2014 IRS-TPC Research Conference

Abstracts of Papers

Session 1: Taxpayer Compliance Costs and Tax Administration

Improving Form 1098T: How a Revised Form Could Increase Take-Up, Improve Compliance and Lower Taxpayer Burden

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Form 1098T originated with the Taxpayer Relief Act of 1997 (TRA97). TRA97 created the Hope Scholarship Tax Credit (HTC) and the lifetime learning credit (LLC). Both credits allowed qualifying students attending eligible institutions to claim tax credits against qualifying education expenses. TRA97 also required that eligible educational institutions file a return reporting qualified tuition and related expenses and other information for each enrolled student as prescribed by regulations. Among other items, Form 1098T reports on student status, student expenses and scholarships. The current design of Form 1098T helps taxpayers claim certain education tax credits and it also helps the IRS monitor compliance with the education tax credits. Yet, as currently designed and administered, Form 1098T falls short of providing *all* the information necessary for students to claim the tax credits or for the IRS to effectively monitor compliance. This paper presents some evidence that some eligible students may not be taking any education related tax benefit or may not be choosing the optimal benefit. We also present evidence that some students may be taking a tax benefit for which they are not eligible.

Convenience Is Necessary for Pension Participation by the Poor

Valrie Chambers (Texas A & M University – Corpus Christi)

How hard will low-income taxpayers work to increase their tax refund? Not very hard. With limited effort, low-income taxpayers could often increase their overall tax refund by using the deduction for an IRA or other qualified retirement plan in conjunction with the "Savers Credit," but this would require setting up a separate pension account if one did not already exist. Funding this account is relatively simple because using Form 8888, Allocation of Refund (Including Savings Bond Purchases), the funding can be directly allocated from the current year's tax refund if that return is filed and the account is funded by the regular April due date. In a field experiment, taxpayers at an urban Volunteer Income Tax Assistance (VITA) site were offered the opportunity to receive two stages of tax planning with regard to increasing their tax refund through the use of IRA deductions and the Savers Credit. It was expected that where the refund was more than a taxpayer originally anticipated, the taxpayer would increase his/her wealth by funding a qualified pension from the excess refund (above the originally anticipated amount), thus maximizing the amount of the tax refund, with no material financial cost. Instead, consistent with scarcity theory, taxpayers did not increase funding to their pensions, with many listing inconvenience as the reason for leaving often hundreds of dollars in extra tax refund as the reason. A subsequent hypothetical experiment with accounting students confirms that the convenience premium is indeed high.

This research is important, because it demonstrates that the long-held wisdom that poor do not save because they can't afford to is an acute oversimplification. They also apparently do not save because it is not convenient. Some financial professionals and policy makers might attribute this to laziness or exhaustion or being already overwhelmed with the demands of life. These experiments did not measure why convenience was important to respondents, but the author observes that is more important than may be commonly thought and will impede savings even when the poor can afford to save. This effect is not limited to the poor; student participants of varying economic status also place a high premium on convenience and were willing to forego real extra credit potential and hypothetical money for convenience sake.

The Compliance Costs of IRS Post-Filing Processes

John Guyton and Ronald Hodge (IRS, RAS, Office of Research)

Measuring the costs of tax administration better will improve our understanding of factors influencing a tax system and its outputs. As discussed in Slemrod and Yitzhaki (2002), the public's compliance costs are considerably larger than the budget of the tax administrator, hereafter the IRS. The public's compliance costs are typically related to the filing of a tax return. However, there are instances when additional information is required by the IRS after a tax return has been filed, so additional costs are incurred. Since it is impractical to measure these costs directly, they must be estimated. This paper addresses the estimation of these post-filing compliance costs and how they vary based on taxpayer characteristics and administrative treatments.

Prior IRS compliance cost research of individual taxpayers has focused on compliance costs incurred during pre-filing and filing activities [c.f. Contos et al. (2010) and Marcuss et al. (2013)]. An earlier effort (Connors et al. 2007) compared discrete event simulation and econometric microsimulation as potential modeling frameworks for IRS post-filing processes. This paper extends that research on post-filing compliance costs, describing the associated data collection, modeling, and estimation efforts.

We categorize individual taxpayers with post-filing issues into four groups: taxpayers who (1) filed an amended tax return; (2) had accounts receivable with the IRS and made an attempt to reach an agreement as to how the account could reach full paid status; (3) were audited and attempted to comply with the requests of the audit; (4) appealed an IRS decision; or any combination thereof. We sampled tax year 2008, 2009 and 2010 individual taxpayers who concluded a post-filing case during calendar year 2011. The sample was stratified based on the original tax return complexity and preparation method, as well as on how the post-filing case was resolved. The survey collected data on the time and money spent by taxpayers to resolve issues with an already-filed tax return. Survey data were then linked to IRS administrative data to create the estimation data set.

To model the conditional distribution of post-filing compliance costs, we employed a log-linear regression specification in which the natural log of post-filing compliance costs is linearly related to a set of explanatory variables. Given that post-filing compliance cost data are available from survey respondents, it was important that the dependent variables in the model be based on IRS administrative data. The modeling approach used for this study is similar to one described in Contos et al. (2009).

The model controls for: (1) at-filing characteristics (such as original tax return complexity and preparation method, third-party designee, etc.); (2) post-filing characteristics (third-party representation, IRS administrative costs, post-filing results and post-filing case type); and (3) collection-related resolutions. Preliminary results estimate post-filing compliance costs at $4.56B for a population of 11.44M affected taxpayers. This yields an average post-filing compliance cost of $400 per taxpayer, comparable to but higher than average per taxpayer pre-filing and filing (PF&F) compliance costs of $373 estimated in Marcuss et al. (2013).

Beyond the population-level comparisons of PF&F and post-filing compliance costs we also compare PF&F and post-filing compliance costs for post-filing survey respondents using available IRS PF&F compliance cost models. It should be noted that because post-filing survey respondents did not receive the PF&F survey, we assume that their PF&F compliance costs are similar to taxpayers with similar reported tax return characteristics. Further we must emphasize that the post-filing survey respondent population is not representative of the overall filing population.

Available data on IRS post-filing processes allows us to determine with which IRS function a taxpayer's post-filing case originated. Using this data and PF&F compliance costs models we were able to segment the post-filing respondent population and determine both PF&F and post-filing compliance costs. We were particularly interested in how these costs varied based on the amount of original tax return information would have to be substantiated in order to resolve a post-filing issue. These finding are discussed in this paper for select segments of the post-filing population.

Finally we extend the model beyond the respondent population to a more general post-filing population and compare the general population's post-filing compliance costs with those of the respondent population. The general population also allows us to allocate post-filing compliance costs across IRS post-filing functions.

Session 2: Innovative Enforcement Strategies

Incentivized Offshore Voluntary Disclosure Schemes: An Analysis

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Recent years have seen Incentivized Offshore Voluntary Disclosure Schemes (IOVDS) implemented by tax authorities across the globe. IOVDS are characterized by the acquisition of non-audit (often third-party) information on taxpayer liabilities by the tax authority, and a subsequent opportunity for affected taxpayers to make a voluntary disclosure. Accepted disclosures are subject to a discounted fine rate, but under-disclosure may attract higher penalties. In recent years the British tax authority, in particular, has implemented a number of such Schemes, targeted at offshore funds (e.g., New Disclosure Opportunity, Offshore Disclosure Facility). This paper analyses the optimal design of IDS in a principal-agent setting between taxpayers and the tax authority. Using both theory and simulation, a number of implications for the design of IDS are uncovered.

Uncollectible versus Unproductive: Compliance Impact of Working Collection Cases that are Ultimately Not Fully Collectible

Erik Miller, Stacy Orlett, and Alex Turk (IRS, SB/SE)

Each year a fraction of voluntary and enforcement tax assessments are not paid timely. There is little benefit that results from continuing to use IRS's scarce resources to attempt to collect from taxpayers that cannot pay and that are not at risk for future non-compliance. Therefore, some accounts are moved out of the collection work streams and identified as *Currently Not Collectible (CNC)* when taxpayers are unable to pay anything further due to significant hardship or when the IRS is unable to locate the taxpayers.

A common misconception is that a case identified as *Currently Not Collectible* was not a productive case. Furthermore, the Currently Not Collectible determination is sometimes used as evidence that the IRS should not have worked the case at all. However, many cases that are identified as *Currently Not Collectible* are associated with significant enforcement revenue and the IRS intervention may have curtailed future noncompliance.

In this paper we analyze individual and business accounts having unpaid assessments for calendar years 2008-2010 that are not fully resolved during the notice process. For cases identified as *Currently Not Collectible*, we estimated the impact of various collection treatments on resolving the unpaid amounts and on the taxpayer's subsequent payment compliance. We find positive impacts to dollars collected and subsequent compliance of working cases that are ultimately *Currently Not Collectible*. Thus, working uncollectible cases can be an important part of the IRS accomplishing the goals of tax administration.

A Plan for Turning "Worst-First" into "Best-Case" Tax Enforcement

Leigh Osofsky (University of Miami School of Law)

The IRS should make enforcement decisions based not only on direct revenue yield from enforcement, but also based on the indirect effect of enforcement on future voluntary compliance of both taxpayers who were actually subject to the enforcement efforts and taxpayers who were not subject to the enforcement efforts. And yet, tax scholars have not focused much on how the IRS should allocate enforcement resources within taxpayer sectors (for instance, within the cash business tax sector) in order to maximize voluntary compliance. In this Article, I set forth one model ("microdeterrence") for allocating enforcement resources within a low compliance tax sector. The intuition behind microdeterrence is that, under a number of different circumstances, concentrating enforcement resources (in the form of rotating enforcement projects) may raise voluntary compliance. Indeed, although the Discriminant Index Function score ("DIF score") has received extensive attention as a means of allocating scarce enforcement resources within taxpayer sectors, under certain circumstances microdeterrence may work in conjunction with the DIF score to create a more comprehensive, best-case enforcement regime. A best-case enforcement regime would focus not only on direct revenue yield from enforcement, but also voluntary compliance. This Article proceeds by first exploring the existing literature regarding allocation of tax enforcement resources and then setting forth some empirical evidence from the criminology context that suggests

the potential for a project-based approach to increase voluntary compliance. The bulk of the Article describes the conditions under which microdeterrence may increase voluntary compliance, and how it might work in the particularly problematic cash business tax sector.

Session 3: Tax Uncertainty and Corporation Compliance

Large Corporation Schedule M-3 Book-to-Tax Profiles of Schedule UTP (Uncertain Tax Position) Filers and Non-Filers: 2010 – 2011

Charles Boynton, Portia DeFilippes, Ellen Legel, and Lisa Rupert (IRS, LB&I)

Taxpayers prepare corporate and partnership tax returns by adjusting amounts from their financial statements (FS) or books and records. The goal of the Schedule M-3 reconciliation is to increase taxpayer transparency to the IRS with respect to the adjustments (book-to-tax differences or BTD) made to FS or books and records in preparing the tax return. Schedule UTP (Uncertain Tax Position Statement) was introduced in 2010 for corporations with assets of $100 million or more with audited FS reporting uncertain tax positions in the income tax footnote and for certain related corporations. The goal was to increase taxpayer transparency to the IRS with respect to items giving rise to federal income tax uncertain tax positions in the taxpayer's FS. The study presents and compares Schedule M-3 and Form 1120 tax return data profiles for Schedule UTP filers and non-filers with $100 million or more in assets in 2010-2011 and includes 12,044 corporations in 2010 and 12,307 corporations in 2011.

Unintended Consequences of Linking Tax Return Disclosures of Tax Uncertainty to Financial Reporting for Tax Uncertainty

Erin M. Towery (University of Georgia)

The recently-issued *Uncertain Tax Position Statement* (Schedule UTP) requires firms to list and describe on their federal tax return all income tax positions that management classifies as 'uncertain' for financial reporting purposes. This study exploits the implementation of Schedule UTP to examine how linking tax return disclosures of tax uncertainty to financial reporting for tax uncertainty affects firms' reporting decisions. Using confidential tax return data and public financial statement data, I find that after the imposition of Schedule UTP reporting requirements, firms report lower reserves for uncertain income tax positions in their public financial statements, but do not claim fewer income tax benefits on their federal tax returns. These findings suggest some firms modified their financial reporting for uncertain tax positions to avoid Schedule UTP reporting requirements while still claiming the underlying tax positions. My results imply linking tax return disclosures of uncertain tax positions with financial reporting for tax uncertainty can distort financial reporting decisions.

The Effect of CAP on Tax Aggressiveness

Amy Dunbar and Andrew Duxbury (University of Connecticut)

The IRS compliance assurance process (CAP) program is a voluntary program in which participating large corporations work collaboratively with the IRS to identify and resolve potential tax issues in real-time before the annual tax return is filed. As of the end of 2011, there were 160 firms that have participated in CAP, which started in 2005 with 16 firms. Prior to 2012, taxpayers were invited to apply to the CAP pilot program by the IRS. Beginning in 2012 the CAP program moved from an invitation-only program to an application program.

In 2013, the Government Accountability Office recommended that the IRS measure the effectiveness of the CAP program with respect to seven goals including ensuring taxpayer compliance. Focusing on the taxpayer compliance goal, we compare CAP firms with a sample of nonCAP firms, considering both firm characteristics potentially associated with tax aggressiveness, such as size and foreign operations, and tax aggressiveness measures. We measure tax aggressiveness using proxies from the tax aggressiveness literature including several measures for effective tax rates (ETRs), book-tax differences and unrecognized tax benefits (UTBs). We also compare the distribution of forms filed by U.S. parents for foreign subsidiaries (Form 5471) and foreign disregarded entities (Form 8858).

The IRS required CAP taxpayers not to be in litigation with the IRS or any federal or state agency, and to display a general willingness to be transparent and cooperative with the IRS. If the IRS was successful in identifying potential CAP firms as compliant firms, then CAP firms may have lower tax aggressiveness measures in both pre-CAP and CAP participation years. If the compliant scenario is not initially descriptive, the CAP firms may become less tax aggressive in subsequent years. In addition to comparing CAP and nonCAP firms, we also compare pre- and post-CAP tax aggressiveness. Our initial results do not support the hypothesis that the CAP firms are less aggressive from the nonCAP firms either before or after joining CAP. We do document that the UTBs typically decrease before the CAP entrance year, providing support for firms joining CAP to achieve audit currency.

Session 4: Understanding Taxpayer Behavior

Tax Evasion and Self-Employment in the US: A Look at the Alternative Minimum Tax

Donald Bruce and Xiaowen Liu (University of Tennessee)

Originally designed to target high-income households, the Alternative Minimum Tax (AMT) for individuals is a separate income tax system that operates in parallel to the regular income tax. Using Individual Public Use Tax Files for 1994-2002, this paper is the first to look into individuals' income-reporting behavior in response to the AMT. We find strong evidence that taxpayers, especially self-employed individuals, appear to manipulate their incomes to avoid the AMT. We also find suggestive evidence that the notch created by the AMT generates both a real response and an evasion response. The self-employed act more aggressively than wage earners to avoid the AMT. Specifically, we find evidence suggesting that the self-employed are likely to increase the ratio of certain tax deductible consumption to their income as they approach the AMT threshold. This is suggestive evidence that they underreport their taxable income as they move closer to the AMT threshold. We also find the Schedule C filers may increase their business expenses in order to avoid the AMT. These results have important policy implications for the AMT design and for the evaluation of the welfare loss from taxation of small businesses.

Do Doubled-Up Families Minimize Household-Level Tax Burden?

Amy B. O'Hara and Maggie R. Jones (U.S. Census Bureau)

Income tax law is complex, and filers often need to interpret the rules regarding exemptions, deductions, and credits. In this paper, we examine the income tax implications for families who "double up." Doubling up in this case specifically refers to two or more families that combine households for economic reasons and in which there is a familial, rather than a romantic, relationship between two or more family heads. Using the Current Population Survey Annual Social and Economic Supplement (CPS ASEC) linked with 1040 data from the IRS, we examine households with children and at least two adult tax filers to determine whether the household minimizes income tax burden, and thus maximizes refunds, by optimally claiming dependents. We also examine specifically the relationship between the EITC and the sorting of dependent children among filers in households. We find the following: The propensity to sort increases as the number of filers who are potentially eligible for the EITC increases; sorting probability increases as the optimal household EITC amount increases; and among households with at least one EITC-eligible filer, the propensity to sort increases as the difference between modeled household EITC amount and the maximum amount possible increases. We also exploit the 2009 change in EITC benefit for families with three or more children, finding that the propensity to sort to exactly three children increased after the change in the rule. The results of this analysis improve our understanding of filing behavior, particularly how households form filing units, and have implications for poverty measurement in complex households.

RAS Affordable Care Act Microsimulation Model

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Implementation of the Affordable Care Act (ACA) tax provisions imposes significant new responsibilities on the Internal Revenue Service (IRS). To support IRS in understanding administrative impacts of the new legislation, IRS Research, Analysis, and Statistics (RAS) built an administrative model to estimate likely outcomes and workload volume, supported by studies and research. Given the uncertainties surrounding fundamental reform, the model provides a flexible framework in which IRS can conduct 'what if' analysis to estimate plausible estimates of employer-sponsored health insurance (ESI) and other forms of coverage, eligibility for the Premium Tax Credit (PTC), receipt of the Advanced Premium Tax Credit (APTC), and incidence of the Individual Shared Responsibility Payments (ISRP).

Before building a model, IRS explored other large scale health insurance simulation models, including those used by The Congressional Budget Office (CBO) / Joint Committee on Taxation (JCT) and Department of Treasury Office of Tax Analysis (OTA). These models share a common microsimulation approach, which can be broken down into four major elements: Data, Policy, Behavior, and Outcomes. The input data consists of individual records, usually sampled, from population data, administrative records or surveys. The primary data source may append parameters, assumptions or supplementary variables used in prediction. Microsimulation models then encode policy rules, in this case ACA policy provisions, deterministically to assess eligibility and liability. Behavior, such as participation in public programs, can be modeled in various ways, including cell-based imputation, elasticity approaches and/or utility-based equations. A key strength of microsimulation is the variety of outcome measures which can be produced from their rich, micro-level data outputs. The RAS ACA Model is similar to these models with two exceptions: the primary unit of analysis is the tax return and by design, the model has no built-in behavioral model to drive post-ACA transitions.

The RAS ACA Model is built on a nationally representative sample of tax data from Compliance Data Warehouse (CDW). In an innovative sample design, we sampled employers and their employees through a two-stage cluster sampling approach (a total sample of approximately 20,000 employers and 400,000 returns). This allows us to model the distribution of employees associated with a given employer, which can be a critical factor in an employer's decision whether to drop coverage in the presence of the PTC. The tax data contain many characteristics of the return, including preparation method, submission method and enforcement actions. However, they do not include any variables representing health insurance. We therefore perform a series of econometric imputations to assign returns in our sample to one of the following four current day health insurance categories: ESI, Private, Public or Uninsured. Our data source for these imputations is the Annual Social and Economic Supplement (ASEC) of the Current Population Survey (CPS). We rely on tax-based imputations provided in the ASEC to assign households to tax return units; the returns of elderly filers (65 and older) are excluded from our analysis. IRS also seeks to better understand customer service demand, so we enrich the input file with an imputation of service channel usage from the Taxpayer Experience Survey. In the case of employers, we impute ESI offer status based on tabulations of ESI offer rates from the Medical Expenditure Panel Survey Insurance Component (MEPS-IC) along with matched information on employer filings of reports of health insurance plans on their income tax returns and Form 5500.

Under ACA, the key factor in determining coverage will be the available health insurance coverage choices. Therefore, the probability transitions are assigned based on the employer's offering status. Decisions are dependent on household income as well as other characteristics not available for our model, such as health status, risk aversion, religious and social norms and values. Since current day preferences reflect some of these unobserved characteristics, we assign new insurance status conditional on today's insurance status. This is one of many behavior and policy parameters exposed to the model user through an Excel Interface. Analysts can also estimate future marginal increases in service and compliance behavior, as well as state-by-state insurance premiums and Medicaid eligibility levels. Model users can specify parameters, such as the percentage of firms offering by size and type (private, state/local or federal government) in the Excel Interface, or perform more sophisticated scenarios by manually setting the 'offer' levels in SAS. The model runs on a standard desktop in approximately 30-40 minutes.