preparer. Getting this information at the return preparation stage would also quickly alert taxpayers using such data to the existence of the misuse of their identity information and hasten the process of correction.

The difficulty of communicating with the low income taxpayer population should enter into this calculus. Presenting the Real Time information to them at the return preparation stage rather than afterwards has significant advantages. The Government does show its hand in such a system by revealing the amount of third party data it has. This downside does not overcome the significant upside of getting the information to a preparer prior to the submission of the return.

Avoiding Expansion of Math Error Authority

Another factor to consider with the Real Time information concerns its use in the absence of taxpayer consent. Many taxpayers will not agree to an additional liability based on the finding of a mismatch of information either because of genuine disagreement, a failure to respond or a lack of comprehension. Faced with a return that appears wrong at a point prior to assessment (and refund), the Service will want to include this information into the liability calculus. It may quickly turn to the math error process as a source of increasing the assessment over the liability shown on the return.

The Government Accountability Office has recently proposed increasing the authority of the Service to make math error adjustments for certain refundable credits.⁸ The math error process sings a siren song of efficient tax administration yet it holds significant problems particularly for low income taxpayers who do not understand and do not respond quickly to these notices.⁹ The math error process gives taxpayers less time to react before a proposed adjustment is assessed than the notice of deficiency process (60 versus 90 days); less notice of what is proposed;¹⁰ and fewer rights with respect to information returns - the very subject of the Real Time initiative.¹¹ In a shorter period of time, with less

⁸ See "Enhanced Prerefund Compliance Checks Could Yield Significant Benefits, GAO-11-691T (May 25, 2011)

⁹ For a detailed history of the math error process and the problems overuse of this process can pose to low income taxpayers see Robert Nadler, "Math Error Notices: In Search of Taxpayer Rights" 2003 Tax Notes Today 131-6 (July 9, 2003). See also Written Statement of Nina Olson, National Taxpayer Advocate, Hearing on Improper Payments in the Administration of Refundable Credits before the Subcommittee on Oversight, Ways and Means Committee, House of Representatives, May 25, 2011, at page 26 for a call for more judicious use of math error adjustment authority.

¹⁰ See Robert Nadler's article describing the nature of the math error notice itself.

¹¹ Information returns put taxpayers in an awkward position. Congress and the courts have acknowledged this awkwardness in the manner in which proof of the correctness of an item on information return plays out in litigation. Section 6201(d) of the Internal Revenue Code shifts the burden of going forward to the Service if the

explanation than exists in a notice of deficiency, a taxpayer can see rights cut off and an assessment made.

Low income taxpayers are more likely than other taxpayers to fail to speak up during the period of math error adjustment and more likely to lose their right to contest the adjustment in Tax Court. Once they lose their prepayment forum, low income taxpayers also possess less financial capability to pay the tax and sue for refund when faced with an incorrect assessment. This forces them into the audit reconsideration process where no recourse to the courts exists. If math error authority authority expands to include the types of adjustments suggested by mismatches of data, the Real Time program simply accelerates the AUR process into a preassessment time frame. This would significantly disadvantage low income taxpayers who are the least responsive to notices received from the Service. Safeguards must exist to keep this from becoming the result of this change. Those safeguards could involve use of the deficiency process rather than the math error process, significant enhancements in the math error notices or other processes that will adequately safeguard low income taxpayers and their opportunities to contest proposed adjustments.

Education

The Real Time program will result in delayed refunds while the Service seeks to resolve a mismatch.¹² Taxpayers, particularly low income taxpayers, need to know that the Service has moved forward its time frame for questioning items on a return and need to understand the consequences of the new process so that they quickly respond to any inquiries received. In rolling out the program, specific effort should be made to ensure that low income taxpayers understand the new procedure.

Timing

The possibility exists that a very small amount of potentially underreported income will significantly delay a large refund. Because Real Time occurs prior to assessment and because assessment stands as a predicate to issuance of the refund, an unreported Form 1099 for \$50 of interest from a bank, which might result in little or no tax could hold up the issuance of a \$5,000 refund return to a low income taxpayer claiming EITC. Processes should exist permitting the immediate issuance of a portion of the refund unaffected by the information item on which a mismatch has resulted. Holding up a large refund to a low income taxpayer will place a burden on that taxpayer and probably a burden on the Taxpayer Advocate Service as the hardship calls begin rolling into their office.

Aside from the partial refund issue, the timing of the response period in these cases also bears some thought due to the effect of the delayed refund. While the taxpayer controls, or essentially controls, the timing of their response, will the Service build into its handling of these cases an expedited feature that ensures taxpayers' refunds will not lag in the system because of the inquiry? Can the Service commit to

taxpayer cooperates during the examination phase of a case. Court cases led to the adoption of that section of the Code. See e.g. *Portillo v. Commissioner*, 932 F.2d 1128 (5th Cir. 1991)

¹² Assuming that the Real Time system does not also result in delayed refunds as a result of delays in loading into the system the information return data, the questioning of a return prior to assessment will necessitate delay of any refund requested on a return.

expedited processing of the responses received regarding the mismatched return information? Will the Service shift to the deficiency process if its response time lags and allow the taxpayer to receive the refund pending a determination?

Areas of Special Interest

Identity Issues

Another potential benefit of the proposed “Real Time” system exists with respect to identity issues. Inappropriate Identity use creates enormous problems and frustrations for individuals caught in its web.¹³ If the Service matches information returns as it processes tax returns, the returns with identity issues should come out of the return processing pipeline immediately because of the mismatches in data. Pulling these returns off line early could allow the “real” taxpayer to be properly identified and protected in weeks rather than in months or years. Victims of this problem currently spend significant time in tax purgatory seeking to prove their true identity and their entitlement to benefits claimed. Flagging this problem at the outset of the process presents major opportunities for enhancement in a process that does not currently work well for the victims.

Many individuals in the United States want to file and pay their federal taxes but lack the ability to obtain a social security number. The Service issues these taxpayers ITINs to allow them to have identification for purposes of filing their tax returns.¹⁴ Because employers must verify the ability of these individuals to work based on a social security number, these individuals may invalidly use a social security number which does not belong to them for purposes of obtaining employment but procure a valid ITIN for purposes of filing tax returns. By definition the identification number used on their returns will not match with the identification number used on the information returns to report their compensation. A special system for handling ITIN returns may be needed to account for the failure of the payor to use the SSN appropriately. Accelerating the matching program into a preassessment process moves the now slow moving identity issue process into a much accelerated system. If this is to work, new ways of finding and fixing identity misuse must be found.

EITC

Low income taxpayers have special concerns with programs impacting EITC. The Real Time program could impact EITC in two ways that immediately come to mind and probably in many other ways. The impact on EITC deserves specific thought. One potential impact concerns verification of income amounts. The National Taxpayer Advocate spoke to this in her report to the Ways and Means Oversight Committee in May, 2011.¹⁵ Using information return data through Real Time to seek to verify the

¹³ National Taxpayer Advocate Nina Olson has described identity theft as “the number one consumer complaint in the United States, far outpacing all others. National Taxpayer Advocate 2007 Annual Report to Congress 96 (Rev. Nov. 2007)

¹⁴ See “Effectively Representing Your Client before the IRS” (5th Ed.) at pages 22-6 through 22-11 for a detailed discussion of identification numbers used in tax administration.

¹⁵ Written Statement of Nina Olson, National Taxpayer Advocate, Hearing on Improper Payments in the Administration of Refundable Credits before the Subcommittee on Oversight, Ways and Means Committee, House

income of persons claiming EITC has many advantages as long as the data is properly analyzed. Properly preventing the issuance of EITC refunds benefits the system and the taxpayer obtaining a large refund which will prove difficult or impossible to repay.

The Real Time program may delay the issuance of returns of low income taxpayers claiming EITC such that during the delay the return of a second taxpayer claiming the same qualified child as a dependent will arrive. Now the Service has information which significantly impacts the issuance of the EITC refund but which was not directly a part of the Real Time project. How will the Service handle these returns in the preassessment posture? Today, the first taxpayer filing a return claiming a dependent receives the benefit of the claim while subsequent returns claiming the same dependent have their refunds frozen or denied. Delaying the issuance of returns to resolve mismatch issues will undoubtedly cause this and other cross claimed issues to present themselves in the future that do not present themselves in the manner returns are processed today. A system for dealing with this fallout of the Real Time program needs to exist.

of Representatives, May 25, 2011, at page 23 praising the initial proposal of Real Time as a means of quickly verifying income prior to the issuance of the EITC refund.

The effort to verify the information on returns claiming EITC has also been the subject of a recent regulation proposal. See Reg-140280-09, Proposed Regulation Changing Tax Preparer Due Diligence Standards Relating to the Earned Income Tax Credit. The proposed regulation would change the penalty provisions under IRC 6695(g) to require the filing of Form 8867 with a return claiming EITC.