

## Introduction to Diversity Issues: The IRS Should Do More to Accommodate Changing Taxpayer Demographics

### OVERVIEW

The tax law refers to a generic taxpayer. Yet the taxpayer population has become more diverse over time due to demographic developments as well as expansions in the scope of the tax law. For example:

- The 2010 Census identifies about a quarter of the population as racial minorities, not counting Hispanics, over half of whom are identified as white;<sup>1</sup>
- About a fifth of the U.S. population speaks a language other than English at home;<sup>2</sup> and
- The tax law applies to low income individuals, who make up 15.1 percent of the population.<sup>3</sup>

With a tax return for every couple of people, demographic trends create a question of whether there will continue to be an “average” taxpayer. Against a history of growing population and return volume, the number of returns per IRS employee generally has risen over the past century, while tax law complexity has increased along with automation.<sup>4</sup> Automation works for standard cases, but accommodating the various needs of a diverse taxpayer population has become a challenge for tax administration.

### DISCUSSION

#### Taxpayer Service Has Given Way to Mass Production

When the federal individual income tax was enacted in 1913, it applied to high-income taxpayers. At that time, the predecessor to the IRS began as a hands-on collector of various excise and other taxes. In 1942, Congress enacted the “greatest tax bill in American history” largely to fund the U.S. effort in World War II, expanding the income tax to the middle class.<sup>5</sup> At this juncture, the Treasury made an historic effort to popularize the income tax, and employed tactics such as famously deploying the Disney cartoon character Donald Duck as a mascot of the public fisc.<sup>6</sup> Since then, however, the IRS has not made a parallel effort to popularize the income tax to an increasingly diverse population.

<sup>1</sup> U.S. Bur. of the Census, *Overview of Race & Hispanic Origin*, 2010 Census Brief (Mar. 2011) Table 1 at 4, Table 2 at 6.

<sup>2</sup> Census, 2005-09 AMER. COMM. SURVEY, Table S0501, *Selected Characteristics of the Native and Foreign-born Populations* (relating to population five years and older).

<sup>3</sup> Census, *Income, Poverty and Health Insurance Coverage in the U.S.: 2010* (Sept. 13, 2011).

<sup>4</sup> Since World War II, however, the number of returns per IRS employee has remained relatively steady. See vol. 2, Research Study: *From Tax Collector to Fiscal Automaton: Demographic History of Federal Income Tax Administration, 1913-2011*, *infra*.

<sup>5</sup> See Randolph Paul, *TAXATION IN THE UNITED STATES* (BOSTON: Little, Brown & Co., 1954) 294-318.

<sup>6</sup> See Carolyn Jones, *Class Tax to Mass Tax: The Role of Propaganda in the Expansion of the Income Tax During World War II*, 37 *BUFF. L. REV.* 685 (1989).

In the second half of the last century, the tax system began to be automated. During the same period, women became a more significant taxpayer population.<sup>7</sup> In recent decades, a diverse low income population has become a significant customer base of an increasingly “faceless” IRS.

As set forth later under the subtitle “Demographic History of Federal Income Tax Administration, 1913-2011,”<sup>8</sup> the past century of income tax administration can be characterized as a transformation “From Tax Collector to Fiscal Automaton” because the IRS started as a revenue bureau but now administers social expenditures as well, through highly automated systems.<sup>9</sup> The National Taxpayer Advocate’s last two Annual Reports to Congress have examined aspects of this transformation. The 2009 Annual Report detailed the effects of social benefits administration, which in part involves a low income population.<sup>10</sup> Subsequently, the 2010 Annual Report proposed that the IRS adopt a dual mission statement, in part recognizing the diversity of its customer base.<sup>11</sup> More recently, the National Taxpayer Advocate’s mid-year report recommended “as a tax agency we deal with taxpayers as we find them, with all the vagaries of human existence, *i.e.*, ‘life in all its fullness.’”<sup>12</sup>

In the face of an historical trend toward automation, the National Taxpayer Advocate collaborated with the IRS and its Oversight Board in preparing a Taxpayer Assistance Blueprint in accordance with a 2005 congressional mandate.<sup>13</sup> While this document identifies IRS services of interest to taxpayers, it can be expanded in terms of its profile of taxpayer demographics to determine which services particular populations might need. Given a mission of customer service, it would be logical for the IRS to develop taxpayer profiles by pursuing market segment research, a widely accepted business practice.<sup>14</sup>

### Taxpayers Represent Diverse Demographics

Individual taxpayers are a subset of the U.S. population, characterized by diverse demographic groups. Individual taxpayers filed 141.2 million returns in 2010,<sup>15</sup> when there were

<sup>7</sup> See Edw. McCaffery, *TAXING WOMEN* (Univ. of Chicago Press, 1997).

<sup>8</sup> See vol. 2, Research Study: “*From Tax Collector to Fiscal Automaton: Demographic History of Federal Income Tax Administration, 1913-2011*,” *infra*.

<sup>9</sup> As a leading tax official put it in 1961: “With population growth and a broadened tax base, paperwork threatened to engulf tax administration. In self-defense, more and more attention had to be given to the development of means and methods for improving the processing of the paperwork. Invariably, a key element in this effort was the substitution of mechanical for manual methods of processing data.” Stanley S. Surrey, *Automatic Data Processing and Tax Administration: The Potentialities of ADP & Factors Involved in its Adoption*, *TAX POL’Y & TAX REFORM, 1961-1969: SELECTED SPEECHES & TESTIMONY*, ed. Wm. Hellmuth & Oliver Oldman (Chicago: Commerce Clearing House, 1973) 497-98.

<sup>10</sup> National Taxpayer Advocate 2009 Annual Report to Congress vol. 2 at 75 (Research Study: *Running Social Programs Through the Tax System*).

<sup>11</sup> National Taxpayer Advocate 2010 Annual Report to Congress 15 (Most Serious Problem: *The IRS Mission Statement Does Not Reflect the Agency’s Increasing Responsibilities for Administering Social Benefits Programs*); see also vol. 2 at 101 (Research Study: *Evaluate the Administration of Tax Expenditures*).

<sup>12</sup> National Taxpayer Advocate FY 2012 Objectives Report to Congress x; *Welch v. Helvering*, 290 U.S. 111, 115 (1933) (Cardozo, J.) (“The standard set up by the statute is not a rule of law; it is rather a way of life. Life in all its fullness must supply the answer to the riddle.”)

<sup>13</sup> IRS Pub. 4525, *The 2006 Taxpayer Assistance Blueprint*.

<sup>14</sup> See, e.g., Dennis Adcock, Al Halborg & Caroline Ross, *MARKETING: PRINCIPLES & PRACTICE* 4th ed. (Prentice Hall, 2001).

<sup>15</sup> IRS Pub. 55B, *Data Book* (2010) Table 2, Number of Returns Filed, by Type of Return, Fiscal Years 2009 and 2010, at 4.

308.7 million people in the United States according to the 2010 census.<sup>16</sup> With a tax return for about every two people, demographic trends are likely to have an impact on taxpayer service needs, and may fall into categories such as ethnicity, economics, gender, age, geography, and other characteristics.

### *Ethnic Groups*

About an eighth of the U.S. population is foreign-born,<sup>17</sup> about a fifth of the population speaks a language other than English at home, and 8.6 percent speak English less than “very well.”<sup>18</sup> Spanish is spoken in the homes of about 12 percent of the population.<sup>19</sup> According to the 2010 census, the Hispanic or Latino population is 16.3 percent of the country as a whole, while Asians make up 4.8 percent.<sup>20</sup> Consequently, English is not the vernacular for a significant number of taxpayers. As an economic matter, Hispanics are overrepresented in agricultural, construction, and maintenance occupations.<sup>21</sup>

The black or African-American population represents 12.6 percent of the U.S.<sup>22</sup> In combination, the American Indian, Alaska Native, Native Hawaiian, and other Pacific Islander population is more than one percent.<sup>23</sup> Historically, these populations have been concentrated in certain inner-city or rural communities which in turn may have characteristic needs, especially concerning media of communication.<sup>24</sup>

### *Economic Groups*

The U.S. population in poverty is 15.1 percent.<sup>25</sup> This population may be significant for tax provisions for low income taxpayers, like the Earned Income Tax Credit (EITC).<sup>26</sup>

In tax year (TY) 2008, 22.6 million sole proprietors owned businesses other than farming.<sup>27</sup> In calendar year (CY) 2007, 1.7 million farmers filed Schedule F, *Profit or Loss from Farming*, with the IRS.<sup>28</sup> In 2010, there were approximately 422,000 tax-exempt

<sup>16</sup> Census, *Population Distribution & Change: 2000 to 2010*, 2010 Census Brief (Mar. 2011).

<sup>17</sup> Census, 2005-09 AMER. COMM. SURVEY, Table S0501, *Selected Characteristics of the Native and Foreign-born Populations*.

<sup>18</sup> *Id.*

<sup>19</sup> Census, 2005-09 AMER. COMM. SURVEY, Table S1601, *Language Spoken at Home*.

<sup>20</sup> Census, *Overview of Race & Hispanic Origin*, 2010 Census Brief (Mar. 2011) Table 1 at 4.

<sup>21</sup> CENSUS, STATISTICAL ABSTRACT OF THE U.S. (2011) Table 36 at 40-41, *Selected Characteristics of Racial Groups & Hispanic Population: 2008*.

<sup>22</sup> Census, *Overview of Race & Hispanic Origin*, 2010 Census Brief (Mar. 2011) Table 1 at 4.

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

<sup>24</sup> Census, *We the Americans: Blacks* (Sept. 1993) 3; Census, *We the People: American Indians and Alaska Natives in the U.S.* (Feb. 2006) 14; see also National Taxpayer Advocate 2008 Annual Report to Congress 95, 99-100 (Most Serious Problem: *Bringing Service to the Taxpayer*) (praising IRS outreach to Indian Tribal taxpayers).

<sup>25</sup> Census, *Income, Poverty and Health Insurance Coverage in the U.S.: 2010* (Sept. 13, 2011).

<sup>26</sup> IRC § 32.

<sup>27</sup> IRS Statistics of Income (Sol), Table 1, *Nonfarm Sole Proprietorships: Business Receipts, Selected Deductions, Payroll, & Net Income, by Indus. Sectors* (TY 2008), <http://www.irs.gov/taxstats/indtaxstats/article/0,,id=134481,00.html>.

<sup>28</sup> IRS Sol, Table 21, *Selected Returns & Forms Filed or to Be Filed by type During Specified CYs*, <http://www.irs.gov/taxstats/article/0,,id=175902,00.html>.

organizations with annual gross receipts under \$25,000.<sup>29</sup> These groups represent small businesses, including non-profit enterprises, that are the target of certain provisions, like the recently enacted health-care credit for small employers.<sup>30</sup>

Individuals who have low incomes or own small businesses represent disparate economic groups. In either case, they are taxpayers who may need particular assistance in complying with their tax requirements.

### *Gender-Related Groups*

In TY 2008, 37.7 percent of individual returns were filed jointly by married couples (including surviving spouses).<sup>31</sup> Consequently, over a third of individual taxpayers could fall into an “innocent spouse” situation. Historically, tens of thousands of taxpayers have filed Form 8857, *Request for Innocent Spouse Relief*, each year.<sup>32</sup>

More than five percent of U.S. households consist of unmarried partners; 4.9 percent are opposite-sex and 0.6 percent are same-sex partners.<sup>33</sup> While unmarried partners may share costs of living, they must segregate their income and expenses for tax purposes.

### *Other Populations*

The 2010 Census reports that 13 percent of the U.S. population is age 65 or over,<sup>34</sup> while earlier data show that 12 percent have a disability.<sup>35</sup> Seventy-nine percent of the U.S. population lives in urban areas, with 21 percent in rural areas.<sup>36</sup> Most of the former, or 68.3 percent of the population, are in central places within the urban areas.<sup>37</sup> For each of these groups, particular means of communication may be more effective than others.

### **Taxpayers Have a Typology of Needs**

Reviews of demographic characteristics of the population may indicate particular needs for taxpayer service, which in turn facilitates compliance with the tax law. Put another way, noncompliance may be averted by addressing tendencies where they arise in the taxpayer community. Which type of tax enforcement or service action will be most effective depends on whether the noncompliance is intentional (or purposeful), inadvertent, or

<sup>29</sup> Katie L. Roeger, *Small Nonprofit Organizations: A Profile of Form 990-N Filers*, Urban Inst. (Aug. 2010) Table 1 at 2.

<sup>30</sup> IRC § 45R.

<sup>31</sup> IRS Pub. 1304, *Individual Income Tax Returns* (2008) Table 1.6 at 75.

<sup>32</sup> National Taxpayer Advocate 2005 Annual Report to Congress 329 (Most Serious Problem: *Innocent Spouse Claims*); see also Status Update: *The IRS Has Removed the Two-Year Deadline for Requesting Equitable Innocent Spouse Relief But Further Adjustments to its Procedures in Innocent Spouse Cases Are Warranted, infra*.

<sup>33</sup> Census, 2005-2009 AMER. COMM. SURVEY, Table S1101, *Households & Families*.

<sup>34</sup> Census, *Age & Sex Composition*, 2010 Census Brief (May 2011) Table 1 at 2.

<sup>35</sup> Census, 2009 AMER. COMM. SURVEY, *Selected Social Characteristics in the U.S.*

<sup>36</sup> Census, STATISTICAL ABSTRACT OF THE U.S. (2011) Table 29 at 36, *Urban & Rural Population by State: 2000*.

<sup>37</sup> Census, 2000 Summary File 1, Matrix P1, Table GCT-P1, *Urban/Rural & Metropolitan/Nonmetropolitan Population*; Census, *Urban and Rural Definitions* (Oct. 1995) (stating that an urban area “comprises one or more places (‘central place’) and the adjacent densely settled surrounding territory (‘urban fringe’) that together have a minimum of 50,000 persons”).

somewhere in between. To represent that spectrum or continuum of noncompliance, researchers have offered a typology of noncompliance encompassing eight types of behavior as follows.<sup>38</sup>

Even if noncompliance is intentional, distinguishing among five types of behavior may sharpen the response of the tax administrator. For “asocial” noncompliance motivated by economic gain, traditional deterrence measures that make the cost of noncompliance outweigh the benefit should mitigate this behavior. For “habitual” or knowing repetition of previous noncompliance, an effective enforcement action could break this cycle.

However, three other types of intentional noncompliance require more nuanced responses. For “symbolic” noncompliance due to a perception of the law or the IRS as unfair, enforcement could exacerbate the perception, while education (or even procedural or legislative change) could adjust it. For “social” noncompliance that accords with social norms or peer behavior, outreach to a whole community may be more effective than enforcement with respect to an individual whose reference group remains unchanged. Finally, “brokered” noncompliance mediated by professional advice is the most complex type of intentional behavior because it incorporates a third party, but by the same token, it offers the most leverage for the IRS, which can regulate tax return preparers.<sup>39</sup>

For inadvertent noncompliance, there are two types. “Unknowing” noncompliance is due to misunderstanding of rules, while “procedural” noncompliance is due to failure to follow complex processes, such as quarterly filing and tax deposit requirements. In both cases, education or procedural simplification may be the most effective response.

Between intentional and inadvertent noncompliance is “lazy” failure to follow burdensome requirements, such as recordkeeping. In this case, help may come from improved systems, an outstanding legislative example of which would be cost-basis reporting by brokers.<sup>40</sup>

Certain types of noncompliance may be characteristic of particular populations. For example, ethnic groups characterized by limited English proficiency and low income groups with literacy challenges may unknowingly miss substantive or procedural requirements.<sup>41</sup> Further, these populations may become dependent on tax preparers to translate English as well as “legalese.” In fact, EITC taxpayers are more likely than individual taxpayers in

<sup>38</sup> See Rob’t Kidder & Craig McEwen, *Taxpaying Behavior in Social Context: A Tentative Typology of Tax Compliance & Noncompliance*, 2 *TAXPAYER COMPLIANCE* 47 (1989); Leslie Book, *The Poor & Tax Compliance: One Size Does Not Fit All*, 5 *KANS. L. REV.* 1145 (2003).

<sup>39</sup> See IRS Pub. 4832, *Return Preparer Review* (Dec. 2009); National Taxpayer Advocate 2008 Annual Report to Congress 423 (Legislative Recommendation: *The Time Has Come to Regulate Federal Tax Return Preparers*).

<sup>40</sup> See IRC § 6045 as amended by Pub. L. No. 110-363 (2008); National Taxpayer Advocate 2005 Annual Report to Congress 433 (Legislative Recommendation: *Requiring Brokers to Track and Report Cost Basis for Stocks and Mutual Funds*).

<sup>41</sup> See Leslie Book, *The IRS’s EITC Compliance Regime: Taxpayers Caught in the Net*, 81 *ORE. L. REV.* 351, 393-405 (2002).

general to use preparers.<sup>42</sup> At the same time, recent immigrant populations may harbor a distrust of government, and may even perceive Volunteer Income Tax Assistance (VITA), a volunteer program sponsored by IRS, as an arm of the government.<sup>43</sup> Thus, “brokered noncompliance” also can become a factor for these groups.

For small businesses, “laziness” in recordkeeping (among other factors) can give rise to non-compliance.<sup>44</sup> Likewise, married or unmarried couples may not document their individual income and expenses when they share a household.<sup>45</sup>

Moreover, the tax law’s characterization of couples as either single or married may not adequately capture the economic reality of innocent spouses, domestic partners, persons of the opposite sex sharing living quarters, or inter-generational households. Because IRS programs and materials may not accurately characterize certain populations of taxpayers, they may not receive adequate tax treatment. For example, a Treasury Regulation requires a taxpayer who receives an information report on interest from a joint account to issue a Form 1099-INT, *Interest Income*, as to the joint owner, unless he or she is a spouse.<sup>46</sup> This regulation may be unrealistic for various types of joint owners, such as adult children who access accounts for elderly parents. Individuals who do not have the skills to file information returns may not find it worthwhile to acquire those skills only for a personal asset owned with another member of the household.

Finally, noncompliance by failure to pay may be characteristic of low income populations that historically have been racially marked. Blacks and Hispanics have been almost twice as likely as the general population to fall below the poverty level.<sup>47</sup> With respect to taxation, researchers have found that African-Americans and Hispanics are subject to enforcement actions (particularly liens) at double the rate of the general population.<sup>48</sup> Assuming that the IRS does not intend to discriminate, characteristic types of income or transactions may be more prevalent in particular populations.

For example, an academic analysis of census data has shown that “African-American households are more likely to pay a marriage penalty and White households are more likely to

<sup>42</sup> About two-thirds of tax returns claiming EITC benefits are completed by preparers rather than by the taxpayers themselves, while generally, 60 percent of individual taxpayers pay preparers. See IRS EITC Prep. Ofc., *EITC Summary of Vital Statistics* (May 2011); IRS Compliance Data Warehouse, *Individual Returns Transaction File* (TY 2008); Geo. Contos, John Guyton, Patrick Langetieg & Melissa Vigil, *Individual Taxpayer Compliance Burden: The Role of Assisted Methods in Taxpayer Response to Increasing Complexity* 7, IRS Research Conf. (June 2010).

<sup>43</sup> See 81 ORE. L. REV. at 401-402.

<sup>44</sup> Pres. Advisory Panel on Fed. Tax Reform, *Simple, Fair, & Pro-Growth: Proposals to Fix America’s Tax System* (Nov. 2005) 51 (“recordkeeping burdens and accounting rules are especially onerous for small businesses”).

<sup>45</sup> See Anthony Infanti, *The Internal Revenue Code as Sodomy Statute*, 44 STA. CLARA L. REV. 763 (2004).

<sup>46</sup> See Treas. Reg. § 1.6049-4(f)(4)(i).

<sup>47</sup> In 2010, 27.4 and 26.6 percent of Blacks and Hispanics, respectively, but only 15.1 percent of the whole population, were in poverty. See Census, *Income, Poverty and Health Insurance Coverage in the U.S.: 2010* (Sept. 13, 2011) Table B.

<sup>48</sup> *Blacks & Hispanics Face IRS Enforcement Actions at Double the Rate of General Population, Taxlifeboat Finds: Possible Discrimination Unintended Consequence of Automation & Increased Emphasis on Enforcement Rather than Services*, BUSINESS WIRE (Dec. 2, 2010).



receive a marriage bonus.”<sup>49</sup> This is because of “the significantly high percentage of African-American wives who contribute between 40 and 60 percent to total household income.”<sup>50</sup> Differential taxation follows from socio-economic characteristics of the population.

In any case, if inability to pay becomes an accepted pattern in economically downtrodden areas, it could become a form of social noncompliance, if not habitual for individuals. As TAS previously has reported, low income taxpayers need service in structuring payment plans even though they have relatively small liabilities.<sup>51</sup>

### **Means of Communication May Exclude Distinct Populations.**

In view of taxpayer demographics, there appears to be a significant population for whom English is a second language. Similarly, there are groups for which the Internet may be an ineffective means of communication. The medium or means of communication that the IRS uses to transmit information is crucial because tax administration depends on dissemination and collection of accurate information. Effective tax administration will use communication methods that taxpayers can understand.

Certain taxpayers whose first language is not English disproportionately use preparers.<sup>52</sup> This suggests that these taxpayers need preparers not only for tax advice but simply for translation, which would be consistent with the personal experience of TAS staff with un-enrolled but bilingual preparers. To the extent that the IRS does not translate tax forms or other information, taxpayers with limited English proficiency bear an extra cost to comply with their tax obligations.

Historically, the IRS has been able to leverage human resources through automation, modernizing through electronic communication. Nevertheless, statistics show that the Internet may not reach all populations. In particular, low income, less educated, minority, elderly, disabled, or rural populations are less likely than others to use the Internet as discussed below.

Only 40 percent of the population with income under \$30,000 has a broadband connection at home, compared to 87 percent of those with income of \$75,000 or more.<sup>53</sup> Similarly, 56 percent of low income Internet users have visited a government website at the local, state,

<sup>49</sup> See Dorothy A. Brown, *The Marriage Penalty/Bonus Debate: Legislative Issues in Black & White*, 16 N.Y.L. SCH. J. HUMAN RIGHTS 287 (1999).

<sup>50</sup> 16 N.Y.L. SCH. J. HUMAN RIGHTS at 294.

<sup>51</sup> See National Taxpayer Advocate 2006 Annual Report to Congress 141 (Most Serious Problem: *Collection Issues of Low Income Taxpayers*).

<sup>52</sup> See IRS, *Multilingual Initiative Customer Base Report* (FY 2006) 159, 214 (reporting that over 66 percent of low English proficiency survey respondents use a tax preparer (even though, with the exception of EITC claims, their relatively low incomes would indicate “simple” filing); 53 percent of Spanish speakers would have used a paid preparer if VITA services were not available compared to only 11 percent for English speakers). Overall, about 60 percent of individuals pay preparers. See IRS Compliance Data Warehouse, Individual Returns Transaction File (TY 2008); George Contos, John Guyton, Patrick Lange-tieg & Melissa Vigil, *Individual Taxpayer Compliance Burden: The Role of Assisted Methods in Taxpayer Response to Increasing Complexity 7* (presented at IRS Research Conference, June 2010).

<sup>53</sup> Jim Jansen, *Use of the Internet in Higher-Income Households*, Pew Research Ctr. (Nov. 24, 2010), Fig. 1 at 2.

or federal level, versus 79 percent of the high income group.<sup>54</sup> There is no Internet use at home for 67.8 percent of the population that did not graduate from high school, compared to only 25.3 percent for those who attended college.<sup>55</sup> In 2010, 56 percent of African-Americans were broadband users, compared to 67 percent of whites.<sup>56</sup> In 2009, only 31 percent of the population over age 72, and 56 percent of those from 64 to 72, were online, whereas 74 percent of all adults were online.<sup>57</sup> Only 41 percent of adults reporting certain disabilities have broadband at home, compared to 69 percent of those without a disability; similarly, 54 percent of disabled adults use the Internet, compared to 81 percent of other adults.<sup>58</sup> In 2010, half of rural adults subscribed to broadband at home, compared to 70 percent of non-rural adults.<sup>59</sup>

While information technology may be an inevitable sign of progress, modernization that neglects traditional means of communication, including face-to-face, paper, and telephone contact, may have the side effect of excluding distinct populations. No wonder that 56 percent of Americans believe that lack of broadband is a major or minor disadvantage when it comes to using government services, while only 37 percent think it is “not a disadvantage.”<sup>60</sup> As TAS previously recommended, demographic research is necessary to determine taxpayer needs, because “the IRS cannot forego offering services to groups of taxpayers who are difficult or costly to serve.”<sup>61</sup>

Moreover, mere access to home broadband does not guarantee skill at searching the Internet for tax rules, rights, or remedies. At the same time, some of the population without home broadband may be likely to use a land-line or cellular telephone instead.<sup>62</sup>

## SUMMARY

The IRS often does not address taxpayer needs by market segment because the problem of population dynamics is overarching while the IRS is organized around administration of particular provisions. Yet the discussion above shows a need to meet taxpayers where they are. Prior National Taxpayer Advocate reports to Congress suggested or offered a basis for

<sup>54</sup> *Use of the Internet in Higher-Income Households* 5.

<sup>55</sup> CENSUS, CURRENT POPULATION SURVEY (Oct. 2009), *Reported Internet Usage for Households by Selected Householder Characteristics*.

<sup>56</sup> Aaron Smith, *Home Broadband 2010*, Pew Research Ctr. (Aug. 11, 2010) 2.

<sup>57</sup> Sydney Jones & Susannah Fox, *Generations Online in 2009*, Pew Research Ctr. (Jan. 28, 2009) 5.

<sup>58</sup> Susannah Fox, *Americans Living with Disability & Their Technology Profile*, Pew Research Ctr. (Jan. 21, 2011) 3.

<sup>59</sup> *Home Broadband 2010*, 8.

<sup>60</sup> *Id.* at 3.

<sup>61</sup> National Taxpayer Advocate 2006 Annual Report to Congress vol. 2, 13 (*Study of Taxpayer Needs, Preferences, & Willingness to Use IRS Services*).

<sup>62</sup> See Forrester Research, Inc., *North American Technographics Benchmark Survey Q2/Q3, 2011* (U.S., Canada), July 2011 (indicating that about 70 percent of low-income individuals have a mobile telephone).



the following administrative and legislative recommendations to help address the needs of diverse populations:

1. **Translate Tax Forms for Identified Linguistic Groups.** Translate Form 656, *Offer in Compromise*, and the statutory notice of deficiency into Spanish, while reviewing needs of other linguistic groups for further translation.<sup>63</sup> As discussed above, the Spanish-speaking population overlaps with the low income population that needs help structuring payment of small liabilities. As TAS previously recommended, IRS documents that are “vital” for translation include any document that affects taxpayer rights, provides taxpayer protection, or proposes to assess a tax or levy on taxpayer property.<sup>64</sup> These documents include Form 12153, *Request for a Collection Due Process or Equivalent Hearing*. When various linguistic groups immigrate into the U.S., different translation needs may arise.
2. **Educate Small Businesses in Person as well as Online.** While the IRS has an excellent online Virtual Small Business Tax Workshop, this electronic presentation is unlikely to reach proprietors in populations with low Internet penetration.<sup>65</sup> As these proprietors may be engaged in the cash economy, targeted face-to-face workshops could be a worthy investment.<sup>66</sup>
3. **Conduct Targeted Outreach to Increase Take-up Rate for Special Tax Provisions.** Develop a pilot program to better communicate about special tax benefits in which participation is key, *e.g.*, health-care provisions under the Patient Protection and Affordable Care Act of 2010.<sup>67</sup> While the traditional mission of the IRS was to collect tax, now the IRS administers several special tax breaks that effectively disburse social benefits to target populations (*e.g.*, small businesses or low income taxpayers). A measure of success for such programs is their take-up rate, which means that the IRS must not only counsel compliance with the tax law but also encourage participation by taxpayers, many of whom may not otherwise have to file returns. This new outreach program, with front-line responsibility for the take-up rate, would dovetail with the dual mission statement for the IRS previously recommended by the National Taxpayer Advocate. A good example of outreach is a pilot program in which the IRS is collaborating with TAS to improve communication with EITC taxpayers.<sup>68</sup>
4. **Revise Guidance on Joint Property for Diverse Family Situations.** Revise guidance on joint or custodial accounts for benefit of elderly, disabled, or unmarried taxpayers. As discussed above, existing regulations may be unrealistic for a taxpayer who receives

<sup>63</sup> See IRM 4.8.9.8 (June 14, 2011) (describing notice of deficiency).

<sup>64</sup> National Taxpayer Advocate 2006 Annual Report to Congress 333 (Most Serious Problem: *Limited English Proficient (LEP) Taxpayers: Language & Cultural Barriers to Tax Compliance*).

<sup>65</sup> Pub. 1066-C.

<sup>66</sup> See National Taxpayer Advocate 2007 Annual Report to Congress 38 (Most Serious Problem: *The Cash Economy*) (“Although such education can be resource intensive, the IRS can leverage its resources by first using research to identify common small business errors that significantly contribute to the tax gap as well as those taxpayers who are most likely to make such errors and most likely to respond to workshops rather than other types of outreach”).

<sup>67</sup> Pub. L. No. 111-148.

<sup>68</sup> See National Taxpayer Advocate FY 2012 Objectives Report to Congress xxii.

an information return on income held jointly or custodially for another member of the household. Regulations should reflect the economic reality of a taxpayer's household. While household members other than spouses may not necessarily be recognized under the tax law, it should be possible to recognize certain classes by reference to state law, such as parents who are senior citizens, persons with disabilities, or registered domestic partners.<sup>69</sup>

5. **Allow Withholding for Economic Groups Not Incorporated into the Class of Wage Earners.** A previous TAS legislative recommendation would allow voluntary withholding for workers who are classified as independent contractors.<sup>70</sup> As discussed above, low income workers may become chronically unable to pay taxes, a situation that may be exacerbated if their employers classify them as contractors who are not subject to withholding. This classification may be a practice in certain industries, like agriculture, construction, and maintenance, in which certain populations, namely Hispanics, are disproportionately employed.<sup>71</sup> Voluntary withholding is a systematic mechanism that could remedy the problem (and eliminate some if not all of the incentive to misclassify such workers).<sup>72</sup>
6. **Expand the IRS Mission to Encompass Social Benefits Embedded in the Tax Law.** As previously recommended in connection with the dual mission statement, appoint a Deputy Commissioner for social benefits.<sup>73</sup> Pending appointment, undertake the following initiatives that ultimately will come under the new Deputy Commissioner:
  - Expand demographic analysis in the work of the IRS, and train more IRS personnel to use market segmentation techniques to paint useful portraits of taxpayer groups.
  - Update and expand the Taxpayer Assistance Blueprint regarding the needs and preferences of individuals as well as small enterprises, both for- and not-for-profit.<sup>74</sup>

<sup>69</sup> See National Taxpayer Advocate 2010 Annual Report to Congress 391 (Most Serious Problem: *State Domestic Partnership Laws Present Unanswered Federal Tax Questions*).

<sup>70</sup> National Taxpayer Advocate 2005 Annual Report to Congress 391 (Legislative Recommendation: *Measures to Reduce Noncompliance in the Cash Economy*).

<sup>71</sup> Steven F. Hipple, *Self-employment in the U.S.*, MONTHLY LABOR REV., U.S. Bur. of Labor Stats. (Sept. 2010) 17 ("self-employment continues to be more common . . . in the agriculture, construction, and services industries"); Census, STATISTICAL ABSTRACT OF THE U.S. (2011) Table 36 at 40-41, *Selected Characteristics of Racial Groups & Hispanic Population: 2008*.

<sup>72</sup> Another cash economy measure is S. 974, the Small Business Tax Equalization and Compliance bill (112th Cong.), which would extend the IRC § 45B credit for Social Security tax on cash tips now allowed in the restaurant industry to the cosmetology or beauty industry, with corresponding information reports.

<sup>73</sup> See National Taxpayer Advocate 2010 Annual Report to Congress 15 (Most Serious Problem: *The IRS Mission Statement Does Not Reflect the Agency's Increasing Responsibilities for Administering Social Benefits Programs*).

<sup>74</sup> See National Taxpayer Advocate 2006 Annual Report to Congress 172 (Most Serious Problem: *Small Business Outreach*) & vol. 2 (*Study of Taxpayers' Needs, Preferences, and Willingness to Use IRS Services*); National Taxpayer Advocate 2007 Annual Report to Congress 197 (Most Serious Problem: *Exempt Organization Outreach and Education*); National Taxpayer Advocate 2008 Annual Report to Congress 95 (Most Serious Problem: *Bringing Service to the Taxpayer*).

- Systematically analyze proposed or recently enacted legislation in terms of its target population to minimize burden and determine taxpayer service needs.<sup>75</sup>
- Form partnerships with agencies that have subject-matter expertise in relevant social programs, such as the Department of Health and Human Services.
- Evaluate the effectiveness of delivery of benefits and participation by eligible taxpayers as well as compliance.

With respect to diverse taxpayers, the Most Serious Problems described below are detailed in the following pages:

- Certain improvements in EITC service could enhance compliance as well as participation, which is essential for a provision that funds basic living expenses.
- Accelerated third-party reporting and pre-populated returns could address procedural and “lazy” noncompliance.
- Taxpayers who are victims of domestic violence and are kept in the dark at home about financial and tax matters need to be served by IRS employees trained to understand their circumstances.
- A telephone system for filing tax returns (TeleFile, as recommended by TAS last year), along with other demographically appropriate electronic preparation and filing options, could relieve the IRS from processing paper returns, even as distinct groups are unlikely to use the Internet.<sup>76</sup>

<sup>75</sup> See National Taxpayer Advocate 2009 Annual Report to Congress vol. 2, 75 (Research Study: *Running Social Programs Through the Tax System*); cf. National Taxpayer Advocate 2010 Annual Report to Congress vol. 2, 116 ff. (Research Study: *Evaluate the Administration of Tax Expenditures*).

<sup>76</sup> See National Taxpayer Advocate 2010 Annual Report to Congress vol. 2, 122 (Research Study: *TeleFile – Taxpayers’ Characteristics and Filing Behaviors: A Study to Enhance Taxpayer Assistance Blueprint Knowledge*).

MSP  
#13**Accelerated Third-Party Information Reporting and Pre-Populated Returns Would Reduce Taxpayer Burden and Benefit Tax Administration But Taxpayer Protections Must Be Addressed****RESPONSIBLE OFFICIALS**

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**DEFINITION OF PROBLEM**

Taxpayers face considerable compliance burdens and incur significant costs when preparing even simple tax returns. Much of the data needed for return preparation is supplied to the IRS by third-party reporting. This data remains unprocessed and unused for verification long after taxpayers file their returns and the IRS releases refunds. To reduce taxpayer burden, the IRS can follow the lead of other domestic and international tax agencies by enabling taxpayers to download third-party data directly into their return preparation software or even access a return pre-populated with such data. Both taxpayers and the IRS would benefit from the anticipated reduction in inadvertent noncompliance and the associated downstream costs.

While the benefits of incorporating information reporting data into the filing season are significant, concerns remain about the accuracy of the third-party data and the manner in which the IRS will make adjustments based on that data. Thus, before implementing accelerated information reporting, the IRS must develop procedures that provide taxpayers with the standard taxpayer rights that accrue during an examination, including adequate notice and an opportunity to contest the proposed adjustment administratively and in Tax Court.<sup>1</sup>

**ANALYSIS OF PROBLEM****Background - Third-Party Data Processing**

Forms *W-2*, *Wage and Tax Statement*, and most Forms 1099, *U.S. Information Return*, must be issued to the taxpayer by January 31. Under present law, issuers who file these forms electronically have another two months (until March 31) to file the forms with the government. Issuers send Forms 1099 directly to the IRS and Forms *W-2* directly to the Social Security Administration (SSA), which in turn sends information extracted from the forms to the IRS each week, starting in January.<sup>2</sup>

<sup>1</sup> Introduction to Revenue Protection Issues: *As the IRS Relies More Heavily On Automation to Strengthen Enforcement, There is Increased Risk it Will Assume Taxpayers Are Cheating, Confuse Taxpayers About Their Rights, and Sidestep Longstanding Taxpayer Protections*, *supra*.

<sup>2</sup> IRC §§ 6051(a), 6049(a), 6042(a); see IRS Instructions for Forms *W-2* and *W-3*, *Wage and Tax Statement and Transmittal of Wage and Tax Statements*; Social Security Administration, *Employer W-2 Filing Instructions & Information*, available at <http://www.ssa.gov/employer/gen.htm> (last visited Aug. 25, 2011); IRS, *Seven-Day Response to Most Serious Problem: Accelerated Third Party Info Reporting* (Nov. 17, 2011).

The IRS generally holds all third-party data until mid-May (after the filing season), when it downloads its Information Returns Master File (IRMF) database.<sup>3</sup> The IRS currently has initiatives studying the possibility of obtaining Form W-2 data from the SSA earlier to enable the IRS to match tax return data on potentially non-compliant returns by the third week in March.<sup>4</sup>

The IRS uses third-party reporting data to verify information reported on returns. The Automated Underreporter (AUR) program compares amounts shown on a taxpayer's return with third-party reports such as Forms W-2 and 1099s that have been uploaded to the IRMF.<sup>5</sup> For example, AUR matches wages shown on a Form W-2 with wages reported on a return, and interest shown on a Form 1099-INT, *Interest Income*, with interest reported on a return.<sup>6</sup>

### Compliance Rationale for Third-Party Reporting

Tax gap data illustrates that tax compliance is highest when IRS procedures make it simple. For example, withholding and third-party information reporting, which make it easier to report income and pay taxes, are key drivers of compliance.<sup>7</sup> Reporting compliance rates are about 99 percent on wages subject to withholding and third-party information reporting, about 96 percent on income subject to full third-party information reporting (*e.g.*, interest and dividends) — yet less than 50 percent on income not subject to third-party information reporting.<sup>8</sup> When a taxpayer receives a copy of an information reporting document showing income already reported by a third party to the IRS, the taxpayer expects the IRS to notice if the income is omitted from the return. Thus, “deterrence” likely accounts for some of these results.

Perhaps just as importantly, however, information reporting reduces one type of procedural burden — the complexity of determining what income should be reflected on the return. In addition, third-party reporting may facilitate recordkeeping for a taxpayer.<sup>9</sup> On the other hand, preparation of an information report is an incremental burden on the third party that has to prepare and file it. Because of the impact of reporting on compliance, Congress

<sup>3</sup> IRM 5.19.4.3.5(6).

<sup>4</sup> IRS, Overview of the Accelerated Refund Assurance Program (ARAP), Slide 8 (Oct. 6, 2011); IRS, PRP ESC, Slide 17 (July 25, 2011); IRS, Seven-Day Response to Most Serious Problem: *Accelerated Third Party Info Reporting* (Nov. 17, 2011).

<sup>5</sup> IRM 4.19.3.1.

<sup>6</sup> See National Taxpayer Advocate 2009 Annual Report to Congress 338-345.

<sup>7</sup> For additional discussion of the importance of third-party information reporting in prior testimony, see, *e.g.*, *The Tax Gap and Tax Shelters*, Hearing Before the Senate Comm. on Finance (July 21, 2004) (statement of Nina E. Olson, National Taxpayer Advocate); *The Causes of and Solutions to the Federal Tax Gap*, Hearing Before the Senate Comm. on the Budget (Feb. 15, 2006) (statement of Nina E. Olson, National Taxpayer Advocate); *The Tax Gap*, Hearing Before the Senate Subcomm. on Federal Financial Management, Government Information, and International Security Comm. on Homeland Security and Governmental Affairs (Sept. 26, 2006) (statement of Nina E. Olson, National Taxpayer Advocate); *The Causes of and Solutions to the Federal Tax Gap*, Hearing Before the Senate Comm. on the Budget (Feb. 15, 2006) (statement of Nina E. Olson, National Taxpayer Advocate); *The IRS and the Tax Gap*, Hearing Before the H. Comm. on the Budget (Feb. 16, 2007) (statement of Nina E. Olson, National Taxpayer Advocate).

<sup>8</sup> See IRS, Tax Gap Map for Year 2001 (Feb. 2007).

<sup>9</sup> Data show that information reporting dramatically increases the accuracy of taxpayer returns. See IRS, *Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance* 15 (Aug. 2, 2007).

over the years has required it where benefits of reporting outweigh the burdens on payers/reporters. However Congress has also repealed reporting where burden outweighs compliance benefits.<sup>10</sup>

### **Late Processing of Third-Party Data Harms Both Taxpayers and Tax Administration.**

The IRS receives and processes third-party data long after the taxpayer has filed the tax return and the IRS has released any associated refunds. The current system of “pay refunds first, verify later” harms taxpayers and undermines tax compliance. From a taxpayer perspective, the process leads to inadvertent overclaims that the IRS does not identify until months later, exposing the taxpayer to mounting penalties and interest. From a tax administration perspective, the system leads to payment of unwarranted refunds that the IRS must spend resources to recover. If the IRS processed third-party information returns before filing deadlines or, at the very latest, before the IRS releases refunds, it would spare taxpayers unnecessary assessment and collection action, stop more questionable claims, and collect more revenue.<sup>11</sup>

### **How the IRS Could Improve Taxpayer Electronic Access to Third-Party Information.**

Providing taxpayers with timely electronic access to third-party data will require the IRS to overhaul its current system of processing third-party reporting information and document matching. We propose the IRS evaluate the feasibility of taking the following steps:

#### *Expedite the Processing of Information Returns by Eliminating the Extra Month Provided to E-Filers and Imposing Stricter E-File Mandates.*

To provide taxpayers and the IRS with access to third-party data before the return filing deadline, the IRS must receive information returns earlier in the process. While the IRS should assess and consider the burden imposed on third-party reporters, it seems reasonable, given modern technology, to expect employers and financial institutions to be able to file reports with the government at the same time they issue them to employees and customers – on January 31.<sup>12</sup>

In addition to receiving the reports earlier, the IRS could process the information quicker if it received the returns electronically. The IRS currently encourages all third-party reporters

<sup>10</sup> Patient Protection and Affordable Care Act of 2010 would have required businesses to issue 1099 forms to other corporations from whom they purchased more than \$600 of goods and services in a single fiscal year. This was a significant expansion of the reporting requirements and was seen by many as a huge burden on businesses, particularly small businesses. On April 14, 2011, the Comprehensive 1099 Taxpayer Protection and Repayment of Exchange Subsidy Overpayments Act of 2011 was signed into law, repealing the reporting requirements. Pub. L. No. 112-9, 125 Stat. 36 (2011). See National Taxpayer Advocate 2010 Annual Report to Congress 373 (Legislative Recommendation: *Repeal Information Reporting on Purchases of Goods but Require Reporting on Corporate and Certain Other Payments*).

<sup>11</sup> See National Taxpayer Advocate 2009 Annual Report to Congress 338-345.

<sup>12</sup> Many countries have early filing deadlines for third-party reporting. See, OECD, *Using Third Party Information Reports to Assist Taxpayers Meet their Return Filing Obligations – Country Experiences With the Use of Pre-populated Personal Tax Returns* 19 (Mar. 2006), available at <http://www.oecd.org/dataoecd/42/14/36280368.pdf>; HM Revenue and Customs, *Key Tax Deadlines for Tax Agents 2011-2012*, available at <http://www.hmrc.gov.uk/transparency/other-data.htm>; Australia Office of Taxation, *PAYG withholding, NAT 8075, 22* (Dec. 2010), available at <http://www.ato.gov.au/content/downloads/BUS-31962nat8075122010.pdf>. If the transition to an accelerated schedule creates a significant burden, Congress can create an incentive to encourage the behavior in the transition years, such as providing a tax credit to recover the incremental costs of transition.



to file information returns electronically. In addition, third-party reporters that are required to file 250 or more of any particular information return must file electronically.<sup>13</sup> The due date for most of these forms is one month later than the date for paper filing.<sup>14</sup> However, this extended deadline undermines the goal of processing these forms before releasing refunds. In addition, given advances in technology, it is reasonable for Treasury to tighten the mandate by significantly reducing the 250-return threshold. Thus, by tightening the e-file mandate and eliminating the extended e-file deadline, the IRS could minimize processing delays.<sup>15</sup>

***Coordination of Processing W-2s with the Social Security Administration Would Allow the IRS to Begin Processing These Documents Earlier.***

The IRS could begin processing W-2 data earlier if it receives the information at the same time or shortly after the forms are filed with the SSA. Employers file Forms W-2 with the SSA — not the IRS — and the SSA screens the forms to identify name/SSN mismatches before sending data extracts to the IRS. The length of time between the SSA's receipt and transmission to the IRS should be assessed. If there is a significant lag, the IRS should evaluate options to reduce the delay, including processing improvements and whether the IRS could receive the data directly and perform the screens itself.<sup>16</sup>

***Real-Time Downloading of Data into the Database and Running the IRMF Screen with Other Pre-Refund Screens Could Protect Revenue by Preventing Incorrect Refunds.***

In order to match documents before releasing refunds, the IRS's Information Return Master File (IRMF) database should upload information return data soon after the information returns are received by the IRS. However, the current return processing pipeline does not permit the IRS to run refund claims against the database in a timely manner. Thus, in order to match documents before releasing refunds, the IRS must modify the pipeline so it can run an IRMF screen simultaneously with its other pre-refund screens.<sup>17</sup>

<sup>13</sup> Treas. Reg. § 301.6011-2. The requirement applies to Forms 1042-S, 1098, 1098-E, 1098-T, 1099 series, 5498, 8027 and W-2G. There is a hardship waiver to this requirement. In fiscal year 2010, the IRS received approximately 2.69 billion information returns, of which 2.36 billion were filed electronically. 2010 Internal Revenue Service Data Book 37, Table 14 (Mar. 2011).

<sup>14</sup> IRS Publication 1220, *Specifications for Filing Forms 1097-BTC, 1098, 1099, 3921, 3922, 5498, 8935, and W-2G Electronically*; Rev. Proc 2010-26, 2010-30 I.R.B. 91 (July 26, 2010).

<sup>15</sup> In its final report, the National Commission on Restructuring the Internal Revenue Service recommended that the threshold for electronic submission of information returns be lowered to 100. Report of the National Commission on Restructuring the Internal Revenue Service, *A Vision for a New IRS*, Appendix G (June 25, 1997). Information returns filed on paper with the IRS are required to be scannable and are transcribed manually when the taxpayer does not meet this requirement. IRS General Instructions for Certain Information Returns (2011) (Forms 1097, 1098, 1099, 3921, 3922, 5498, and W-2G), Section G. Paper Document Reporting; IRS, Seven-Day Response to Most Serious Problem: *Accelerated Third Party Info Reporting* (Nov. 17, 2011).

<sup>16</sup> Because both the IRS and SSA need the W-2 data, consideration should be given to sending the information to a joint processing center. Both the IRS and SSA would have immediate access to the data at the center. Alternatively, a portal could be created to give the IRS direct access to the SSA database.

<sup>17</sup> The National Taxpayer Advocate has concerns with respect to how the IRS will notify taxpayers that there is a question about IRMF data on their returns and what legal authority the IRS has to adjust the return. See Most Serious Problem: *The IRS's Wage and Withholding Verification Process May Encroach on Taxpayer Rights and Delay Refund Processing*, *supra*; Introduction to Revenue Protection Issues: *As the IRS Relies More Heavily on Automation to Strengthen Enforcement, There Is an Increased Risk that It Will Assume Taxpayers Are Cheating, Confuse Taxpayers About Their Rights, and Sidestep Longstanding Taxpayer Protections*, *supra*. Nevertheless, the IRS should proceed with modifying its pipeline while we work through these concerns.



*Encourage Taxpayers to Wait for Third-Party Data Before Filing Returns.*

While the IRS has a significant revenue protection interest in performing document matching before releasing refunds, taxpayers who are entitled to refunds should not be forced to wait for an extended time. Low income taxpayers in particular may have difficulty, at least initially, adjusting to any changes in their accustomed timeframe for receiving refunds.<sup>18</sup> Once the IRS manages to expedite third-party data processing, it should conduct a marketing campaign to entice taxpayers to wait for the data to be available before preparing and filing returns. The campaign should list the many benefits of accessing third-party data before filing returns, such as confidence in the completeness of the return.<sup>19</sup>

With the virtual elimination of the refund anticipation loan market, most taxpayers will have to wait to receive their refunds.<sup>20</sup> Taxpayers might be even more willing to wait if the IRS offers them the ability to download their third-party data directly into their return preparation software or even provide a pre-populated return option to either (1) accept as prepared or (2) modify with additional information.<sup>21</sup> Taxpayers and their authorized preparers already have electronic access to some of this data directly from the third-party reporters. However, the IRS could create a “one-stop shopping” platform for the taxpayer to receive all data from one government-provided location. With direct electronic access to a complete set of downloadable third-party data, compliance would increase through the elimination of keystroke mistakes and inadvertent omissions.

The wait might be even more acceptable to taxpayers once the IRS has fully migrated all applications to the new CADE 2 database and can process returns quicker. Once taxpayers are accustomed to this approach, third-party filers have sufficiently transitioned, and the IRS systems have fully incorporated the benefits of CADE 2, the IRS can evaluate moving the start of the filing season later to coincide with the completion of the IRMF database.<sup>22</sup>

<sup>18</sup> 28.8 percent of tax year 2009 returns filed in processing year 2010 were filed by Feb. 28, 2010. Of those early filed returns, 98.5 percent were due a refund, with the average refund amounting to approximately \$3,273. In addition, 38.9 percent of the early filers claimed EITC. Individual MasterFile and Individual Returns Transaction File tax year 2009 processing year 2010 from the Compliance Data Warehouse (Oct. 2011).

<sup>19</sup> In § 2001 of RRA 98, Congress authorized the IRS “to promote the benefits of and encourage the use of electronic tax administration programs, as they become available, through the use of mass communications and other means...[and] implement procedures to provide for the payment of appropriate incentives for electronically filed returns.” Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98), § 2001(c), Pub L. 105-206, 112 Stat. 723 (July 22, 1998). Our proposal is an extension of this program.

<sup>20</sup> A refund anticipation loan is a short-term loan secured by a taxpayer’s anticipated tax refund. See IRS, IRS Removes Debt Indicator for 2011 Tax Filing Season, IR-2010-89 (Aug. 5, 2010); Sandra Block, IRS Rule to End Release of Debt Info Threatens Refund-Anticipation Loans, USA Today (Aug. 6, 2010);

<sup>21</sup> The National Commission on Restructuring the Internal Revenue Service envisioned the realignment of due dates for tax return and third-party reporting. Report of the National Commission on Restructuring the Internal Revenue Service, *A Vision for a New IRS* 39 (June 25, 1007) (“Realigning the due dates for tax and information returns could rationalize the entire filing process, provide a more realistic timetable for submission and incentives for electronic filing, level the workload of the IRS and tax practitioners, and establish the foundation for return-free filing for many individual taxpayers.”).

<sup>22</sup> For a comprehensive discussion of the experience in various countries in developing and implementing pre-populated tax return programs, see *Studies in Budget & Tax Policy: Prefilled Personal Income Tax Returns: A Comparative Analysis of Australia, Belgium, California, Québec, and Spain* (Frasier Institute June 2011). Chapter 1 of such study (authored by Chris Evans and Binh Tran-Nam) discusses the obstacles faced by Australia in receiving third-party data at a point in the filing season that is well after the time such users would normally file. The discussion also addresses the benefits to taxpayers and tax administrators. Countries with pre-populated returns often start the filing season several months after the end of the tax year. See OECD, Forum on Tax Administration Taxpayer Services Subgroup, *Using Third-Party Information Reports to Assist Taxpayers Meet their Return Filing Obligations – Country Experiences with the Use of Pre-Populated Personal Tax Returns* (Mar. 2006).

IRS Commissioner Douglas Shulman also described a tax system with improved use of third-party data when he recently stated:

I also see technology as one of the keys for unlocking a potential new tax structure that could fundamentally change the way taxpayers and tax practitioners prepare and file individual returns. It would deal in real time and avoid audits that may take place three years after a return is filed.

In this long-term vision, the IRS could get all information from third parties before individual taxpayers filed their returns. Taxpayers or their return preparers could then access that information, via the Web, to prepare their tax returns.

Taxpayers or their return preparers could then add any self-reported and supplemental information to the returns, and file it with the IRS. The IRS could embed this third-party information into its pre-screening filters, and could ask the taxpayer to fix the return before accepting it if it contains data that does not match the taxpayer's records. This is a real game-changer as it could help ensure more accurate returns and far less of the troublesome back-end auditing.<sup>23</sup>

#### **Despite Challenges, Pre-populated Returns Will Improve Taxpayer Compliance.**

The pre-populated return is not a novel idea. In fact, § 2004 of the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98) mandated that the Department of Treasury develop procedures to implement a return-free tax system for appropriate individuals by 2007.<sup>24</sup> The provision further called for the Secretary to report periodically on the additional resources the IRS would need to implement the system, the changes to the Internal Revenue Code that would enhance such a system, the procedures developed for the implementation of a return-free tax system for appropriate individuals, and the number and classes of taxpayers permitted to use those procedures.<sup>25</sup>

In a 2003 report mandated by RRA 98, the Department of Treasury analyzed the various types of return-free systems around the world and identified challenges faced by other countries as well as findings from its own independent research. In general, countries ei-

<sup>23</sup> IRS, IR-2011-55, *Prepared Remarks of IRS Commissioner Doug Shulman to the Leaders & Legends Series, Johns Hopkins Carey Business School, Baltimore* (May 18, 2011).

<sup>24</sup> Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98), § 2004 (a), Pub L. 105-206, 112 Stat. 726 (July 22, 1998) ("The Secretary of the Treasury or the Secretary's delegate shall develop procedures for the implementation of a return-free tax system under which appropriate individuals would be permitted to comply with the Internal Revenue Code of 1986 without making the return required under section 6012 of such Code for taxable years beginning after 2007.")

<sup>25</sup> Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98), § 2004 (b), Pub L. 105-206, 112 Stat. 726 (July 22, 1998).

ther had an exact withholding system or a tax agency reconciliation system.<sup>26</sup> The Treasury report included the following findings from its review:

- The simpler the tax system, the easier it is to operate a return-free system.
- In a 2000 IRS telephone survey of taxpayers' attitudes toward a return-free system, approximately 72 percent of the respondents expressed concerns regarding increased government control over individuals' lives.<sup>27</sup>
- At the time of the report, many countries with return-free systems had exact withholding systems, which shift the burden to payers of income. In addition, it is difficult to apply progressive tax rates in an exact withholding system when income is derived from many sources. Thus, the burden on the payers and tax administration would decrease if the requirement applied only to taxpayers in the lowest tax bracket;
- With a tax agency reconciliation system, third-party reporters would be required to accelerate reporting and the IRS and SSA would have to speed up the processing and editing of these returns to avoid significant delays in refunds.<sup>28</sup>

The National Taxpayer Advocate believes these challenges are not insurmountable. First, technology has advanced in the years since these concerns were raised. We agree that a simpler tax system is ideal and would make administration of a return-free system less burdensome. However, the U.S. can make the system voluntary so that taxpayers with less complicated returns can use the system to prepare their complete returns. Those with more complicated returns can make adjustments to the pre-populated return. Finally, the IRS can address the government intrusion concern in a marketing campaign that conveys that the IRS would be making accessible to taxpayers information it already has, and the result of that access is to reduce the taxpayers' burden.

While there are many ways to implement a pre-populated return, one possibility would be to use the existing Free File Fillable Forms program, which is accessible on the IRS website. The proposed program would download the taxpayers' third-party data, populate the tax return, and perform basic calculations. Because not everything that must be reported on a return is subject to third-party reporting, taxpayers would still need to fill in information such as family status and composition, and other items of income, deductions, and credits.

<sup>26</sup> Treasury differentiated between two types of return-free systems: (1) an exact withholding system whereby the tax agency attempts to ensure that the exact amount of tax liability is withheld so that taxpayers are not required to file returns at the end of the year, and (2) a tax agency reconciliation system, whereby taxpayers can elect to have the tax agency prepare their returns. The tax agency reconciliation system has four steps: (1) electing taxpayers provide basic information to the tax authority; (2) the tax authority then calculates tax liabilities, given the information returns it receives; (3) the taxpayer then has a chance to review (and contest) these calculations; and (4) refunds or tax payments are made.

<sup>27</sup> Dept. of Treasury, *Report to the Congress on Return-Free Tax Systems: Tax Simplification Is a Prerequisite* 26 (Dec. 23, 2003), available at <http://www.treasury.gov/resource-center/tax-policy/Documents/noreturn.pdf> 28 (last visited Nov. 1, 2011).

<sup>28</sup> *Id.*

In addition, the IRS can evaluate the feasibility of delaying the filing deadline for pre-populated returns to encourage more taxpayers to participate in the program.<sup>29</sup>

The IRS can learn from the experiences of other jurisdictions in providing taxpayers with timely electronic access to third-party reporting. The National Taxpayer Advocate has met with tax administrators from numerous countries and has discussed a variety of approaches, including setting earlier deadlines for information reporting and starting the filing season later in the year. Several of these countries, such as Sweden and Australia, also generate pre-populated returns to simplify return preparation for its taxpayers. In the United States, California administers the ReadyReturn program.<sup>30</sup>

## CONCLUSION

The IRS does not fully utilize its third-party reporting system to maximize the potential benefits to taxpayers as well as tax administration. If the IRS received, processed, and made third-party data accessible to taxpayers before return filing deadlines, both taxpayers and the IRS would benefit through higher compliance rates and fewer downstream consequences.

To reduce taxpayer burden and meet the needs of taxpayers as well as tax administration, the National Taxpayer Advocate preliminarily recommends that the IRS take the following actions:

1. Conduct a study on information reporting and work with the Department of Treasury to develop a legislative recommendation to accelerate third-party reporting deadlines, tighten the current e-file mandate, and enable the IRS to receive Form W-2 data at the same time taxpayers receive the forms from their employers.
2. Evaluate ways to build the IRS Information Return Master File database in real time as information returns come in.
3. Provide taxpayers with the ability to download third-party data directly from the IRS into their return preparation software and evaluate the feasibility of developing a pre-populated return option for taxpayers.

<sup>29</sup> See Joseph Bankman, *Using Technology to Simplify Individual Tax Filing*, *National Tax Journal* (Dec. 2008); OECD, Forum on Tax Administration Taxpayer Services Subgroup, *Information Note, Third-party Reporting Arrangements and Pre-Filled Tax Returns: The Danish and Swedish Approaches* (Jan. 22, 2008); OECD, Forum on Tax Administration Taxpayer Services Subgroup, *Using Third-Party Information Reports to Assist Taxpayers Meet their Return Filing Obligations – Country Experiences with the Use of Pre-Populated Personal Tax Returns* (Mar. 2006); Joseph Cordes and Arlene Holen, Technology Policy Institute, *Should the Government Prepare Individual Income Tax Returns?* (Sept. 2010). All Party Parliamentary Taxation Group, *Pre-Populated Returns: Briefing Paper* (Sept. 2009)."

<sup>30</sup> See *Studies in Budget & Tax Policy: Prefilled Personal Income Tax Returns: A Comparative Analysis of Australia, Belgium, California, Québec, and Spain* (Fraser Institute June 2011); State of California Franchise Tax Board, *ReadyReturn: Frequently Asked Questions*, available at [http://www.ftb.ca.gov/readyReturn/faq\\_about.shtml](http://www.ftb.ca.gov/readyReturn/faq_about.shtml) (last visited on Aug. 25, 2011); OECD, Forum on Tax Administration Taxpayer Services Subgroup, *Using Third-Party Information Reports to Assist Taxpayers Meet their Return Filing Obligations – Country Experiences with the Use of Pre-Populated Personal Tax Returns* (Mar. 2006); OECD, Forum on Tax Administration Taxpayer Services Subgroup, *Survey Report: Survey of Trends and Developments in the Use of Electronic Services for Taxpayer Service Delivery* (Mar. 2010).

## IRS COMMENTS

The IRS recognizes the benefits that can be achieved for taxpayers and the tax system by receiving third-party information on an accelerated basis. The IRS has been working on the early development of a “real time” tax system. This vision was described by the IRS Commissioner in a speech to the National Press Club in April 2011.<sup>31</sup>

In that speech, the Commissioner described a vision where the IRS would move away from the traditional “look back” model of compliance, and instead perform substantially more “real time,” or upfront matching of tax returns when they are first filed with the IRS. The goal of this initiative is to improve the tax filing process by reducing burden for taxpayers and improving overall compliance upfront.

Under the envisioned “real-time” tax system, the IRS would get information returns, such as Forms W-2 and 1099, from third parties before individual taxpayers filed their returns. The IRS could then check submitted information during processing and provide taxpayers an opportunity to fix inconsistent data before the return is accepted.

This is a long-term vision that will take some time to fully realize. The IRS is soliciting feedback and input from outside stakeholders on the proposal. We are in the process of holding a series of public meetings to gather insight on implementing this fundamental long-term change. We look forward to working with the National Taxpayer Advocate as we take steps to realize this vision.

## Taxpayer Advocate Service Comments

We commend the IRS for recognizing the need for accelerated third-party reporting. In fact, the IRS demonstrated its commitment to this important issue on December 8, 2011 when it kicked off a series of public meetings for the Real Time Tax System Initiative. During the initial meeting, there was universal agreement among the panelists that the IRS needs to move away from a “look back” model of compliance and toward upfront matching. However, the panelists also raised several questions about how the IRS would accomplish this, including the following:

1. ***Would the IRS reject returns that include mismatched data?*** The National Taxpayer Advocate shares the concerns of many of the panelists on this issue. Before implementing any program that would reject mismatched returns, the IRS should duly consider the resulting significant burden on both taxpayers and the IRS, and the potentially serious consequences for the taxpayers. For example, such a rejection would cause a significant number of taxpayers or their preparers to call the IRS

<sup>31</sup> IRS, *Prepared Remarks of Commissioner Doug Shulman at the National Press Club* (Apr. 6, 2011), available at [www.irs.gov/newsroom/article/0,,id=238204,00.html](http://www.irs.gov/newsroom/article/0,,id=238204,00.html).

toll-free line. It could also cause more taxpayers to file by paper if they cannot resolve inaccuracies before April 15. While it is ideal to inform taxpayers about mismatches as early as possible, the IRS does not necessarily need to reject a return to accomplish this goal. The IRS should consider which method creates the least burden.<sup>32</sup>

2. **Who would have access to the real-time tax data?** Taxpayers should have access to third-party data before they file their returns. This access, which would prevent mismatches from happening at all, would become even more imperative should the IRS decide to reject returns with mismatches. Ideally, the IRS would build a system that enables taxpayers to download the data directly to their return preparation software as well as making pre-populated returns available.<sup>33</sup>
3. **Expansion of Math Error Authority.** The National Taxpayer Advocate cautions against the expansion of math error authority under IRC § 6213(g) to cover mismatched third-party data.<sup>34</sup> Such expansion would significantly harm taxpayers, especially low income taxpayers who may not understand the notices or realize the need to respond in a timely manner. Accordingly, these taxpayers may lose their right to contest the adjustment in Tax Court.<sup>35</sup>

As the IRS develops the real-time tax system, the National Taxpayer Advocate has serious concerns about the protection of fundamental taxpayer rights. We urge the IRS to develop procedures for accelerated information reporting to afford taxpayers with the same standard taxpayer rights that accrue during a traditional examination.<sup>36</sup> In the past, the IRS has not considered automated adjustments resulting from third-party data mismatches to be “examinations.”<sup>37</sup> Thus, it is unclear whether the IRS will consider Automated Underreporter (AUR) adjustments as traditional examinations if they shift to the filing season. If not, taxpayers may lose such protections as the avoidance of repetitive and

<sup>32</sup> See, e.g., American Institute of Certified Public Accountants Statement Presented to the Internal Revenue Service on Real Time Tax System 3 (Dec. 8, 2011); Comments of Bonnie Speedy, Vice President and National Director, AARP Foundation Tax-Aide, IRS Public Meting – Real Time Tax System (Dec. 8, 2011).

<sup>33</sup> See also Comments of T. Keith Fogg, Director, Villanova Law School Federal Tax Clinic, IRS Real Time Tax System Initiative 3-4 (Dec. 8, 2011).

<sup>34</sup> IRC § 6213(b) or (g) gives the IRS the authority to make an assessment without filing a statutory notice of deficiency (SNOD). Once the IRS notifies taxpayers of math errors, they have 60 days to request abatement of the additional tax. If the taxpayer makes a timely request, the IRS will abate the assessment and follow formal deficiency procedures to reassess the tax (i.e., send the taxpayer a SNOD). However, if the taxpayer fails to request abatement timely, the IRS may collect the additional tax. At this point, the assessment cannot be appealed in the U.S. Tax Court. See Most Serious Problem: *Expansion of Math Error Authority and Lack of Notice Clarity Create Unnecessary Burden and Jeopardize Taxpayer Rights*, *supra*; Legislative Recommendation: *Mandate That the IRS, in Conjunction with the National Taxpayer Advocate, Review any Proposed Expanded Math Error Authority to Protect Taxpayer Rights*, *infra*.

<sup>35</sup> See, e.g., Comments of T. Keith Fogg, Director, Villanova Law School Federal Tax Clinic, IRS Real Time Tax System Initiative 4-5 (Dec. 8, 2011);

<sup>36</sup> Introduction to Revenue Protection Issues: *As the IRS Relies More Heavily on Automation to Strengthen Enforcement, There Is an Increased Risk that It Will Assume Taxpayers Are Cheating, Confuse Taxpayers About Their Rights, and Sidestep Longstanding Taxpayer Protections*, *supra*.

<sup>37</sup> See, e.g., Rev. Proc. 2005-32, § 4.03 2005-1 C.B. 1206.



unnecessary examinations, adequate notice by the IRS, and an opportunity to contest the proposed adjustment administratively and in Tax Court.<sup>38</sup>

In addition, the inaccuracy of third-party data is a significant issue with direct impact on both taxpayers and the IRS. If the IRS identifies a mismatch, and does not receive a taxpayer response to an automatically-generated letter, the IRS assumes the third-party data is correct and the information reported on the tax return is incorrect, without conducting any further investigation. However, the high abatement rate on AUR assessments indicates that third-party data may not be reliable and illustrates the need for the IRS to improve procedures to verify return information<sup>39</sup>

Finally, the reliability of third-party data has a direct impact on the IRS if the taxpayer challenges in court an adjustment based solely on third-party data, about which the taxpayer has responded to the IRS. In such a case, the burden of production shifts to the Commissioner, who must produce “reasonable and probative information concerning such deficiency in addition to such information return.”<sup>40</sup>

During the December 8, 2011 public meeting, Commissioner Shulman stated that the IRS would not address pre-filled returns as a part of this initiative. We understand the need to focus on the real-time issues before building on the system to develop pre-populated or pre-filled returns. However, we urge the IRS, as it builds the real-time infrastructure, to consider how any future pre-populated return program would interact with the system. The National Taxpayer Advocate continues to believe that the provision of a pre-populated return would significantly reduce burden on taxpayers and increase compliance.

<sup>38</sup> See generally IRS Pub 1, *Your Rights as a Taxpayer* (2005); IRS, Pub. 556, *Examination of Returns, Appeal Rights and Claims for Refund* (2008); IRS Pub. 3498-A, *The Examination Process* (2004); Introduction to Revenue Protection Issues: *As the IRS Steps up Enforcement Using Automation, There Is an Increased Risk that It Will Assume Taxpayers Are Cheating, Confuse Taxpayers About Their Rights, and Sidestep Longstanding Taxpayer Protections*, *supra*.

<sup>39</sup> The IRS granted 83.3 percent of all AUR abatement requests in FY 2011. IRS, Enforcement Revenue Information System Summary Database (Dec. 2011). Further, according to TIGTA, more than two billion information returns were submitted to the IRS in TY 2007, of which 31.7 million (1.5 percent) had invalid payee data. TIGTA, Ref. No. 2011-30-019, *Targeted Compliance Efforts May Reduce the Number of Inaccurate Returns Submitted by Government Entities* 3-4 (Feb. 15, 2011).

<sup>40</sup> IRC § 6201(d). Congress enacted IRC § 6201(d) following the decision in *Portillo v. Commissioner*. *Portillo v. Comm’r*, 932 F.2d 1128 (5th Cir. 1991). Section 6201(d) places the burden of production in litigation on the Commissioner where the taxpayer raises a reasonable dispute concerning certain information returns supplied by third parties. In *Portillo*, the court found the IRS’s determination that the taxpayer had received unreported income was arbitrary and erroneous, because a Form 1099 sent to the IRS by another taxpayer was the sole basis for the determination. The court concluded that the IRS had a duty to investigate the accuracy of the Form 1099 and determine if it could be verified by other information, such as the books or records of the taxpayer who submitted the Form 1099. The court held the IRS did issue a valid deficiency notice but determined that notice to be arbitrary and erroneous, because the IRS failed to substantiate the charge that the taxpayer had unreported income.



## Recommendations

The National Taxpayer Advocate recommends that the IRS take the following actions:

1. Conduct a study of information reporting and work with the Department of Treasury to develop a legislative recommendation to accelerate third-party reporting deadlines, tighten the current e-file mandate, and enable the IRS to receive Form W-2 data at the same time taxpayers receive the forms from their employers.
2. Evaluate ways to build the IRS Information Return Master File database in real time as information returns are submitted to the IRS.
3. Provide taxpayers with the ability to download third-party data directly from the IRS into their return preparation software.
4. Evaluate the feasibility of developing a pre-populated return option for taxpayers.
5. Study the accuracy of third-party reporting data, analyzing its reliability by type of third-party reports (such as interest, dividend, broker transactions, cancellation of debt, merchant card and third party network payments, nonemployee compensation, certain government payments, etc).
6. Develop procedures for accelerated third-party reporting that do not include math error authority for adjustments based solely on third-party reporting mismatches.
7. Develop procedures for accelerated third-party reporting that provide taxpayers with the standard taxpayer rights that accrue during an examination, including a prohibition on repetitive and unnecessary examinations, adequate notice, and an opportunity to contest the proposed adjustment administratively and in Tax Court.
8. Develop procedures pursuant to IRC § 6201(d) that provide the protections afforded to taxpayers who have responded to the IRS and challenge an adjustment based solely on information return data in court.
9. Work with the National Taxpayer Advocate to design any associated taxpayer notices in a clear and straightforward manner so the taxpayer can easily understand his or her rights in the process, the changes made by the IRS, and the steps to take if the taxpayer disagrees with the adjustment.

MSP  
#14**The IRS Should Reevaluate Earned Income Tax Credit Compliance  
Measures and Take Steps to Improve Both Service and Compliance****RESPONSIBLE OFFICIALS**

Richard E. Byrd Jr., Commissioner, Wage and Investment Division  
Faris Fink, Commissioner, Small Business/Self-Employed Division  
Jodi Patterson, Director, Return Integrity & Correspondence Services

**DEFINITION OF PROBLEM**

The Earned Income Tax Credit (EITC), a refundable credit available to working low income taxpayers, lifted approximately six million individuals, including approximately three million children, out of poverty in 2009.<sup>1</sup> At the same time, this essential program is now classified as the fourth largest source of “improper payments” by the government in fiscal year (FY) 2010.<sup>2</sup> This classification is based on a compliance estimate derived from old 2006 data and is most likely overstated.<sup>3</sup> Moreover, the IRS has not released studies for subsequent years to the Taxpayer Advocate Service (TAS) or the public, which means that although the estimates of improper payments are published, the underlying data and assumptions are not.

Overstated or not, however, there is room for improvement in the administration of EITC, which now accounts for approximately 37 percent of *all* individual taxpayer audits, even though other components of the tax gap have greater noncompliance.<sup>4</sup> While the IRS is collaborating with TAS on pilot programs to improve EITC service and foster compliance, there is more to be done. The IRS should not only refine the compliance measurement itself, but should explore proposals to improve EITC compliance while reducing taxpayer burden and protecting taxpayer rights.

Efforts to reduce improper payments should not curtail EITC’s successes. In particular:

- Because EITC funds can be a vital component of a family’s basic living expenses, the EITC presents a special case in which tax administration should encourage participation as well as compliance.

<sup>1</sup> The most recent year for which data are available is 2009. IRS Individual Returns Transaction File (IRTF) tax year 2009 data from the Compliance Data Warehouse (CDW) (Oct. 2011); accord John Wancheck and Robert Greenstein, Center on Budget and Policy Priorities, *Earned Income Tax Credit Overpayment and Error Issues* 1 (Apr. 19, 2011).

<sup>2</sup> Government Accountability Office (GAO), GAO-11-575T, *Improper Payments: Recent Efforts to Address Improper Payments and Remaining Challenges*, Table 1 at 4 (Apr. 15, 2011).

<sup>3</sup> The compliance estimate referenced in the GAO report is the IRS FY 2010 estimate based on tax year (TY) 2006 data. Also note the more recent IRS 2011 estimate incorporating TY 2007 data in the IRS response to this Most Serious Problem, *infra*.

<sup>4</sup> IRS Pub. 55B, *Data Book* (2010), Table 9a. On the tax gap, business income of \$109 billion went unreported by individuals in TY 2001. IRS, *Reducing the Federal Tax Gap – A Report on Improving Voluntary Compliance*, Fig. 1 at 10 (Aug. 2, 2007). For FY 2009, \$11 to \$13 billion of EITC payments were considered improper. Treasury Inspector General for Tax Administration (TIGTA), Ref. No. 2011-40-023, *Reduction Targets and Strategies Have Not Been Established to Reduce the Billions of Dollars in Improper Earned Income Tax Payments Each Year 1* (Feb. 7, 2011).

- EITC administration and compliance measures should take into account the taxpayer's learning curve. The population of taxpayers eligible for the credit changes by an estimated one-third annually, which means that one in three EITC taxpayers each year is in a learning mode.<sup>5</sup>
- The intricacies of the EITC law (set forth in IRS Publication 596, *Earned Income Credit*, designed to present "Earned Income Credit in a Nutshell" (yet now running 63 pages) should be applied to each taxpayer's facts — not to data that may afford administrative shortcuts while abridging individual rights.

## ANALYSIS OF PROBLEM

### Background

The IRS is responsible for administering the EITC, a refundable tax credit available to certain low income working taxpayers and their families.<sup>6</sup> The EITC was enacted in 1975 to provide an incentive to work and offset the burden of Social Security taxes for low income working families.<sup>7</sup> Because the credit is refundable, if the EITC exceeds the taxes owed, the IRS refunds the overpayment to the taxpayer. The credit can be substantial for a working family. For tax year (TY) 2011, the maximum EITC for a married couple with three (or more) qualifying children is more than \$5,700.<sup>8</sup> Among taxpayers who received both EITC benefits and tax refunds for TY 2009, the refund amounted to approximately 24 percent of adjusted gross income.<sup>9</sup>

The EITC has become an important anti-poverty program with high participation rates at comparatively low costs. EITC lifted 6.6 million individuals, about half of whom were children, out of poverty in 2009 (the most recent year for which data are available).<sup>10</sup> Because EITC funds can be a vital component of a family's basic living expenses, the credit presents a special case in which tax administration should encourage participation as well as compliance. At the same time, the EITC has a high rate of overpayments. As a result, it was classified as the fourth largest source of "improper payments" by the government in FY 2010.<sup>11</sup>

<sup>5</sup> TIGTA, Ref. No. 2009-40-024, *The Earned Income Tax Credit Program Has Made Advances; However, Alternatives to Traditional Compliance Methods Are Needed to Stop Billions of Dollars in Erroneous Payments 2* (Dec. 31, 2008).

<sup>6</sup> Internal Revenue Code (IRC) § 32.

<sup>7</sup> Pub. L. No. 94-12, 89 Stat. 26 (1975); S. Rep. 94-36, 94th Cong. 1st Sess. (1975) 33 ("your committee agrees with the House that it is appropriate to use the income tax system to offset the impact of the social security taxes on low income persons in 1975 by adopting a refundable income tax credit against earned income").

<sup>8</sup> Rev. Proc. 2011-12, 2011-2 I.R.B. 1.

<sup>9</sup> The average AGI was \$17,292; average refund, \$4,108. IRS IRTF for TY 2009 from the CDW (Oct. 2011).

<sup>10</sup> John Wancheck and Robert Greenstein, Center on Budget and Policy Priorities, *Earned Income Tax Credit Overpayment and Error Issues 1* (Apr. 19, 2011).

<sup>11</sup> GAO, GAO-11-575T, *Improper Payments: Recent Efforts to Address Improper Payments and Remaining Challenges*, Table 1 at 4 (Apr. 15, 2011).

The Improper Payments Information Act of 2002 requires the IRS to estimate the amount of such payments and report to Congress on steps to reduce them.<sup>12</sup> For TY 2009, the IRS reported that 24 million taxpayers received \$55 billion in EITC and that for FY 2009, 23 to 28 percent, or \$11 to \$13 billion,<sup>13</sup> was improper.<sup>14</sup> The IRS also disclosed that this figure is based on an historical sample of tax returns rather than current filings, analyzed, projected, and adjusted to estimate the rates of mistakes and noncompliance.<sup>15</sup>

### The IRS may be relying on a misleading estimate of EITC noncompliance.

Research studies report that the IRS's estimate of improper payments may be flawed and is most likely significantly overstated.<sup>16</sup> Specifically, estimates of improper EITC payments have an uncertain statistical basis to the extent that they are based on audit results. A majority (60 percent) of EITC audits are conducted by correspondence (pre-refund) before the credit is paid.<sup>17</sup> In these audits, almost 70 percent of the taxpayers do not respond to the audit inquiry letters from the IRS,<sup>18</sup> which then denies the EITC.<sup>19</sup> A 2004 TAS Research study found that on reconsideration of audits, about 17 percent of taxpayers were unaware they had been under audit, and 43 percent of taxpayers "were entitled to virtually all of the EITC they claimed," that is "on average, 94 percent of the EITC amount claimed on the original return."<sup>20</sup>

The data suggest audit outcomes are frequently incorrect because the IRS erroneously denies a significant number of credits.<sup>21</sup> Further, the Treasury Inspector General for Tax Administration has expressed concern that the improper payment rate does not account for individuals who are eligible for the EITC and do not claim it.<sup>22</sup> Additionally, the

<sup>12</sup> Pub. L. No. 107-300, 116 Stat. 2350.

<sup>13</sup> TIGTA, Ref. No. 2011-40-023, *Reduction Targets and Strategies Have Not Been Established to Reduce the Billions of Dollars in Improper Earned Income Tax Payments Each Year 1* (Feb. 7, 2011).

<sup>14</sup> Pub. L. No. 107-300, § 2(d)(2)(A) (generally governing payments over \$10 million "derived from Federal funds") defines an "improper payment" as any payment that should not have been made or that was made in an incorrect amount. The Office of Management and Budget (OMB) has imposed a 2.5 percent floor on improper payments. See OMB Circ. A-123, Appdx. C, M-11-16, Pt. I at 5 (Apr. 14, 2011) (imposing threshold of 2.5 percent of program outlays).

<sup>15</sup> *Hearing Before the H. Ways and Means Comm. Subcomm. on Oversight on Refundable Tax Credits 10*, 112th Cong. (May 25, 2011) (statement of Steven T. Miller, Deputy Commissioner for Services and Enforcement, Internal Revenue Service).

<sup>16</sup> TIGTA, Ref. No. 2011-40-023, *Reduction Targets and Strategies Have Not Been Established to Reduce the Billions of Dollars in Improper Earned Income Tax Payments Each Year 13* (Feb. 7, 2011); see also *Hearing on Improper Payments in the Administration of Refundable Tax Credits Before the Subcomm. on Oversight Comm. on Ways and Means 17*, 112th Cong. (May 25, 2011) (statement of Nina E. Olson, National Taxpayer Advocate).

<sup>17</sup> TIGTA, Ref. No. 2011-40-023, *Reduction Targets and Strategies Have Not Been Established to Reduce the Billions of Dollars in Improper Earned Income Tax Payments Each Year 29* (Feb. 7, 2011) ("Of the approximate 500,000 audits conducted by the IRS annually, 60% are conducted before the EITC portion of the refund is released.").

<sup>18</sup> IRS Automated Information Management System (AIMS) FY 2010 (Oct. 2011) (ranging from 63 to 73 percent); see also National Taxpayer Advocate 2004 Annual Report to Congress vol. 2, 9 (*EITC Audit Reconsideration Study*) ("Communication challenges (taxpayers had not responded or responded late) were the trigger 38 percent of the time.").

<sup>19</sup> In FY 2010, the IRS fully or partially disallowed approximately 87 percent of taxpayer claims for EITC. IRS Automated Information Management System (AIMS) FY 2010 (Oct. 2011).

<sup>20</sup> See National Taxpayer Advocate 2004 Annual Report to Congress vol. 2, i, 21, 29 (*EITC Audit Reconsideration Study*).

<sup>21</sup> National Taxpayer Advocate FY 2004 Objectives Report to Congress 21.

<sup>22</sup> TIGTA, Ref. No. 2011-40-023, *Reduction Targets and Strategies Have Not Been Established to Reduce the Billions of Dollars in Improper Earned Income Tax Payments Each Year 13* (Feb. 7, 2011).

computation does not include instances where a wrongly claimed EITC would be allowable to another taxpayer. In this case, any loss to the Treasury is a net figure.<sup>23</sup>

It is difficult to suggest improvements to the methodology behind the computation of improper payments without additional information. A 2001 IRS estimate of improper EITC payments has still not been released for review, apparently because it is not comparable to a prior study (relating to 1999).<sup>24</sup> Similarly, the IRS has not released studies for subsequent years to TAS or the public, which means that although the estimates of improper payments are published, the underlying data and assumptions are not. It would be in the best interest of tax administration to share these data, invite rigorous professional and peer review, and reevaluate the estimates.

Designating EITC as the fourth largest improper payment may be misleading. Not only was the potentially flawed estimate the basis for a GAO report indicating that improper EITC payments jumped from approximately \$12 billion in FY 2009 to \$16.9 billion in FY 2010, but the GAO report did not explain increases in overall eligibility rates.<sup>25</sup> The number and amount of EITC claims have steadily increased each year, for reasons unrelated to noncompliance. Two factors may contribute to the recent reported increase in the dollar amount of EITC noncompliance. The American Recovery and Reinvestment Act of 2009 expanded the EITC to remedy a marriage penalty and allow a higher rate for taxpayers with three (or more) children.<sup>26</sup> At the same time, the economic recession may have increased the population of low income workers eligible for the EITC.

#### **Mere classification as an “improper payment” does not result in a solution.**

Even if the improper payment estimates are correct, the implications for tax administration are unclear. EITC, the single tax provision classified as an “improper payment,” accounts for only a small percentage of the tax gap.<sup>27</sup> By contrast, in a study of tax compliance, the IRS determined business income of \$109 billion went unreported by individuals, almost ten times the amount of EITC payments now considered improper.<sup>28</sup> By this measure, “improper payment” status should not necessarily make EITC a higher priority. Even if it does become a higher priority, alternative solutions range from preparer regulation and

<sup>23</sup> John Wancheck and Robert Greenstein, Center on Budget and Policy Priorities, *Earned Income Tax Credit Overpayment and Error Issues* 6 (Apr. 19, 2011).

<sup>24</sup> For the 1999 study, see IRS, *Compliance Estimates for Earned Income Tax Credit Claimed on 1999 Returns* (Feb. 28, 2002).

<sup>25</sup> GAO, GAO-11-575T, *Improper Payments: Recent Efforts to Address Improper Payments and Remaining Challenges*, Table 1 at 4 (Apr. 15, 2011) (reflecting \$16.9 billion for FY 2010). For the \$12 billion figure, see TIGTA, Ref. No. 2011-40-023, *Reduction Targets and Strategies Have Not Been Established to Reduce the Billions of Dollars in Improper Earned Income Tax Payments Each Year 1* (Feb. 7, 2011) (reporting \$11 to \$13 billion of improper payments in FY 2009).

<sup>26</sup> Pub. L. No. 111-5, Div. B, § 1002, 123 Stat. 115, 312 (2009).

<sup>27</sup> According to the IRS’s 2001 tax gap estimates – the most recent available – taxpayers timely and voluntarily paid \$1.767 trillion and paid another \$55 billion late or as a result of IRS enforcement, leaving \$290 billion unpaid (the net tax gap). See IRS, *Reducing the Federal Tax Gap – A Report on Improving Voluntary Compliance*, Fig. 1 at 10 (Aug. 2, 2007).

<sup>28</sup> IRS, *Reducing the Federal Tax Gap – A Report on Improving Voluntary Compliance*, Fig. 1 at 10 (Aug. 2, 2007). For FY 2009, \$11 to \$13 billion of EITC payments were considered improper. TIGTA, Ref. No. 2011-40-023, *Reduction Targets and Strategies Have Not Been Established to Reduce the Billions of Dollars in Improper Earned Income Tax Payments Each Year 1* (Feb. 7, 2011). In turn, \$109 billion is almost ten times \$11 billion.

improved taxpayer service to more effective audits and elimination of Refund Anticipation Loans (RALs).

Reliably determining the EITC noncompliance rate is paramount because a number of upcoming initiatives should, if properly implemented, increase EITC compliance. In particular, the registration and testing of tax return preparers promises to take significant steps toward reducing EITC fraud and error because practitioners prepare 66 percent of all EITC returns (based on TY 2009 data).<sup>29</sup> The IRS cannot measure the impact of this initiative and others without a reliable starting point.

As previously mentioned, the Improper Payments Information Act of 2002 also requires the IRS to report on its steps to reduce improper payments. Executive Order 13520, on reducing improper payments, “targets error, waste, fraud, and abuse—not legitimate use of Government services.” Consequently, the executive order continues, “efforts to reduce improper payments under this order must protect access to Federal programs by their intended beneficiaries.”<sup>30</sup> This order highlights the expanded responsibility and dual mission of the IRS to not only collect taxes imposed by Congress but also administer social benefit programs such as the EITC.<sup>31</sup>

### **Correspondence audits are inapt as the primary tool used to address EITC noncompliance.**

The IRS relies primarily on an aggressive, audit-driven, compliance program to address improper EITC payments and verify the accuracy of EITC claims.<sup>32</sup> While acknowledging that this program cannot fully address EITC noncompliance,<sup>33</sup> the IRS has increased the number of EITC audits from 483,825 in FY 2009 to 585,202 in FY 2010, or approximately 34 to 37 percent, respectively, of *all* individual taxpayer audits.<sup>34</sup> Because the IRS has limited resources, any increase in EITC examinations can lead to a decrease in other audits designed to identify cash transactions and close the tax gap. EITC filers are already under disproportionate scrutiny, as they are almost twice as likely to be examined as other individual filers.<sup>35</sup>

<sup>29</sup> EITC Program Office response to TAS information request (May 18, 2011).

<sup>30</sup> 74 Fed. Reg. 62,201 (Nov. 25, 2009) § 1.

<sup>31</sup> For a discussion of the emerging dual mission of the IRS, refer to National Taxpayer Advocate 2010 Annual Report to Congress 15-27 (Most Serious Problem: *The IRS Mission Statement Does Not Reflect the Agency's Increasing Responsibilities for Administering Social Benefits Programs*).

<sup>32</sup> TIGTA, Ref. No. 2011-40-023, *Reduction Targets and Strategies Have Not Been Established to Reduce the Billions of Dollars in Improper Earned Income Tax Payments Each Year* (Feb. 7, 2011).

<sup>33</sup> *Id.*

<sup>34</sup> IRS Pub. 55B, *Data Book* (2010, 2009), Table 9 (FY 2010 had 585,202 EITC audits; FY 2009, 483,825).

<sup>35</sup> *Id.* at Table 9a, col. 3 at 22 (reporting 1.1 percent examination coverage of individual returns in total but up to 2.4 percent of EITC returns); EITC Program Office response to TAS information request (May 18, 2011).



The National Taxpayer Advocate has reported on the barriers, burdens, and complexity of EITC since 2001.<sup>36</sup> Statutorily, one barrier is the complicated eligibility criteria for the credit. IRS Publication 596, *Earned Income Credit*, designed to present “Earned Income Credit in a Nutshell,” is now 63 pages. Factually, relevant aspects of family situations can change from year to year, altering eligibility. It is estimated that the group of taxpayers eligible for the EITC changes by a third each year, which means at least a third of EITC taxpayers each year are learning about the credit.<sup>37</sup> Realistically, the EITC income requirement presents an opportunity to under-report or over-report, especially for self-employed taxpayers.

The IRS conducts almost all EITC audits by correspondence, with limited personal interaction.<sup>38</sup> This approach is particularly inappropriate for low income workers who face literacy challenges and are often transient.<sup>39</sup> Because the process does not meet taxpayer needs and characteristics, the EITC that the IRS denies may reflect the taxpayer’s inability to navigate the audit process rather than an improper payment.<sup>40</sup> Moreover, correspondence is not a reliable means of communication when, for example, a TIGTA audit estimated that during FY 2009 approximately 19.3 million pieces of mail, or almost ten percent of all correspondence for the year, were returned to the IRS.<sup>41</sup>

Commissioner Shulman recently said the goal for administering any social benefit program is to balance high participation with low noncompliance. He stressed, “There’s not a magic wand you can wave around the EITC.”<sup>42</sup> Nonetheless, the IRS can improve EITC compliance through preparer oversight, proper use of third-party data, and improved service to taxpayers under audit.

<sup>36</sup> National Taxpayer Advocate 2001 Annual Report to Congress 14, 20, 26, 36 (Most Serious Problems: *Determining EITC Eligibility; Documenting EITC; EITC Examinations; Recertification for EITC*); National Taxpayer Advocate 2002 Annual Report to Congress 47-87 (Most Serious Problems: *EITC Eligibility Determination Can Be Made Less Burdensome; Procedures for Examining EITC Claims Cause Hardship and Infringe on Appeal Rights; Lack of Response During EITC Exams; IRS Oversight of EITC Return Preparers Can Be Improved; The Length of EITC Audits Contributes to Taxpayer Concerns; EITC Recertification Compounds Taxpayer Burden*); National Taxpayer Advocate 2003 Annual Report to Congress 26, 87, 152, 163 (Most Serious Problems: *EITC Compliance Strategy; Combination Letter; EITC – Outreach & Education; EITC Nonfilers*); National Taxpayer Advocate 2005 Annual Report to Congress 94 (Most Serious Problem: *EITC Exam Issues*); National Taxpayer Advocate 2007 Annual Report to Congress 222 (Most Serious Problem: *EITC Examinations and the Impact of Taxpayer Representation*), vol. 2, 94, 118 (Research Studies: *IRS EIC Audits – A Challenge to Taxpayers; Simulating EITC Filing Behaviors: Validating Agent Based Simulation for IRS Analyses: The 2004 Hartford Case Study*); *Hearing on Improper Payments in the Administration of Refundable Tax Credits Before the Subcomm. on Oversight Comm. on Ways and Means*, 112th Cong. (May 25, 2011) (statement of Nina E. Olson, National Taxpayer Advocate).

<sup>37</sup> TIGTA, Ref. No. 2009-40-024, *The Earned Income Tax Credit Program Has Made Advances; However, Alternatives to Traditional Compliance Methods Are Needed to Stop Billions of Dollars in Erroneous Payments* 29 (Dec. 31, 2008).

<sup>38</sup> Automated Correspondence Examination (ACE) is a multifunctional software application that fully automates the initiation, aging, and closing of certain EITC and non-EITC cases. Using the ACE, the Correspondence Exam function can process specified cases with minimal to no tax examiner involvement until a taxpayer reply is received. Because the ACE system will automatically process the case through creation, statutory notice of deficiency, and closing, it eliminates tax examiner involvement entirely on no-reply cases. IRM 4.19.20.1 (Jan. 1, 2011).

<sup>39</sup> See generally 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*).

<sup>40</sup> See National Taxpayer Advocate 2008 Annual Report to Congress 227-42 (Most Serious Problem: *Suitability of the Examination Process*).

<sup>41</sup> TIGTA, Ref. No. 2010-40-055, *Current Practices Are Preventing a Reduction in the Volume of Undelivered Mail* 1 (May 14, 2010); see National Taxpayer Advocate 2010 Annual Report to Congress 221-34 (Most Serious Problem: *The IRS Has Not Studied or Addressed the Impact of the Large Volume of Undelivered Mail on Taxpayers*).

<sup>42</sup> Alison Bennett, *IRS Working to Ensure Credit Card Reporting Information Properly Analyzed, Shulman Says*, Daily Tax Report (June 23, 2011).



**The IRS must establish an EITC compliance benchmark for preparer oversight.**

Sixty-six percent of EITC returns are prepared by paid tax preparers (based on TY 2009).<sup>43</sup> One might assume these returns would be more accurate than those prepared by the taxpayers themselves, but this is not the case. A return selected for EITC audit is more likely to be that of a paid preparer than self-prepared.<sup>44</sup> This is why the IRS Tax Return Preparer Initiative (RPI) is expected to significantly reduce EITC error (and even fraud). This program requires preparer registration, testing, and continuing education, with a focus on EITC eligibility.<sup>45</sup> The RPI also places all return preparers under the ethical rules of Circular 230, which gives the IRS disciplinary tools to address preparer misconduct.<sup>46</sup>

To increase preparer EITC compliance, the IRS should not only test preparers on their understanding of EITC eligibility, but also verify that preparers have met expanded EITC due diligence requirements.<sup>47</sup> The IRS is implementing a new requirement for preparers to provide their Preparer Tax Identification Number (PTIN) and file a due diligence checklist with the return when the preparer has helped the taxpayer claim the credit.<sup>48</sup> The National Taxpayer Advocate encourages the IRS in implementing this requirement, revising the related regulations to require preparers to inquire about the taxpayer's eligibility for the EITC, and review and retain specific information.<sup>49</sup>

The IRS should also closely monitor excessive EITC claims submitted by paid preparers. In the Automated Underreporter (AUR) Study of Preparers with Excessive EITC Claims, researchers were able to stratify automated underreporter cases and identify preparers with what appear to be excessive EITC on their clients' returns and even on their own individual returns.<sup>50</sup> This type of analysis, combined with the use of PTINs, has the potential to curtail many improper or negligent and potentially fraudulent EITC preparer practices. This study is a good advertisement for the need for real-time information return data.<sup>51</sup> While excellent, analysis of data in 2009 means as a chronological matter that these preparers may have filed excessive EITC claims for two additional years before they were identified (*i.e.*, TYs 2009 and 2010).

<sup>43</sup> EITC Program Office, *EITC Summary of Vital Statistics* (May 2011).

<sup>44</sup> Of FY 2010 EITC returns selected for audit, 75 percent were prepared by a paid preparer. IRS AIMS FY 2010 and IRTF from the CDW (Sept. 2011).

<sup>45</sup> Previously, a similar proposal was in National Taxpayer Advocate 2002 Annual Report to Congress 216 (Legislative Recommendation: *Regulation of Federal Tax Return Preparers*).

<sup>46</sup> Treasury Decision 9527, FR Doc. 2011-13666 (filed May 31, 2011), 76 Fed. Reg. 32,286 (June 3, 2011).

<sup>47</sup> Due diligence requirements provide guidance to tax return preparers to ensure information used and factors analyzed to claim EITC are correct. See Form 8867, *Paid Preparer's Earned Income Credit Checklist*.

<sup>48</sup> See Treas. Reg. § 1.6695-2, Treas. Decision 9570, 76 Fed. Reg. 78816 (Dec. 20, 2011); Notice of Proposed Rule-making, 76 Fed. Reg. 62,689 (Oct. 11, 2011). Previously, a proposal for certification by preparers based on the greatest compliance concerns was in National Taxpayer Advocate 2003 Annual Report to Congress 270 (Legislative Recommendation: *Federal Tax Return Preparers: Oversight and Compliance*).

<sup>49</sup> For relevant prior proposals, see 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*).

<sup>50</sup> IRS, *TY09 EITC Preparer Analysis Observations* (Mar. 17, 2011).

<sup>51</sup> See Most Serious Problem: *Reinstatement of a Modernized Telefile Would Reduce Taxpayer Burden and Benefit Tax Administration, infra*.

The IRS contends, and the National Taxpayer Advocate agrees, that regulation of return preparers will markedly reduce improper EITC claims.<sup>52</sup> TIGTA, however, has found the IRS has not reported on how it plans to measure the impact of return preparer oversight on EITC overpayments, and it remains unknown whether increased preparer oversight will significantly reduce the improper payment rate. This concern underscores the immediate need to determine a reliable rate of EITC noncompliance to be used as a benchmark for RPI program effectiveness.

**Third-party data should be used as an indicator, not an absolute.**

The IRS recognizes it cannot fully address EITC noncompliance by simply auditing returns and must pursue alternatives to traditional compliance efforts.<sup>53</sup> At the end of 2010, the Department of the Treasury announced a pilot program to assess the availability, quality, completeness, and overall usefulness of state-administered benefits data, as well as state benefit screening processes, to help validate EITC eligibility. The pilot would address whether state data could identify both ineligible individuals who receive improper EITC payments and eligible individuals who do not claim the credit.<sup>54</sup>

Meanwhile, TIGTA has reiterated a recommendation that the IRS consider Federal Case Registry (FCR) information combined with increased math error authority to deny EITC during upfront processing of returns.<sup>55</sup> *Applying data collected for other purposes to deny EITC is shortsighted and may abridge taxpayer rights.*<sup>56</sup> Mass-production compliance efforts overlook the fact that most EITC errors result from applying the complexity of the EITC rules to the complexity of families' lives. If it was easy to determine and apply EITC eligibility, malfeasance or fraud would be the only reason for an improper payment.

The National Taxpayer Advocate continues to object specifically to the use of FCR data for *summary* denial of EITC claims.<sup>57</sup> A taxpayer should have an opportunity and the un-abridged due process right to present his or her own facts. In 1976, Congress specified that math error assessment is appropriate when “not only is the error apparent from the face of

<sup>52</sup> National Taxpayer Advocate 2009 Annual Report to Congress 41-69 (Most Serious Problem: *The IRS Lacks a Servicewide Return Preparer Strategy*).

<sup>53</sup> TIGTA, Ref. No. 2011-40-023 *Reduction Targets and Strategies Have Not Been Established to Reduce the Billions of Dollars in Improper Earned Income Tax Payments Each Year* 30 (Feb. 7, 2011).

<sup>54</sup> Partnership Fund for Program Integrity Innovation Pilot Concept: Assessing State Data (Nov. 23, 2010); see also Dept. of the Treasury, *Performance and Accountability Rept.* FY 2010 at 280 (Nov. 15, 2010).

<sup>55</sup> TIGTA, Ref. No. 2009-40-024, *The Earned Income Tax Credit Program Has Made Advances; However, Alternatives to Traditional Compliance Methods Are Needed to Stop Billions of Dollars in Erroneous Payments* 13-14 (Dec. 31, 2008) (recommending that the IRS consider “Federal Case Registry information to determine its accuracy and applicability for exercising existing math error authority to deny the EITC during upfront processing of the tax return”), referenced in TIGTA, Ref. No.2011-40-023, *Reduction Targets and Strategies Have Not Been Established to Reduce the Billions of Dollars in Improper Earned Income Tax Payments Each Year* 9 (Feb. 7, 2011). IRC § 6213(b)(1) gives the IRS the authority to adjust an account for a mathematical, clerical, or other specified error or omission in IRC § 6213(g)(2) by issuing a notice instead of following Statutory Notice of Deficiency procedures.

<sup>56</sup> See Most Serious Problem: *Expansion of Math Error Authority and Lack of Notice Clarity Create Unnecessary Burden and Jeopardize Taxpayer Rights*, *supra*; National Taxpayer Advocate 2003 Annual Report to Congress 113 (Most Serious Problem: *Math Error Authority*); National Taxpayer Advocate 2002 Annual Report to Congress 187, 193-97 (Legislative Recommendation: *Math Error Authority*).

<sup>57</sup> For a discussion of the National Taxpayer Advocate's concerns about using FCR information, see National Taxpayer Advocate 2002 Annual Report to Congress 187, 193-97 (Legislative Recommendation: *Math Error Authority*).

the return, but the correct amount is determinable with a high degree of probability from the information that appears on the return.”<sup>58</sup> It is difficult, if not impossible, to apply the “High Degree of Probability Standard” to the fluid living arrangements parents make on a sometimes daily basis over the residency of their children.<sup>59</sup>

### Improved service can increase EITC compliance.

Two components of EITC eligibility, relationship and residency,<sup>60</sup> are particularly difficult to substantiate,<sup>61</sup> especially when low income taxpayers find the IRS’s letters and information requests confusing. IRS letters are legalistic, not tailored to the taxpayer’s particular situation, and do not discuss alternate sources of documentation. Low income persons may live without written leases or may not have school records for their children because of their living situation or patterns of moving. Migratory living patterns, lack of education, lack of time (*e.g.*, holding multiple jobs), lack of transportation, and limited access to technology (Internet, faxes, etc.) add to the difficulty of finding and submitting documents. IRS time-frames can be so tight that even if a low income taxpayer gathers the documents, by the time he or she submits them the IRS has already issued a Statutory Notice of Deficiency. If the taxpayers have moved, the mail may never reach them in time for a timely response.

In 2008, the IRS convened a Taxpayer Correspondence Taskgroup (TACT) Examination Team with the task of increasing voluntary taxpayer compliance and enhancing customer service by improving the language, content, and processes of written communications about audits. The team, which included TAS representation, reviewed research compiled by TAS and identified the Initial Contact Letter as a high-volume letter that needed substantial improvement.<sup>62</sup> The team made suggestions and designed a prototype, which the IRS referred to an outside contractor for improvement, but has not finalized and put into use. While the IRS has made significant progress updating account notices, the IRS has not yet finalized the Initial Contact Letter or the other high-volume letters used in correspondence examination.

TAS is collaborating with the IRS on two pilot programs to improve EITC compliance by improving service. One pilot tests the use of affidavits to establish qualifying child

<sup>58</sup> H. Rep. 94-658 (1976), p. 292; S. Rep. 94-938 (1976), p. 378.

<sup>59</sup> See Most Serious Problem: *Expansion of Math Error Authority and Lack of Notice Clarity Create Unnecessary Burden and Jeopardize Taxpayer Rights*, *supra*; see also Legislative Recommendation: *Mandate that the IRS, in Conjunction with the National Taxpayer Advocate, Review Any Proposed Expanded Math Error Authority to Protect Taxpayer Rights*, *infra*.

<sup>60</sup> Under the relationship requirement, a taxpayer generally may claim EITC with respect to a child who is his or her 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. IRC § 152(c)(2). Under the residence requirement, a taxpayer generally may claim EITC only with respect to a child who lives with the taxpayer for more than half the calendar year. IRC § 152(c)(1)(B).

<sup>61</sup> See Leslie Book, *EITC Noncompliance: What We Don’t Know Can Hurt Them*, Tax Notes (June 23, 2003) 1821; Leslie Book, *The Poor and Tax Compliance: One Size Does Not Fit All*, 51 Kans. L. Rev. 1145 (2003), available at [http://works.bepress.com/leslie\\_book/8](http://works.bepress.com/leslie_book/8); National Taxpayer Advocate 2002 Annual Report to Congress 50 (Most Serious Problem: *EITC Eligibility Determinations Can Be Made Less Burdensome*).

<sup>62</sup> The Initial Contact Letter (Letter 566) is the notification issued to inform a taxpayer that he or she is under correspondence audit and to detail the substantiation needed to resolve the issues under review.

status, while the other tests the impact of enhanced one-on-one telephone communication throughout the examination process.

According to a 2002 study of 1999 EITC returns, the most common reason the IRS disallows EITC is that taxpayers do not substantiate that their children lived with them for over half of the tax year.<sup>63</sup> In 2009, the IRS, with the assistance of TAS Research, began a three-year study to investigate whether the use of third-party affidavits can help claimants demonstrate the residency of qualifying children during audits. While current audit procedures allow taxpayers to provide either official records or letters on official letterhead to document the residence of a child, this pilot program gives the taxpayer the option of using another type of documentation — a third-party affidavit. This procedure allows third parties with knowledge of the child's residency to fill out a standardized affidavit rather than write a letter.<sup>64</sup> The objectives of this study are to answer the following questions:

- To what extent do affidavits reduce underclaims or increase overclaims?
- What percentage of taxpayers used affidavits to try to demonstrate residency of their qualifying children?
- How does the option of using the third-party affidavit affect the efficiency of the audit process?

In the second pilot program, TAS is working with the Wage and Investment (W&I) and Small Business/Self-Employed (SB/SE) divisions to test whether alternative approaches to conducting EITC correspondence examinations affects the audit change rate. Phase 1 of the program requires correspondence examiners to make telephone calls to test-group taxpayers at two points during the examination process: about ten days after the initial contact letter, and just prior to issuing the Statutory Notice of Deficiency.<sup>65</sup>

In Phase 2, taxpayers who did not retain all of their EITC and who did not agree to (or filed an appeal or protest of) their audit outcomes will be referred to TAS. TAS case advocates will then attempt to contact these taxpayers to help them through the process of proving eligibility for EITC. The goals of this phase are:

- To determine whether TAS assistance affects audit results;
- If so, to estimate the extent to which TAS assistance reduces overclaims or increases underclaims; and
- To complete this study by the end of July 2012.

<sup>63</sup> IRS, *Compliance Estimates for Earned Income Tax Credit Claimed on 1999 Returns* 13 (Feb. 28, 2002).

<sup>64</sup> The IRS first tested the use of affidavits to establish residency of qualifying children on TY 2003 taxpayers who participated in a test of a proposed EITC certification process. Generally, this pilot program found affidavits more reliable than traditionally accepted documentation: "Affidavits were believed to be easier for taxpayers to obtain than official documents or letters. The results show that affidavits had a higher acceptance rate than the other two types of documents." See *IRS Earned Income Tax Credit (EITC) Initiatives: Report on Qualifying Child Residency Certification, Filing Status, and Automated Under-reporter Tests* 8, 14 (2008).

<sup>65</sup> See vol. 2, *Research Study: An Analysis of the IRS Examination Strategy: Proposals to Maximize Compliance, Improve Credibility, and Respect Taxpayer Rights*, *infra*; see also National Taxpayer Advocate FY 2012 Objectives Report to Congress xxii (*EITC Examination Effectiveness*).

## CONCLUSION

The EITC has complex eligibility requirements that present administrative challenges to both taxpayers and the IRS. A delicate balance is required to encourage participation and at the same time promote compliance. Research studies on the struggles experienced by low income taxpayers have influenced and resulted in a number of initiatives that, *if properly implemented*, can improve EITC compliance and allow the IRS to refocus on other, potentially more productive audits. Lessons learned in EITC cases may help the IRS avoid mistakes with the administration of the health care premium tax credit, a new refundable credit for low income individuals.<sup>66</sup> An improved and effective EITC process could provide a starting point for the health care credit. Without such a process, the IRS will face additional challenges and costs in testing new systems for an expansive and complicated new credit.

In conclusion, the National Taxpayer Advocate offers these preliminary recommendations:

1. Update the estimate of EITC improper payments, disclose the methodology utilized, and share the data and methodology with TAS and the general public;
2. Review proposals, especially those that apply math error authority, in light of the reliability (or unreliability) of external data as well as each taxpayer's right to present his or her own facts;
3. Finalize requirements that paid preparers inquire about taxpayer eligibility for the EITC, retain relevant information, and file a due diligence checklist with the return;
4. Use the revised Initial Contact Letter to clearly notify taxpayers that they are under correspondence audit; and
5. Fast-track the implementation of successful pilot and study recommendations (*e.g.*, affidavits and increased communication).

## IRS COMMENTS

The IRS administers a balanced Earned Income Tax Credit program with two strategic goals — to increase participation of eligible taxpayers and reduce erroneous payments. Our outreach and compliance efforts are directed to improving both of these goals. Each year we complete in-depth research studies to measure EITC participation and improper payments, based on the most recent data available.

The IRS is committed to assisting EITC taxpayers in understanding and fulfilling their tax obligations, while reducing taxpayer burden and protecting taxpayer rights. The IRS has developed a robust, multi-year communication strategy that leverages communication channels and marketing to increase EITC participation and provides resources to both taxpayers and preparers so that they can learn about EITC eligibility and preparer due

<sup>66</sup> IRC § 36B.

diligence requirements. This strategy includes public service announcements, along with the use of social media, the EITC Assistance tool on IRS.gov, the annual EITC Awareness Day, partnering with more than 300 community-based organizations and review of all filed returns for potential EITC eligibility. We also target the paid preparer community to address due diligence by conducting seminars at the Nationwide Tax Forums and access to the Tax Preparer Toolkit on our EITC Central website. Our research studies on participation, completed with the U.S. Census Bureau, show that EITC participation increased from 75 – 77 percent for tax year 2005 to 78 - 80 percent for tax year 2008.

In addition to ensuring eligible taxpayers receive EITC, the IRS also takes very seriously the need to prevent erroneous payments. The IRS employs a number of traditional enforcement tools in this area. In addition to examinations, our enforcement strategy includes traditional taxpayer treatments such as math error that corrected over 340,000 EITC claims and our underreporter program that addressed over 900,000 returns that underreported income. It also includes our soft notice program that solicits self-correction from 150,000 taxpayers annually.

The IRS recognizes, however, that we cannot address the error rate by traditional enforcement tools alone and continues to explore alternatives to address noncompliance. As the National Taxpayer Advocate's report indicated, the IRS's recent Tax Return Preparer Initiative is expected to have a significant impact on reducing EITC fraud and error. Preparers prepare over two-thirds of all EITC returns. The IRS is in the second year of this groundbreaking initiative, which includes requiring registration, testing and continuing education for tax return preparers. The new initiative also brings all return preparers under the ethical rules of Circular 230, which gives the IRS disciplinary tools in the case of preparer misconduct. More than 740,000 tax return preparers have registered since last year. New education and enforcement requirements are aimed at improving the accuracy of EITC returns that paid preparers file on behalf of their clients. The IRS is testing the effectiveness of various preparer treatments, including due diligence audits, educational visits, and letters. Preparers are also addressed through our criminal enforcement efforts.

The Administration's FY 2012 revenue proposals included an increase in the penalty imposed on paid preparers who fail to comply with the EITC due diligence requirements. The increase in the penalty from \$100 to \$500 per return was enacted in recent trade legislation, effective for returns due after December 31, 2011. As noted, the IRS is in the process of finalizing rules to require preparers to include the due diligence checklist with EITC returns. The IRS also formed an EITC Software Developers Working Group to collaborate on software enhancements and other efforts to help reduce EITC errors and assist preparers in meeting their EITC due diligence requirements.

The IRS employs a data-driven approach to identify and treat paid preparers who submit erroneous EITC claims. We continually strive to improve our preparer identification processes and test and evaluate new approaches to reduce erroneous EITC claims. As real-time



data becomes available, we will test and evaluate its use to improve our data driven model with goals of more effective and timely identification and treatment of noncompliant EITC return preparers. We also have been coordinating with Automated Underreporter (AUR) to identify EITC preparers with a high percentage of income mismatches based on information returns. After full implementation of the return preparer initiative, we will begin measuring its impact on EITC improper payments.

The IRS estimate of EITC improper payments is based on the most current information available — the current FY 2011 estimates are based on tax year 2007. The IRS improper payment estimates are based on the examination of a statistically valid sample of returns as part of the National Research Program (NRP). These audits are significantly different from the campus correspondence examinations referred to in the National Taxpayer Advocate's report. NRP audits are research audits, which mean the goal of the audits is to gather accurate information across multiple tax issues. More specifically, the NRP audits are primarily conducted face-to-face with taxpayers, not through correspondence; they are all post-refund; and the rate of non-response for these audits is closer to 15 percent rather than 70 percent referred to in the National Taxpayer Advocate's report. On the issue of non-response, it should be noted that the IRS improper payment estimate does not merely classify all no-shows as undeserving — instead we explicitly assume that many of these taxpayers would qualify for the credit.

The improper payment rate dropped from 26.3 percent in FY 2010 to 23.5 percent in FY 2011. This corresponds to a reduction from \$16.9 billion in FY 2010 to \$15.2 billion in FY 2011. While the reduction is significant, given that estimates are based on lagging audit data and that it is difficult to analytically pinpoint the exact cause of the reduction, the figure should be used cautiously.

The IRS appreciates the recognition of the continuing challenges faced by the EITC Program. The credit's eligibility rules are complicated, particularly the requirements to meet the relationship and residency tests. The complexity in applying these rules to common real-life situations is a challenge for both taxpayers and preparers and influences EITC error.

The IRS cannot independently validate whether taxpayers meet eligibility requirements for EITC. Reliable third-party data, however, can assist the IRS in compliance filters as well as in math error. In looking for new math error authority opportunities, the IRS considers accuracy and consistency of third-party data, administrative cost savings and efficiencies, compliance enhancements, simplicity and operational feasibility, as well as taxpayer rights and burden reduction.

The IRS recognizes the importance of clear communication and is working at improving notices sent to EITC taxpayers. In FY 2011, the IRS initiated revisions to the CP 75 notice series, *i.e.*, the initial contact letters used for most EITC audits. We anticipate the new



notices will be ready for use by 2013 and will provide taxpayers with a better understanding of the EITC audit process.

In the report, the National Taxpayer Advocate implies that IRS timeframes do not allow taxpayers enough time to provide documents to show EITC eligibility prior to the issuance of a Statutory Notice of Deficiency. The IRS does not believe that is the case. Taxpayers receive at least two notices requesting the documentation prior to the issuance of a SNOD. Besides stating the timeframe for responding, the notices also provide a telephone number for taxpayers to call with questions or if they need assistance. If a taxpayer requests additional time to provide documentation (either by telephone or written communication), the IRS has established procedures that give the taxpayer additional time to respond. Additionally, after a SNOD has been issued, the IRS continues to work with taxpayers and accepts any documents that verify a taxpayer is eligible for the EITC.

The IRS looks for opportunities to improve service to EITC taxpayers on a continuous basis. As the National Taxpayer Advocate discusses in the report, we are currently working with TAS on a three-year test to determine whether the use of third-party affidavits is another viable alternative that taxpayers may use to document the residency requirement. We are also working with TAS on another test on alternative processes for conducting correspondence exams.

The IRS offers the following comments with respect to the preliminary recommendations:

The IRS will continue its annual estimates of EITC improper payments using the most recent NRP data available. IRS will also continue to share that methodology with Treasury, OMB, oversight agencies and the public as it has in the past. The most recent figures are included in Treasury's Performance and Accountability Report (PAR) for FY 2011. Also, the NRP data used in the EITC improper payments estimate are available on the Research, Analysis and Statistics (RAS) Compliance Data Warehouse (CDW).

With respect to new proposals, we will continue to take into account the reliability of third-party data as well as taxpayers rights. While we plan to continue our efforts to identify new sources of information to verify EITC eligibility, math error candidates, and alternative compliance treatments to address EITC error, as with all strategic business decisions to achieve a balanced compliance program, we will consider the protection of taxpayer rights and impact on taxpayer burden as part of any new solutions.

As discussed, the IRS is in the process of finalizing changes to the EITC preparer due diligence requirements that were included in the proposed regulations issued on October 11, 2011. The proposed regulations include the requirement that paid preparers complete and submit Form 8867, *Paid Preparer's Earned Income Credit Checklist*, with every EITC tax return prepared. Under current requirements, preparers are required to keep a copy of the checklist for their records.

The IRS agrees that clear communication is important to inform taxpayers of an audit and help them understand what information they need to provide to resolve their audit issues. We have initiated revisions to CP 75 notice series, the initial contact letters used for most EITC audits. We anticipate the revised notices will be available for use by January 2013.

Finally, with respect to the proposal to fast-track implementation of pilots, after pilots are complete, we will carefully evaluate the results and recommendations. We will review the successes and best practices of the studies, consider operational implications, and roll them out as appropriate.

### Taxpayer Advocate Service Comments

The National Taxpayer Advocate commends the IRS's efforts to improve EITC service and compliance, and welcomes the opportunity for continued collaboration on innovations such as the affidavit and examination pilot programs. However, the National Taxpayer Advocate finds several aspects of the IRS's response to be troubling.

The response above states that the "IRS cannot independently validate whether taxpayers meet eligibility requirements for EITC." Yet IRS validation of taxpayer eligibility is the core of tax administration. Consequently, this statement appears to be a startling abdication of government responsibility. While external data may be a useful *indicator*, the National Taxpayer Advocate questions whether that data can ever substitute for a careful review of facts that a taxpayer may present.

Data-driven approaches are only as good as the underlying data, which must withstand rigorous public and professional peer review. It is unclear if the 23.5 percent improper payment rate based on NRP "research audits" reflects the reality of the EITC, for which many taxpayers undergo correspondence examinations. According to the IRS, the non-response rate for face-to-face audits is 15 percent, compared with 70 percent for correspondence examinations. If so, this confirms that the type of audit drastically affects the outcome. Moreover, the difference between the 15 and 70 percent non-response rates suggests that correspondence examination should not be the primary EITC compliance tool, as it depends on a taxpayer's ability to navigate the particular exam process that the IRS offers.

Additionally, the IRS states that the "improper payment estimate does not merely classify all no-shows as undeserving – instead we explicitly assume that many of these taxpayers would qualify for the credit." It is difficult to suggest improvements to the methodology behind the estimation of improper payments without knowing the underlying assumptions. Accordingly, it is in the best interest of tax administration to share these assumptions as well as data for reevaluation of the estimates.

For that matter, key aspects of data and methodology remain shrouded in obscurity. The IRS response above references the Treasury's FY 2011 Performance and Accountability Report, yet it is unclear that this report addresses EITC.<sup>67</sup> On the other hand, improper payments are discussed in Appendix B of Part 3 of the Agency Financial Report.<sup>68</sup> Consequently, it is difficult to verify the IRS response. While this response states that the relevant data are in the CDW, an all-encompassing IRS database not accessible by the public, the IRS comments above also mention a Census research study, without citing a specific title. Again, it would be a challenge to confirm these assertions, leaving the 1999 study as the last publication to have revealed assumptions, data, and methodology that illuminated a complete picture of EITC compliance.<sup>69</sup> The IRS response states that the improper payment rate dropped from 26.3 to 23.5 percent from FY 2010 to 2011. Would these figures be comparable to the range of 27.0 to 31.7 percent reported in the 1999 study?<sup>70</sup> Taxpayers, Congress, and the public deserve full disclosure to make informed decisions.

The National Taxpayer Advocate commends the IRS on outreach to the target population and their preparers. The National Taxpayer Advocate has long championed regulation of preparers, particularly because it should improve EITC compliance. We encourage the IRS, after finalizing proposed regulations that require preparers to file a due diligence checklist with the return after reviewing and retaining eligibility information, to implement regulations that will expand the scope of what preparers must inquire about and review in order to fulfill their EITC due diligence requirements. At the same time, we encourage the IRS to use plain-language form letters that EITC taxpayers can easily read and understand. Until the IRS provides clear communication, taxpayers may continue to misunderstand requirements and miss deadlines, even if the IRS considers them sufficient (and sufficiently clear).

<sup>67</sup> See <http://www.treasury.gov/about/organizational-structure/offices/Mgt/Documents/Full%20Report%20of%20the%20Treasury%20Department.pdf> (last visited Dec. 19, 2011).

<sup>68</sup> See <http://www.treasury.gov/about/budget-performance/annual-performance-plan/Documents/FY%202011%20AFR-%20Part3.pdf> (last visited Dec. 19, 2011).

<sup>69</sup> See IRS, *Compliance Estimates for Earned Income Tax Credit Claimed on 1999 Returns* (Feb. 28, 2002).

<sup>70</sup> *Compliance Estimates for Earned Income Tax Credit Claimed on 1999 Returns at 3* ("Of the estimated \$31.3 billion in Earned Income Tax Credit (EITC) claims made by taxpayers who filed returns in 2000 for tax year 1999, it is estimated that between \$8.5 and \$9.9 billion (27.0 percent to 31.7 percent) should not have been paid.").

## Recommendations

In conclusion, the National Taxpayer Advocate is pleased that the IRS response above seems generally consonant with her recommendations, but emphasizes that these key items should not be glossed over. The IRS should:

1. Prepare and disclose a full report on its current and prior EITC noncompliance studies, similar to that reporting on 1999. Among other things, this report should disclose assumptions within the methodology as well as data for continued update of the EITC improper payment estimate, which needs to become transparent in light of policies it may generate.
2. Utilize external data only as an indicator for the risk of noncompliance, so that taxpayers retain their right to have an opportunity to present his or her own facts, a right not subject to compromise by an IRS business decision.
3. Send correspondence in plain language by implementing the revised Initial Contact Letter (Letter 566) and beginning revision of the other high-volume letters used in correspondence examinations as discussed above by January 2013.

MSP  
#15**Reinstatement of a Modernized TeleFile Would Reduce Taxpayer Burden and Benefit Tax Administration****RESPONSIBLE OFFICIALS**

Beth Tucker, Deputy Commissioner-Operations Support  
 Julie Rushin, Deputy Chief Information Officer for Operations  
 Richard E. Byrd Jr., Commissioner, Wage and Investment Division

**DEFINITION OF PROBLEM**

The reinstatement of a modernized version of TeleFile would provide individual and small business taxpayers with a free, convenient government method of filing electronically. The program, which the IRS shut down in 2005, allowed taxpayers who filed relatively simple returns and met specific requirements to file by touch-tone telephone. The end of this program left a segment of the taxpaying population, including both individuals and small businesses, with no convenient way to file electronically at no cost.<sup>1</sup> In fact, the IRS's elimination of TeleFile and refusal to revive an expanded Telefile program has an economically and racially discriminatory impact.<sup>2</sup> Although the IRS expected TeleFile users to convert to other e-filing methods, nearly 30 percent of former TeleFile users instead filed paper returns in 2008.<sup>3</sup> By creating a 21<sup>st</sup> century version of the Telefile application, the IRS can take advantage of the surge in demand for services delivered through smartphone and cell phone technology. In fact, approximately 83 percent of American adults own a cell phone and approximately 35 percent own a Smartphone.<sup>4</sup> Telefile can then serve as a bridge to full electronic filing after taxpayers migrate from the program.

**ANALYSIS OF PROBLEM****Background**

In 1996, the IRS launched the nationwide TeleFile, which allowed eligible taxpayers to file returns using the keypads on their phones. TeleFile, which was then the only electronic filing method offered directly by the IRS, was promoted as the most convenient, quickest, and simplest way to file. By 2005, taxpayers could file the Form 1040EZ, *Income Tax Return*

<sup>1</sup> In addition to providing individuals with a free method to electronically file Form 1040EZ, *Income Tax Return for Single and Joint Filers With No Dependents*, and 4868, *Application for Automatic Extension of Time To File U.S. Individual Income Tax Return*, TeleFile was the only free way to electronically file Forms 941, *Employer's Quarterly Federal Tax Return*. Thus, the decision to terminate TeleFile also increased the compliance burden of some small businesses.

<sup>2</sup> The results of a Pew Internet & American Life Project Survey from May 2011 indicate a significant decrease in Internet use as age increases, along racial lines, as education levels decrease, and as annual household income level decreases. The survey was conducted by telephone and 755 of the 2,277 respondents used their cell phones to respond to the interviews (the remaining used land-line telephones). U.S. Census Bureau, *Statistical Abstract of the United States: 2012, Information and Communications, Table 1158, Adult Computer and Adult Internet Users by Selected Characteristics: 2000 to 2011*.

<sup>3</sup> National Taxpayer Advocate 2010 Annual Report to Congress vol. 2, 125-156 (*TeleFile - Taxpayers' Characteristics and Filing Behaviors: A Study to Enhance Taxpayer Assistance Blueprint Knowledge*).

<sup>4</sup> Aaron Smith, Pew Internet and American Life Project, *Americans and Their Cell Phones: Mobile Devices Help People Solve Problems and Stave Off Boredom, but Create Some New Challenges and Annoyances* 2, 3 (Aug. 15, 2011).

for *Single and Joint Filers With No Dependents*, certain state individual returns, Form 4868, *Application for Automatic Extension of Time to File U.S. Individual Income Tax Return*, and Form 941, *Employer's Quarterly Federal Tax Return*. On average, the program was used by 4.4 million taxpayers annually and had a satisfaction rate of over 90 percent, the highest of all filing options in 2004.<sup>5</sup> In fact, the initial success of the program led Congress to mandate that “the IRS should continue to offer and improve its TeleFile Program and make a comparable program on the Internet.”<sup>6</sup> In March 2003, the Treasury Inspector General for Tax Administration (TIGTA) suggested the IRS make TeleFile accessible to even more taxpayers. Instead, in 2004 the IRS Electronic Tax Administration Advisory Committee (ETAAC) recommended that the IRS eliminate the program and redirect the funds to the Modernized e-file Project.<sup>7</sup> In August 2005, the IRS discontinued TeleFile, citing the following reasons:

- Increasing costs;
- Declining use;
- Discontinued state telefile programs; and
- Growth of other electronic filing options.<sup>8</sup>

#### **The IRS's Decision to Terminate TeleFile Was Unjustified.**

The National Taxpayer Advocate believes that the IRS should not have terminated the TeleFile program. In fact, the IRS stopped publicizing it and narrowly defined the user population, but then claimed the cost per return was too high. However, the cost to run the program is a fixed contract cost, so the cost per return will increase as the participation rate decreases. Thus, by failing to publicize the program, the IRS increased the cost per return. Before terminating the program, the IRS did not give due consideration to ways to broaden the base of eligible taxpayers to reduce the cost per return. Further, it did not explore ways to modify the program to meet the changing needs of taxpayers. Because of the IRS's decision, millions of individuals and small businesses had to find other ways to prepare their returns – and many reverted to paper or used paid preparers.<sup>9</sup>

#### **Low Usage of TeleFile Was the Result of Eligibility Restrictions.**

The IRS cited declining usage as a reason to discontinue TeleFile. While use steadily decreased between 1998 and the end of the program, the number of taxpayers eligible to use

<sup>5</sup> TIGTA, Ref. No. 2007-40-116, *Eliminating TeleFile Increased the Cost and Burden of Filing a Tax Return for Many Taxpayers 1* (July 20, 2007). For tax year (TY) 2004, TeleFile accounted for over 800,000, or nearly 19 percent of electronically-filed Form 941 returns, *Employer's Quarterly Federal Tax Return*. SB/SE Research, *FY 2005 Nationwide Analysis, Electronic Tax Administration Business Master File Marketing Database*, Slide 9 (June 2005).

<sup>6</sup> H.R. Conf. Rep. No. 105-599 at 235 (1998); TIGTA, Ref. No. 2007-40-116, *Eliminating TeleFile Increased the Cost and Burden of Filing a Tax Return for Many Taxpayers* (July 20, 2007).

<sup>7</sup> Electronic Tax Administration Advisory Committee 2004 Annual Report to Congress 8 (June 30, 2004).

<sup>8</sup> IRS, Announcement 2005-26: *IRS to Discontinue TeleFile*, Internal Revenue Bulletin 2005-17 (Apr. 25, 2005); TIGTA, Ref. No. 2007-40-116, *Eliminating TeleFile Increased the Cost and Burden of Filing a Tax Return for Many Taxpayers 2* (July 20, 2007).

<sup>9</sup> TIGTA, Ref. No. 2007-40-116, *Eliminating TeleFile Increased the Cost and Burden of Filing a Tax Return for Many Taxpayers 5, 6* (July 20, 2007).



the program steadily declined as well.<sup>10</sup> In fact, the percentage of eligible taxpayers who used the program remained fairly constant (an average percentage of almost 45 percent between 1998 and 2005 with the last year at 41.7 percent).<sup>11</sup> Thus, the reduced participation was not necessarily a result of taxpayer preferences, but rather the restrictive eligibility requirements. These requirements included an income and interest threshold, no dependents, age, filing status, disability, no paid preparer use, and address change limitations. Taxpayers also had to receive a TeleFile tax package, which the IRS would mail based on the return filed the previous year. However, taxpayers' circumstances change and ineligibility in one year does not necessarily lead to ineligibility in the next. Thus, the IRS should have explored the feasibility of expanding the requirements and making packages available to previously ineligible taxpayers before terminating the program based on low usage and increasing costs.

In a 2010 study, the Taxpayer Advocate Service Research Office estimated that approximately eight million taxpayers would be eligible for TeleFile if the 2005 eligibility criteria remained constant.<sup>12</sup> If the IRS modified the limitation on moving, it could add about two and a half million taxpayers to the base. If the IRS modified several eligibility restrictions, it could increase participation by as much as 27 million, about a third of which would switch from paper filing.<sup>13</sup>

#### **A Significant Portion of Former TeleFile Users Reverted to Paper Filing.**

The IRS developed TeleFile as a gateway from paper to electronic filing. Therefore, it is no surprise that studies by both TIGTA and TAS found that a considerable percentage of former TeleFile users reverted to paper filing rather than move to another electronic method as anticipated. When reverting to paper, taxpayers lose the benefits of e-filing, including faster refunds and more accurate transcription. In addition, the elimination of TeleFile may have caused some of these taxpayers to purchase commercial refund delivery products with high associated fees. TIGTA found that almost 966,000 (or approximately 48 percent) of the former users who would have remained eligible to use the program in 2006 reverted

<sup>10</sup> TIGTA, Ref No 2007-40-116, *Eliminating TeleFile Increased the Cost and Burden of Filing a Tax Return for Many Taxpayers* Figure 6 (July 20, 2007.)

<sup>11</sup> The percentage of eligible taxpayers using TeleFile by year: 40.8 percent in 1998, 41.2 percent in 1999, 40.8 percent in 2000, 47.5 percent in 2001, 54.6 percent in 2002, 47.4 percent in 2003, 45.9 percent in 2004, and 41.7 percent in 2005 (the year the program ended). TIGTA, Ref. No. 2007-40-116, *Eliminating TeleFile Increased the Cost and Burden of Filing a Tax Return for Many Taxpayers*, Figure 6 (July 20, 2007).

<sup>12</sup> Similarly, in 2005, approximately 7.9 million taxpayers were eligible to use TeleFile and approximately 3.3 million returns were filed in 2005 using TeleFile. In comparison, total Free File usage (including Free File and Free File Fillable Forms) was approximately 3.17 million in 2011, which is down from nearly 3.25 million in 2010. IRS, Daily E-File At-a-Glance, U.S. Totals for Individual Returns, ELF1505 (Oct. 25, 2011); TIGTA, Ref. No. 2007-40-116, *Eliminating TeleFile Increased the Cost and Burden of Filing a Tax Return for Many Taxpayers*, Figure 6 (July 20, 2007).

<sup>13</sup> National Taxpayer Advocate 2010 Annual Report to Congress vol. 2, 146 (*TeleFile – Taxpayers' Characteristics and Filing Behaviors: A Study to Enhance Taxpayer Assistance Blueprint Knowledge*). In January 2004, the IRS enhanced the TeleFile system to allow taxpayers who moved to an address different than that on their TeleFile tax package to use TeleFile if they used direct deposit for their refund. IRS Seven-Day Response to MSP on Low Usage of Telefile (Nov. 16, 2011). However, taxpayers needed to be in possession of the package in order to use TeleFile and packages were not forwarded in the mail. Thus, in order to be in possession of the package, the taxpayer needed to either (1) move after receiving the package but before filing the return or (2) inform the IRS of the new address before the packages were mailed.

to paper.<sup>14</sup> TAS also found that they continued to file by paper for at least several years after TeleFile ended, and nearly 30 percent filed paper returns in 2008.<sup>15</sup>

It is in the best interest of tax administration to steer taxpayers toward electronic filing. TeleFile affords the agency and taxpayers many of the same advantages as traditional e-file. Telefile was simple; available 24 hours a day, seven days a week; allowed for quick refund turnaround time; and provided a filing acknowledgement. Not every household has the required computer or Internet access for standard e-file. A recent Pew Internet Project survey showed that approximately one in four adults does not use the Internet. However, a U.S. Census Bureau American Community Survey found that nearly 98 percent of U.S. households have some type of telephone service.<sup>16</sup>

#### **Many Former TeleFile Users Paid Significant Preparation Fees.**

TeleFile was one of only two ways available to taxpayers to electronically file at no cost and was the *only* free e-file method provided directly by the federal government. TIGTA estimated that of approximately two million individual taxpayers who used TeleFile in 2005, more than 541,000 taxpayers paid \$23.6 million to file in 2006 after the program ended. In effect, when the IRS eliminated TeleFile, it shifted its costs to taxpayers. The IRS expected to save between \$17 million and \$23 million by retiring the program, but TIGTA estimated the former users paid approximately \$23.6 million to file in 2006.<sup>17</sup>

#### **A Modernized Version of TeleFile Would Leverage the Surge in Demand for Services Provided via Smartphone and Cell Phone Technology.**

Taxpayers are increasingly using cell phone technology to receive services. An August 2011 report by the Pew Internet & American Life Project found approximately 83 percent of American adults own a cell phone and 35 percent own a smartphone. Interestingly, approximately 15 percent use their cell phones for online banking.<sup>18</sup> To take advantage of these developments, many financial institutions offer smartphone applications that allow customers to identify account balances, move funds between accounts, pay bills, and receive notifications or alerts. Approximately 15 percent use their cell phones for online banking.<sup>19</sup> Banks actually realize savings by providing such technology, as the cost of a

<sup>14</sup> TIGTA, Ref. No. 2007-40-116, *Eliminating TeleFile Increased the Cost and Burden of Filing a Tax Return for Many Taxpayers* 6 (July 20, 2007).

<sup>15</sup> National Taxpayer Advocate 2010 Annual Report to Congress vol. 2, 141 (*TeleFile – Taxpayers’ Characteristics and Filing Behaviors: A Study to Enhance Taxpayer Assistance Blueprint Knowledge*).

<sup>16</sup> Pew Internet & American Life Project, Pew Research Center, *Internet, Broadband, and Cell Phone Statistics* 2, 7 (Jan. 5, 2010); U.S. Census Bureau, 2009 American Community Survey 1-Year Estimates, Table C25043.

<sup>17</sup> TIGTA, Ref. No. 2007-40-116, *Eliminating TeleFile Increased the Cost and Burden of Filing a Tax Return for Many Taxpayers* 2, 5 (July 20, 2007). In addition, in the year after the TeleFile program was terminated, the IRS required over 640,000 business taxpayers to file Form 944 annually instead of filing a quarterly Form 941. While the 944 program was intended to reduce taxpayer burden, it actually caused confusion as well as many unpostable returns and payments. Thus, many taxpayers were no longer allowed to use TeleFile and were immediately thereafter mandated to use a program that increased burden for both taxpayers and the IRS. 2008 IRPAC Report, Burden Reduction Subgroup Report 1.

<sup>18</sup> Aaron Smith, Pew Internet and American Life Project, *Americans and Their Cell Phones: Mobile Devices Help People Solve Problems and Stave Off Boredom, but Create Some New Challenges and Annoyances* 2, 3 (Aug. 15, 2011).

<sup>19</sup> *Id.* at 5.

smartphone or online transaction is typically two percent or less of the cost of one conducted by a traditional customer service representative.<sup>20</sup>

The IRS recognized the popularity of phone-based applications when it developed such smartphone applications as “IRS2Go,” which includes the popular program “Where’s My Refund?” It also provides the subscriber with the option to receive daily tax tips. The IRS launched the application in late January 2011 and by April 12, 2011, it had already been downloaded over 250,000 times.<sup>21</sup>

The private sector also offers a smartphone-based tax preparation program, TurboTax’s SnapTax, which allows taxpayers to file 1040EZ returns on a smartphone for approximately \$20.<sup>22</sup> By modernizing TeleFile to include smartphone technology, the IRS would not be competing with the private sector. It would merely provide a “plain vanilla” return filing platform without the costs of additional options that attach to commercial products. This new technology should include an option to send text notifications and alerts to subscribers, because the IRS would perform a valuable service by notifying or alerting taxpayers about their returns and refund status, as well as offering tax tips.

Finally, the IRS should evaluate the strengths and weaknesses of existing phone-based products available in the private sector as well as other government agencies and jurisdictions.<sup>23</sup> The IRS is certainly not the leader in this technology and could benefit from lessons learned by those who have already developed these products.

#### **The Expansion of Eligibility Requirements Would Increase Participation.**

Considering that TeleFile is a bridge technology to standard e-filing, the IRS should try to cover as many paper filers as possible when developing eligibility requirements for a new version. Even if it costs marginally more to process a return through TeleFile, the IRS would achieve years of downstream savings by converting paper filers to permanent e-filers. As the returns filed by TeleFile users become more complicated, they will become ineligible for the program. After having used TeleFile in the past, these “graduated” former users will be more comfortable filing through electronic means, will be less likely to revert back to paper, and will likely be more open to using software packages to prepare their own returns.

As mentioned previously, TAS Research analyzed the impact of changing various eligibility restrictions and how each variable would impact usage. We encourage the IRS to review

<sup>20</sup> *Smartphone Usage Creates Opportunities for Many, Including Attevo, Inc.*, PR Newswire (July 1, 2011).

<sup>21</sup> IRS News Release, IR-2011-41, *IRS Reminds Taxpayers to Use the IRS2Go App to Check Refunds; Downloads Top 250,000* (Apr. 12, 2011).

<sup>22</sup> See <http://turbotax.intuit.com/snaptax/mobile> (last visited Aug. 17, 2011).

<sup>23</sup> Some states use phone-based programs to collect business, sales/use, and property taxes. Canada uses a phone-based system called TELEFILE for individual income taxes. See <http://www.cra-arc.gc.ca/esrvc-srvce/tx/ndvdl/tlfl/bt-eng.html> (last visited Aug. 17, 2011). For an example of a local government jurisdiction using smartphone technology for property taxes, see <http://portal.arkansas.gov/services/Pages/servicesMobile.aspx> (last visited Oct. 25, 2011).

TAS's research to design eligibility requirements to maximize participation. Examples of requirements that the IRS might modify are (1) the requirement that the taxpayer receive the TeleFile package from the IRS beforehand, (2) income limits, and (3) the restriction on moving.<sup>24</sup>

## CONCLUSION

Reinstating and upgrading the TeleFile program would meet the needs of taxpayers who are relying more and more on phone-based technology. A modernized TeleFile would provide free electronic filing to both individuals and small businesses on a widely accessible platform. To increase participation and its effectiveness as a bridge technology to standard e-filing, an expansion of TeleFile eligibility requirements and a marketing campaign are necessary.

To reduce taxpayer burden and meet the needs of taxpayers as well as tax administration, the National Taxpayer Advocate preliminarily recommends that the IRS take the following actions:

1. Reinstating TeleFile with expanded eligibility requirements, including allowing taxpayers who move to use the system and increasing income thresholds.
2. Develop modern applications of TeleFile suitable for current technology, such as cell phones, smartphones, and tablets.

## IRS COMMENTS

TeleFile was developed in 1996 as an early initiative to move taxpayers, and the IRS, to a paperless tax filing system. This system provided an alternative to some taxpayers resistant or unable to have their taxes filed electronically. As electronic filing increased, TeleFile experienced a decline in participation that continued until the program was discontinued in August 2005.

The IRS discontinued TeleFile because of the decline in usage and high cost to maintain relative to other filing channels. Based on estimates, TeleFile volumes would have had to nearly triple in order to be cost-competitive. Moreover, TeleFile was more expensive than electronic filing at all achievable volumes.

The decline in usage of TeleFile was primarily due to a decrease in Form 1040EZ filings, which comprised 72 percent of the total TeleFile filings. While volumes for TeleFile of Form 4868, *Application for Automatic Extension of Time to File U.S. Individual Tax Return*, increased, it was not sufficient to offset the overall decline. In January 2004, the IRS allowed taxpayers who moved to a new address to use TeleFile if they directly deposited their

<sup>24</sup> National Taxpayer Advocate 2010 Annual Report to Congress vol. 2, 145-146, 151 (*TeleFile – Taxpayers' Characteristics and Filing Behaviors: A Study to Enhance Taxpayer Assistance Blueprint Knowledge*).

refund into a checking or savings account. This change was not sufficient to offset the decline in Form 1040EZ volumes.

The Free File program has been available as an alternative to TeleFile since August 2005. In 2011, Free File was available to taxpayers with an adjusted gross income of \$58,000 or less. The estimated number of taxpayers eligible to use this free tax preparation and e-filing service is approximately 96 million. Over 33 million federal returns have been filed using Free File since its inception.

In addition, starting in 2009, all filers became eligible to use Free File Fillable Forms, a free federal tax preparation and e-file service available to all taxpayers regardless of income. Other free filing options include Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE). Private industry also offers free Form 1040EZ e-filing services in the marketplace.

When the decision was made to discontinue TeleFile, the future stated vision for IRS Submission Processing was to tailor acceptance channels for efficiency and cost-effectiveness. The backbone of the acceptance process is a single pipeline, Modernized e-file (MeF) in conjunction with CADE2, for capturing data from paper and electronic submissions.

With regard to business returns, a Small Business e-file Communication Team is leading a cross-functional communication effort to increase the visibility and promotion of business e-file, including the Form 94x series and the Form 1120. While there are no free options as there are with individual Free File, the IRS is looking at IRS.gov, publications, and other outlets to inform businesses of the availability and value of e-file. The IRS Office of Online Services (OLS) is looking at various options for increasing Form 941 e-file and online payments.

The IRS does not believe that it is appropriate to reinstate TeleFile at this time. Free File and Free Fillable forms are available as free preparation and e-filing options for simple returns. These alternatives have assisted the IRS in receiving nearly 80 percent of Forms 1040 electronically. Reinstating TeleFile would cost the government and taxpayers millions annually to support and maintain. To the extent resources allow the development of modern applications suitable for current technology, such as cell phones, smart phones, and tablets, we anticipate that such technology would support our current electronic filing system rather than the retired TeleFile program.

## Taxpayer Advocate Service Comments

While the National Taxpayer Advocate understands the IRS's need to encourage traditional electronic filing to realize many of the associated benefits, including reduced return processing costs, she is disappointed by the IRS's short-sighted response to our concerns. Volunteer tax return preparation services, as well as Free File and Free File Fillable Forms, are free options for taxpayers with relatively simple returns.<sup>25</sup> However, the IRS should not eliminate a return preparation and filing program with the expectation that volunteer preparers will absorb a substantial portion of the program's former users. Further, for those who wish to prepare their own returns, electronic filing is not an option if they do not use the Internet, which is still an issue in a significant percentage of U.S. households. In fact, Census Bureau data show that over 31 percent of all U.S. "householders" did not use the Internet at home in 2009.<sup>26</sup> In comparison, a Census Bureau American Community Survey found that nearly 98 percent of households had some type of telephone service in 2009.<sup>27</sup> In addition, an August 2011 report by the Pew Internet & American Life Project found that approximately 83 percent of American adults own a cell phone and 35 percent own a smartphone.<sup>28</sup> In fact, the elimination of TeleFile and the IRS's refusal to revive an expanded program has a disparate impact on the elderly, minorities, and individuals who are in lower income brackets or have not achieved high education levels.<sup>29</sup>

The IRS states that any potential future application suitable for current technology, such as cell phones, smartphones, or tablets, should support the current electronic filing system rather than the retired TeleFile. We support this statement. The IRS does not necessarily need to base a new system on the retired one. If the IRS chooses to start with a completely different platform that uses cell phone, smartphone, and tablet technology, it would accomplish the same goal – a self-assisted preparation and filing application using phone-based

<sup>25</sup> Total Free File usage (including Free File and Free File Fillable Forms) was approximately 3.17 million in 2011, which is down from nearly 3.25 million in 2010. IRS, Daily E-File At-a-Glance, U.S. Totals For Individual Returns, ELF1505 (Oct. 25, 2011).

<sup>26</sup> U.S. Census Bureau, Current Population Survey (Oct. 2009), Table 1, *Reported Internet Usage for Households, by Selected Householder Characteristics: 2009* (Feb. 2010). In nearly 25 percent of households no one living in the household used the Internet at all. The percentage of households that do not use the Internet at home increases to over 41 percent for householders aged 55 or older, over 45 percent for African-American householders, over 47 percent for Hispanic householders, and over 67 percent for those who attained less than a high school degree. "Householder" is defined as the person (or one of the people) in whose name the housing unit is owned or rented.

<sup>27</sup> U.S. Census Bureau, 2009 American Community Survey 1-Year Estimates, Table C25043.

<sup>28</sup> Aaron Smith, Pew Internet and American Life Project, *Americans and Their Cell Phones, Mobile Devices Help People Solve Problems and Stave Off Boredom, but Create Some New Challenges and Annoyances* 2, 3 (Aug. 15, 2011).

<sup>29</sup> The results of a Pew Internet & American Life Project Survey from May 2011 indicates a significant decrease in Internet use as age increases (42 percent of adults 65 years and older as compared to 74 percent of those aged 50 to 64 years old), along racial lines (67 percent of Black, non-Hispanic adults as compared to 79 percent White, non-Hispanic adults), as education levels decrease (42 percent of adults with less than a high school degree compared to 94 percent college graduates or higher), and as income level decreases (63 percent of adults with annual household income of \$30,000 or less as compared to 96 percent of adults in households with annual household income of \$75,000 or more). Interestingly, the survey was conducted by telephone and 755 of the 2,277 respondents used their cell phones to respond to the interviews (the remaining used land-line telephones). U.S. Census Bureau, Statistical Abstract of the United States: 2012, Information and Communications, Table 1158, *Adult Computer and Adult Internet Users by Selected Characteristics: 2000 to 2011*.



technology available to both individual and business taxpayers. We note that the IRS itself is developing smart phone applications for both its current and future platforms.

The IRS also states that its expansion of eligibility requirements in 2004 failed to increase participation to meaningful levels. At that time, the IRS allowed taxpayers who moved to use TeleFile if they direct deposited their refund. However, it is our understanding that the IRS still required taxpayers to have the TeleFile package in order to use the program, and that the postal service did not forward these packages. Thus, taxpayers who moved could only use the program if they changed their addresses with the IRS before the packages were mailed or if they moved after they received the packages. This point is important because it significantly limits the number of taxpayers who moved in the past year and would still be eligible to use the program.

We understand that the cost per return filed under the former TeleFile system was more expensive than e-file. However, this cost is driven by the number of users – which was limited by the IRS’s restrictive participation criteria. Nearly 30 percent of former TeleFile users reverted back to paper filing for at least several years after the program was retired.<sup>30</sup> While the ultimate goal should be to steer all taxpayers to electronic filing, we cannot ignore the fact that a certain portion of taxpayers will choose paper over electronic filing and a sizable portion of the population does not have Internet access or is not computer savvy. The IRS could target remaining paper filers with a preparation and filing program that uses modern phone-based technology as a platform – whether it is a modernized version of the former TeleFile or a completely new program. The TAS 2010 TeleFile Study provides suggestions on how to expand eligibility requirements in order to increase usage and reduce the cost per return.<sup>31</sup>

In its response, the IRS acknowledges the absence of a free convenient method for small businesses to file Form 94x series returns and make payments. However, informing and directing these taxpayers to business e-file is not sufficient, because small businesses will need to pay for software or online preparation. Considering that the filing and payment of payroll taxes is key to our voluntary tax system, the IRS should develop a free and simple telephone application, thereby reducing the burden on millions of small businesses.

<sup>30</sup> National Taxpayer Advocate 2010 Annual Report to Congress vol. 2, 141 (*TeleFile – Taxpayers’ Characteristics and Filing Behaviors: A Study to Enhance Taxpayer Assistance Blueprint Knowledge*).

<sup>31</sup> *Id.* at 146.

## Recommendations

The National Taxpayer Advocate recommends that the IRS takes the following actions:

1. Reinstatement of TeleFile with expanded eligibility requirements, including allowing taxpayers who move to use the system and increasing income thresholds.
2. Develop modern applications of TeleFile suitable for current technology such as cell phones, smartphones, and tablets.
3. Develop a modern application of TeleFile to allow small businesses to file Form 94x series returns as well as make associated payments free of charge.

MSP  
#16**The IRS Does Not Sufficiently Recognize and Address Domestic  
Violence and Abuse and its Effects on Tax Administration****RESPONSIBLE OFFICIALS**

Richard E. Byrd Jr., Commissioner, Wage and Investment Division  
 Debra Chew, IRS Human Capital Officer  
 Faris Fink, Commissioner, Small Business/Self-Employed Division  
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**DEFINITION OF PROBLEM**

Approximately 1.3 million women and 835,000 men are physically assaulted by an intimate partner each year in the United States.<sup>1</sup> Nearly three out of four Americans know someone who is or has been a victim of domestic violence.<sup>2</sup> The problem is no respecter of age, gender, race, ethnicity, income, or occupation; it is a means by which an abuser exercises control over his or her victim.

Domestic violence and abuse, including economic abuse, have real consequences for tax administration. This includes joint returns signed under duress, joint returns signed without any possibility of meaningful review, and an array of tax noncompliance or frivolous litigation by an abuser that implicates the victim but which the victim is powerless to prevent. Identity theft, with all the tax consequences that flow from it, may itself be a form of domestic abuse, and abusive partners may use the IRS to inflict abuse on their victims. The dysfunctions caused by domestic violence and abuse can make the IRS unwittingly complicit in achieving the wrong result — imposing or collecting tax inappropriately, or from the wrong taxpayer. Conversely, the IRS, by achieving the correct tax result, may actually alleviate the economic harm perpetrated by the abuser.

The obstacles that prevent the IRS from effectively dealing with taxpayers who are victims of domestic abuse are:

- A lack of awareness and training, which may cause employees to misinterpret taxpayer responses or not solicit relevant information;
- Document-oriented systems and expectations, which may cause employees to overlook the availability of reliable information that would lead to the correct resolution of tax matters; and

<sup>1</sup> Dept. of Justice, *Full Report of the Prevalence, Incidence, and Consequences of Violence Against Women, Findings from the National Violence Against Women Survey* (July 2000) iv, available at <http://www.ncjrs.gov/pdffiles1/nij/183781.pdf>. The definition of intimate partner includes current or former spouses, opposite-sex cohabiting partners, same-sex cohabiting partners, boyfriends/girlfriends, and dates.

<sup>2</sup> Allstate Foundation *What is Domestic Violence?* (2011), available at <http://www.allstatefoundation.org/about-domestic-violence>.

- A lack of information available to IRS employees and in the literature and resources the IRS distributes to the public.

## ANALYSIS OF PROBLEM

### Background

One in every four women will experience violence at the hands of an intimate partner in her lifetime.<sup>3</sup> Women of all races are about equally vulnerable to violence by an intimate partner, and intimate partner violence affects people regardless of income.<sup>4</sup> Approximately 450,000 elderly persons in domestic settings were abused or neglected during 1996.<sup>5</sup>

Physical violence is one of the most recognizable forms of domestic violence. However, abusers also often use money as a tool to exercise control and ensure financial dependence, which in turn often forces victims to remain in violent situations.<sup>6</sup> Economic abuse takes many forms, but typical fact patterns include an abuser who restricts the victim's knowledge about and access to family finances, forbids the victim from handling money or incurring expenses, or allots the victim's daily expenses and requires the victim to account for every penny.<sup>7</sup> The abuser may deprive the victim of access to credit cards or banking services, take control of the victim's earnings, or prevent or limit employment. By stealing the victim's identity and damaging her or his credit, or filing joint tax returns that give rise to joint and several liability, an abuser can extend the effects of the abuse far into the future.<sup>8</sup> A taxpayer who interacts with the IRS from a position of near-total ignorance of her or his tax filing and payment history, with no control over what was done in her or his name, is at a serious disadvantage.<sup>9</sup> Paradoxically, the victim, particularly one who has been victimized for a long time, may underestimate the frequency and severity of the abuse.

<sup>3</sup> National Coalition Against Domestic Violence *Fact Sheet* (July 2007).

<sup>4</sup> See Bureau of Justice Statistics, *Violence Against Women: Estimates from the Redesigned National Crime Victimization Survey*, Aug. 1995, table 6, available at <http://bjs.ojp.usdoj.gov/index.cfm?ty=pbdetail&iid=805>.

<sup>5</sup> The National Center on Elder Abuse at The American Public Human Services Association in Collaboration with the Westat, Inc., *The National Elder Abuse Incidence Study* (1998) 1, available at [http://www.aoa.gov/AoARoot/AoA\\_Programs/Elder\\_Rights/Elder\\_Abuse/docs/ABuseReport\\_Full.pdf](http://www.aoa.gov/AoARoot/AoA_Programs/Elder_Rights/Elder_Abuse/docs/ABuseReport_Full.pdf).

<sup>6</sup> The most likely predictor of whether a victim will permanently separate from the abuser is whether the victim has the economic resources to survive without the abuser. Three critical ingredients of economic independence for victims are: income from a source other than the abuser; adequate transportation; and sufficient childcare arrangements. Barbara J. Hart, *The Legal Road to Freedom*, Minnesota Center Against Violence and Abuse (1991), available at <http://www.mincava.umn.edu/documents/hart/hart.html>.

<sup>7</sup> See Summary of Workshop Proceedings: *Exploring the Intersection between Financial Capability and Domestic Violence*, Center for Financial Security (2011) (recounting events on May 17, 2011, when the U.S. Dept. of the Treasury, the Social Security Administration, and the University of Wisconsin – Madison's Center for Financial Security hosted an event with the goal of bringing together government officials, academic researchers, domestic violence practitioners and policy makers to explore how personal financial capability relates to domestic violence), available at [http://cfs.wisc.edu/DV\\_Workshop/Gjertson\\_Issue\\_Brief.pdf](http://cfs.wisc.edu/DV_Workshop/Gjertson_Issue_Brief.pdf); see also *Stephenson v. Comm'r*, T.C. Memo. 2011-16, discussed *infra*; *Thomassen v. Comm'r*, T.C. Memo. 2011-88, discussed *infra*.

<sup>8</sup> Financial or material exploitation, defined as the illegal or improper use of an elder's funds, property, or assets, accounted for 30.2 percent of all *substantiated* reports of elder maltreatment in 1996. The National Center on Elder Abuse at The American Public Human Services Association in Collaboration with the Westat, Inc., *The National Elder Abuse Incidence Study* (1998) 1, available at [http://www.aoa.gov/AoARoot/AoA\\_Programs/Elder\\_Rights/Elder\\_Abuse/docs/ABuseReport\\_Full.pdf](http://www.aoa.gov/AoARoot/AoA_Programs/Elder_Rights/Elder_Abuse/docs/ABuseReport_Full.pdf).

<sup>9</sup> IRS Publication 3865, *Your Money Matters, Tax Information for Survivors of Domestic Abuse* (Rev. Oct. 2009) informs taxpayers "Domestic abuse is not just physical abuse. It often includes economic control. As a survivor of domestic abuse, you can take control of your finances. An important part of managing your finances is understanding your tax rights and responsibilities."

**Domestic Violence and Abuse Have Consequences for Tax Administration.**

Many taxpayers who are victims of domestic violence or abuse interact with the IRS, sometimes in the context of enforcement or collection activities. They may not effectively disclose that they are victims, and if the IRS does not recognize that possibility, it may not elicit information that would achieve the correct tax result.

**Example:** The IRS disallows the dependency exemption, child tax credit, and Earned Income Tax Credit (EITC) that a taxpayer properly claimed on a return she filed using head of household filing status. The reason for the disallowance is that the taxpayer's ex-husband (who filed first and is not being audited) improperly claimed the same items with respect to their son on his separate return for the same tax year.<sup>10</sup> The taxpayer was abused by her ex-husband. Her overriding concern is to avoid contact with him. This means she may not reply to the IRS's automatically-generated notices about the discrepancy, preferring to forego tax benefits rather than risk contact with her former spouse. The IRS will make no other attempt to contact the taxpayer and if she does not respond to the notices, will assess additional tax against her by default. The abuser will have successfully "stolen" her tax benefits. Alternatively, if the taxpayer calls the IRS to discuss her tax liability, the IRS employee may notice that she is reluctant to explain her living arrangements and is unfamiliar with her previous tax filing history as a married taxpayer. The employee may perceive her as evasive and seeming to have "something to hide," suggesting that she cheated on her taxes. To the taxpayer, the tax benefits may not compensate for the shame she feels in discussing her abuse and the risk of IRS disclosure to her ex-husband. If the IRS employee does not tactfully explore the taxpayer's situation, elicit additional information, and assure the taxpayer that her information will be kept confidential, the IRS may assess additional tax against her, even though she, rather than her ex-husband, is entitled to the claimed exemption and credits.

Training about how to listen carefully and how to use specific communication approaches if there are signs of domestic violence would prevent communications with taxpayers from becoming barriers to relief. An employee who is able to reassure the victim and explore how to get good information is positioned to address the taxpayer's problem and arrive at the correct tax result.

Perhaps the most common situation in which the problem of abuse comes to IRS attention is when taxpayers request innocent spouse relief. The need for innocent spouse relief stems from the operation of IRC § 6013(d)(3), which imposes joint and several liability on

<sup>10</sup> There were 935,772 dependents claimed by more than one taxpayer for tax year 2010. Individual Returns Transaction File (IRTF) from the Compliance Data Warehouse (CDW) tax year 2010 through cycle 201130 (Sept. 2011). Taxpayers who are not married, and same-sex couples (whether married or not) may encounter the same issues with respect to the dependency exemption and related tax benefits as do married heterosexual couples. See Internal Revenue Code (IRC) § 151 (allowing deductions for personal exemptions); IRC § 152(a)(1); (f)(1)(B) (defining "child" to include an adopted child).

married taxpayers who file joint returns.<sup>11</sup> Joint and several liability means that the IRS may potentially collect the entire tax from a joint filer who is a victim of domestic abuse even if:

- None of the tax liability is attributable to the victim's earnings or deductions;
- The abusive spouse prepared the erroneous or fraudulent return;
- The joint filers are no longer married when the IRS seeks to collect; and
- Responsibility for the tax was assigned to the abusive spouse as part of a divorce decree.

If it were not for the availability of innocent spouse relief, victims of domestic violence and abuse would simply be at the mercy of their abusers with respect to a tax return they may have been powerless to review or correct.<sup>12</sup> Taxpayers who request innocent spouse relief complete an IRS form that includes a question about domestic violence and abuse; about 16 percent indicate that they are victims.<sup>13</sup> Other than through answers on the form, information about domestic violence and abuse may come to light during administrative consideration of a claim or when litigation ensues.<sup>14</sup>

### **The IRS Explicitly Takes Domestic Violence and Abuse into Account in Some Situations.**

The IRS takes abuse into account when it evaluates a claim for innocent spouse relief.<sup>15</sup> IRS Chief Counsel attorneys follow special procedures in cases in which a claim of innocent spouse relief is available, or where one of the spouses may have signed the return under duress. These procedures apply not only when a taxpayer asks for innocent spouse relief or alleges duress, but any time the field attorney or paralegal knows of facts that indicate these claims might be well-founded.<sup>16</sup> In 2011, IRS Small Business/Self-Employed (SB/SE) Counsel developed a "best practices" reference for SB/SE trial attorneys when handling innocent spouse cases. In abuse cases, best practices include requesting third-party information from persons who would have knowledge of whether abuse occurred;

<sup>11</sup> Married taxpayers in community property states who do not file joint returns are generally liable for the tax on half of community income, regardless of which spouse generated the income. *Poe v. Seaborn*, 282 U.S. 101 (1930).

<sup>12</sup> IRC §§ 6015 and 66(c), known as the innocent spouse provisions, permit relief from liability arising from a joint return or from the operation of community property law under certain circumstances. For a more detailed discussion of innocent spouse relief, see Status Update: *The IRS Has Removed the Two-Year Deadline for Requesting Equitable Innocent Spouse Relief, but Further Adjustments to Its Procedures in Innocent Spouse Cases Are Warranted*, *infra*.

<sup>13</sup> Taxpayers request innocent spouse relief by submitting IRS Form 8857, *Request for Innocent Spouse Relief*. In a random sample of 290 Forms 8857 submitted during fiscal year (FY) 2011 that the IRS provided to TAS (IRS response to TAS information request (June 14, 2011)), TAS found that 45 taxpayers affirmatively answered the question "Were you a victim of spousal abuse or domestic violence during any of the tax years you want relief?"

<sup>14</sup> IRS response to TAS information request (Sept. 1, 2011).

<sup>15</sup> See, e.g., Rev. Proc. 2003-61, 2003-2 C.B. 296, used to evaluate claims under IRC § 6015(f). The presence of abuse may result in relief from tax attributable to the abused spouse's own items (sec. 4.01(7)(d)), may mitigate a spouse's knowledge of an item giving rise to a deficiency, and is a separate factor that weighs in favor of granting equitable relief (sec. 4.03(2)(b)(i)).

<sup>16</sup> Chief Counsel Directives Manual 35.4.1.8.1.2 (Aug. 11, 2004). Among other things, the procedures require that a reviewer of grade GS-15 or higher consider the case, and if the innocent spouse or duress claim is not conceded or settled, the reviewer must place a memorandum in the file explaining why the case should go to trial. A grade 15 manager (or other specially assigned reviewer in an "S" case) must also attend the trial, and following conclusion of the trial must again evaluate whether relief is warranted, documenting his or her conclusion in the file.



discussing the abuse allegations with the other spouse; if necessary, subpoenaing the other spouse to testify at trial; and determining which spouse is more credible as to whether there was abuse.<sup>17</sup> The National Taxpayer Advocate acknowledges the importance of fact-finding, especially where joint filers may have conflicting accounts. However, she is concerned that these practices might actually do harm, because they do not explain how to address victims' concerns that stem from abuse, as discussed below. For example, a victim of domestic violence or abuse might be so fearful of a former spouse that she or he would simply opt to not appear in court rather than risk any contact between them as they enter or leave the courtroom. Her or his truthful account may never be heard. An attorney who is alert to this possibility would be better able to manage and address such fearfulness.

The IRS's Criminal Investigation division handles informants who require anonymity because they are victims of domestic violence or abuse as confidential informants, and may offer them various levels of witness protection.<sup>18</sup>

In 2001, the IRS created training on domestic violence and abuse that is still used to train employees who evaluate innocent spouse claims.<sup>19</sup> However, the only IRS employees who routinely receive that training are the Wage and Investment division (W&I) employees working in the Centralized Innocent Spouse Unit.<sup>20</sup>

### **IRS Document-Oriented Systems and Expectations can be Obstacles to Relief for Victims of Domestic Violence and Abuse.**

Victims of domestic violence and abuse may not be able to substantiate the violence or abuse, which can create difficulties when they interact with a document-oriented IRS. There are many reasons why documentation may not be available, but an essential component of domestic violence is isolation imposed by the abuser, which leaves the victim with no access to social services or other witnesses who could corroborate or document the abuse. Isolation may also be self-imposed because the victim is ashamed of her or his condition, or the abuser may have convinced the victim that no one will believe her or him. The secrecy may be so complete that no one other than the victim (and the abuser) has clear knowledge of the violence. Family and friends may deny or have been shielded from

<sup>17</sup> IRS response to TAS information request (Sept. 1, 2011). The other best practices in abuse cases are: "Do not let trial be the first time that you hear the details of petitioner's allegations of abuse; Use informal and, if necessary, formal discovery to commit petitioner to his/her story well in advance of trial; Request documentation from petitioner to substantiate the abuse claim (restraining orders, police reports, doctor's notes, etc.); Recognize that abuse can play a part in all factors for purposes of ascertaining hazards (e.g., may still be married because of fear of leaving, may have reason to know because of duty of inquiry but is fearful to ask, may have mental or health issues because of abuse); Be aware that the Court is generally sympathetic to petitioners who claim to be victims of abuse and have credible evidence to support their claim. If you do not have any evidence to rebut petitioner's abuse claim, then settling or conceding the case may be the best option."

<sup>18</sup> IRS response to TAS information request (Sept. 1, 2011); IRM 9.4.2.5.1.1 (Mar. 3, 2007). Moreover, IRS and Chief Counsel employees may disclose domestic violence and abuse to federal, state, or local law enforcement officials pursuant to the provisions of IRM 11.3.34 (May 6, 2009).

<sup>19</sup> The training was patterned in part on training developed by The Community Tax Law Project, a low income taxpayer clinic in Richmond, VA, *Life After Domestic Violence: Escaping the Tax Consequences* (June 13, 2000). The training has been classified as obsolete as of Nov. 2004 and has not been updated. See IRS Catalog Information, available at <http://publish.no.irs.gov/cat12.cgi?request=CAT1&catnum=86924>.

<sup>20</sup> The IRS in 1998 created a specialized unit, the Centralized Cincinnati Innocent Spouse Operations Unit (CCISO), to handle innocent spouse claims under newly-enacted IRC § 6015.

knowledge of the abuse, bruises may have been hidden by clothing or makeup, and employment absences may have been masked by sick leave or changing jobs.<sup>21</sup> Most victims of domestic abuse do not seek medical attention.<sup>22</sup> Ultimately, the only available evidence of the abuse may be the victim's own testimony or affidavit.

Sometimes available documentation may actually undermine a victim's truthful claim of domestic violence or abuse. For example, a victim may seek a court protective order, only to later withdraw it or not resist an abuser's efforts to dismiss or quash it. This apparently inconsistent behavior may cast doubt on the victim's credibility. In reality, the inconsistency may simply reflect the changing dynamic of domestic abuse, best described as a cycle of violence.<sup>23</sup> An observer who is not familiar with domestic violence and abuse dynamics might question the victim's credibility because of contradictory behavior.

### **Failing to Recognize Domestic Violence and Abuse Can Lead to Incorrect Tax Results.**

When the IRS does not recognize and address domestic violence and abuse, it not only contributes to the taxpayer's distress, but also may arrive at the wrong tax result. Two recent cases illustrate the harm this can cause. In the recent *Stephenson* case, in which the Tax Court granted equitable innocent spouse relief, the taxpayer had difficulty convincing the IRS that she was a victim of physical violence as well as economic abuse.<sup>24</sup> Mrs. Stephenson had learning disabilities and consequently did not finish high school, nor was she able to pass the GED the three times she attempted it. Her husband, a licensed stockbroker who had served in the Marines, was physically abusive. Moreover, he did not allow Mrs. Stephenson access to the mailbox, and kept a filing cabinet with their financial documents under lock and key. When Mr. Stephenson needed Mrs. Stephenson to sign something, he placed it in front of her and told her where to sign. If Mrs. Stephenson asked questions, Mr. Stephenson threatened her or told her she was not intelligent enough to understand. When Mrs. Stephenson told her husband she was leaving him, he pushed her against a wall, pointed a gun at her head, and told her that he would kill her or himself if she left him. Mrs. Stephenson, with the help of a friend and while Mr. Stephenson was out of town, later fled to her mother's home and ultimately obtained a divorce decree.<sup>25</sup>

The court found that Mrs. Stephenson credibly testified as to specific examples of abuse, and her witness credibly testified about her bruises and how she had confided that she was

<sup>21</sup> This discussion is based on *Proving Physical Abuse or Extreme Cruelty*, based on a memorandum by Prof. Deborah Weissman, Univ. N. Carolina-Chapel Hill School of Law, on file with TAS.

<sup>22</sup> Dept. of Justice, *Full Report of the Prevalence, Incidence, and Consequences of Violence Against Women, Findings from the National Violence Against Women Survey* (July 2000), Exhibit 33, available at <http://www.ncjrs.gov/pdffiles1/nij/183781.pdf>.

<sup>23</sup> During early phases in the cycle in which tension builds and culminates in an explosive event, the victim may seek help from law enforcement authorities. However, the violent episode may be followed by the abuser's regret or contrition, expressions of apology, reconciliation, and a "honeymoon" phase, before the cycle begins again. During these later phases, the victim may withdraw her complaint or change her position. Lenore Walker, *The Battered Woman*, 3rd ed. 91-95, Springer Publishing Co., LLC (1979).

<sup>24</sup> *Stephenson v. Comm'r*, T.C. Memo. 2011-16.

<sup>25</sup> *Id.*, slip op. 2-6.

in an abusive relationship. But for the IRS, the lack of documentation supported its position that Mrs. Stephenson was not credible.<sup>26</sup>

In the recent *Thomassen* case, the Tax Court found domestic abuse was a very important factor in granting innocent spouse relief.<sup>27</sup> Mrs. Thomassen, a homemaker and part-time professional cellist, had earned a college degree with a major in music in 1950. She married Dr. Thomassen, an orthopedic surgeon, in 1953, and the couple had ten children. Dr. Thomassen was subject to fits of rage and extremely controlling behavior. For example, he would require his eldest son to get up at four a.m. every day to perform various tasks such as car repair.<sup>28</sup> When Dr. Thomassen found any white bread or any product containing sugar in the household, he would throw it away. Dr. Thomassen controlled the family finances; his office nurse paid the main household bills. He gave Mrs. Thomassen money for miscellaneous household expenses, but these amounts were often insufficient. Rather than risk angering Dr. Thomassen, Mrs. Thomassen would borrow money from her mother or sell personal items to meet the shortfall. She also used her earnings for this purpose. The couple had separate bank accounts, and Mrs. Thomassen had no credit cards. Dr. Thomassen never told Mrs. Thomassen his bank account balance or net worth. Dr. Thomassen either prepared the couple's tax returns himself or engaged someone else to do so, and then presented them to Mrs. Thomassen for her signature. She did not review the returns before signing them.

The Thomassens' eldest daughter once invited college friends to come home with her for the weekend. The friends were so shocked after witnessing Dr. Thomassen's behavior for a few days that they urged the daughter to find another place for Mrs. Thomassen and the other children to live. One of the friends observed that since Mrs. Thomassen had been subjected to Dr. Thomassen's behavior for her entire adult life, she probably did not realize anything was wrong.<sup>29</sup>

Mrs. Thomassen was also victimized by the manner in which Dr. Thomassen handled the couple's tax reporting and payment obligations. Six joint returns Dr. Thomassen prepared were filed untimely, all but one showing zero gross income and no tax owed. These returns led to notices of deficiency to which Dr. Thomassen responded by filing Tax Court petitions. In Tax Court, Dr. Thomassen appeared *pro se* (*i.e.*, without representation) on behalf of himself and Mrs. Thomassen and advanced frivolous arguments that resulted in dismissal of the cases and the entry of judgments against the Thomassens for deficiencies, and for

<sup>26</sup> *Stephenson v. Comm'r*, T.C. Memo. 2011-16, slip op. 25.

<sup>27</sup> *Thomassen v. Comm'r*, T.C. Memo. 2011-88.

<sup>28</sup> Dr. Thomassen had instructed his children not to answer the telephone or the door to the family residence because he was avoiding process servers. One teenage daughter inadvertently answered the door, which allowed papers to be served. Faced with the prospect of her father's anger over this, she attempted suicide. *Thomassen v. Comm'r*, T.C. Memo. 2011-88, slip op. 6.

<sup>29</sup> *Id.*, slip op. 2-6.

additions to the tax.<sup>30</sup> Dr. Thomassen persisted with frivolous appellate litigation, including an unsuccessful bid for Supreme Court review. Finally, when Dr. Thomassen was deceased for two years, Mrs. Thomassen was ordered evicted from her residence so it could be sold in a public sale to pay the taxes. It was at that point that she requested, and ultimately obtained, innocent spouse relief.<sup>31</sup>

### **Another Federal Enforcement Agency Responds to Domestic Violence and Abuse Issues.**

The IRS could gain inspiration from the manner in which another federal agency, U.S. Immigration and Customs Enforcement (ICE), takes into account domestic violence or abuse. For example, although ICE is aware that state or local law enforcement may arrest and book multiple people at the scene of alleged domestic violence, including the victim, ICE reminds its employees that it is against ICE policy to initiate removal proceedings against an individual known to be a victim of domestic violence. Employees are to exercise discretion in making detention and enforcement decisions regarding these victims.<sup>32</sup> Moreover, as part of the Secure Communities initiative, ICE will provide training to local law enforcement about the legal protections and relief for victims of violence and how best to interact with victims of these crimes.<sup>33</sup>

### **The IRS Does Not Provide Enough Information for Employees, Taxpayers, and Other Government Agencies.**

IRS employees may also be victims of domestic violence and abuse. The IRS offers them assistance, including access to professional counselors, through its Employee Assistance Program. However, there is no single source for information about nonprofit support organizations or the array of tax issues a victim of abuse is likely to encounter, such as identity theft, innocent spouse relief, injured spouse relief, determining proper filing status, claiming dependency exemptions, and claiming earned income and other tax credits.<sup>34</sup> Nor is any such resource available to the public. Consequently, employees and taxpayers alike are

<sup>30</sup> In Tax Court, Dr. Thomassen refused to provide substantiation of claimed expenses for his medical practice and other business activities because he contended that providing financial records and information to the government violated his constitutional rights and religious beliefs. *Thomassen v. Comm'r*, T.C. Memo. 2011-88, slip op. 9-10.

<sup>31</sup> *Id.*, slip. op. 7-14.

<sup>32</sup> Memorandum from John Morton, Director, U.S. immigration and Customs Enforcement, Prosecutorial Discretion: Certain Victims, Witnesses, and Plaintiffs (June 17, 2011), available at <http://www.ice.gov/doclib/secure-communities/pdf/domestic-violence.pdf>. In addition, according to the memorandum, an ICE database now flags victims of domestic violence who have filed for or been granted victim-based immigration relief in order for employees to respond appropriately. The IRS could explore the appropriateness of placing a domestic violence “marker” on the accounts of taxpayers who request such a marker, similar to the marker for accounts of victims of identity theft, in order for IRS employees to be aware of the problem whenever they interact with taxpayers.

<sup>33</sup> The Secure Communities program allows the FBI to automatically send fingerprints it receives from local law enforcement to ICE to check against its immigration databases. If these checks reveal that an individual is unlawfully present in the United States or otherwise removable due to a criminal conviction, ICE takes enforcement action. The program is described in the ICE website, at [http://www.ice.gov/secure\\_communities/](http://www.ice.gov/secure_communities/). See “DHS Plan to Provide Training to State and Local Law Enforcement in the Secure Communities Program,” available at <http://www.ilw.com/immigrationdaily/news/2011,0620-securecommunities.pdf>.

<sup>34</sup> IRS employees who take TAS training on domestic violence and abuse will have additional resources, including links to nonprofit support groups. Injured spouse relief may be appropriate where a spouse’s refund was, or will be, offset against the other joint filer’s separate past-due federal tax, state tax, child support, or federal non-tax debt (such as a student loan).

forced to piece together information from various IRS sources as they attempt to solve tax problems that stem from the abuse they experienced. Moreover, employees cannot refer taxpayers to a central source of information or to other nonprofit support organizations, and other federal agencies cannot direct taxpayers who are victims of domestic violence or abuse to an IRS website that meets their needs. The IRS could investigate opportunities to partner with other agencies that assist victims of domestic violence or abuse, such as by appearing in a directory similar to the Online Directory of Crime Victim Services sponsored by the Office for Victims of Crime (OVC).<sup>35</sup> The OVC directory is designed to help service providers and individuals locate nonemergency crime victim service agencies in the United States and abroad. It allows victims to search by location, type of victimization, service needed, and agency type.

#### **TAS Is Launching Initiatives to Heighten Awareness About Domestic Violence and Abuse.**

In October 2011, the National Taxpayer Advocate released training on domestic violence and abuse awareness that is required for all TAS employees, and is available to all IRS employees.<sup>36</sup> The training consists of a video that explores this issue with a panel of participants, including the National Taxpayer Advocate, the Executive Director of the District of Columbia Coalition Against Domestic Violence, a Low Income Taxpayer Clinic attorney, a Local Taxpayer Advocate, and a TAS attorney advisor. The video demonstrates through role-playing scenarios how IRS employees can identify taxpayers of domestic violence and abuse and interact with them appropriately. Written training materials, which contain links to other sources and nonprofit support organizations, supplement the video. TAS is including links to domestic violence resources in its tax toolkit, a public website that TAS maintains to provide taxpayer education. In addition to employee training, TAS is developing a brochure on the tax issues arising from domestic violence and abuse as part of its Consumer Tax Tips series.

### **CONCLUSION**

In conclusion, the National Taxpayer Advocate preliminarily recommends that:

1. The IRS should update its training for public contact and enforcement employees to focus on communication and interview skills, and should incorporate the training prepared by the Taxpayer Advocate Service, *Recognizing and Working with Taxpayers Who Have Experienced Domestic Violence or Abuse*;

<sup>35</sup> The Office for Victims of Crime is one of seven components within the Office of Justice Programs (OJP), U.S. Dept. of Justice. The OJP works in partnership with the justice community to identify the most pressing crime-related challenges confronting the justice system and to provide information, training, coordination, and innovative strategies and approaches for addressing these challenges. See Office of Justice Programs, About Us, available at <http://www.ojp.usdoj.gov/about/about.htm> (last visited Oct. 11, 2011). The Online Directory of Crime Victim Services is available at <http://ovc.ncjrs.gov/findvictimservices/search.asp> (last visited Oct. 11, 2011).

<sup>36</sup> *Recognizing and Working with Taxpayers Who Have Experienced Domestic Violence or Abuse*, IRS Enterprise Learning Management System (ELMS) course 41304.

2. The IRS should develop an online resource page on the internal website with information and resources for IRS employees who may be experiencing domestic violence and abuse;
3. The IRS should work with TAS to create a centralized electronic portal with information about domestic violence and abuse which would include guidance for IRS employees on assisting victims of domestic abuse;
4. The IRS, in collaboration with TAS, should develop a comprehensive communication strategy for taxpayers and other government agencies, with information about domestic violence and abuse and how to resolve tax issues that arise from it, and links to nonprofit support organizations. The strategy should also include distributing TAS's Consumer Tax Tips brochures on domestic violence and abuse and other related material.

### IRS COMMENTS

The IRS takes seriously the effects that domestic violence and abuse may have on taxpayers as well as on employees of the IRS. We recognize that abusive situations could result in tax consequences to the taxpayer that he or she is sometimes powerless to prevent.

The IRS is sensitive to the issues that may arise when dealing with victims of domestic abuse as well as other situations where a taxpayer may be an injured party. We strive to ensure our contact employees communicate with all taxpayers in a courteous and professional manner, with deference to their individual situations, through training and guidance such as IRM 21.1.1.7, *Accounts Management and Compliance Services Operations - Accounts Management & Compliance Services Overview - Communications Skills*; ELMS Lesson 43113, *Identity Theft Awareness Briefing*; and Interviewing Skills training. If a taxpayer makes our employees aware of her or his personal circumstances, employees are trained to provide the taxpayer with the appropriate guidance.

The IRS recently revised the rules that apply in innocent spouse determinations to expand the effect abuse will have in determining whether relief is warranted. The IRS recognizes that when abuse is present, the requesting spouse may not have been able to challenge the treatment of items on a tax return, question the payment of taxes, or challenge the other spouse's assurance regarding the payment of taxes. The new rules recognize that the presence of abuse may mitigate other factors that might otherwise weigh against granting relief. In connection with these changes, the IRS has recently increased its training to innocent spouse unit employees on domestic violence.

IRS employees have been trained to assist taxpayers and address questionable issues that may exist. If the taxpayer fails to bring the issues of domestic violence or abuse to the attention of IRS, an employee would follow the applicable procedures to address the issue based on the tax information that was submitted. IRS contact employees are not trained,



nor is it appropriate, to probe for these underlying issues or make assumptions about what underlying issues the taxpayer might be encountering.

The IRS ensures resources are provided to assist employees in dealing with a variety of personal issues including domestic violence. All IRS employees have access to the Employee Assistance Program (EAP). The EAP is a free benefit program that provides confidential counseling services to managers, employees, and their family members. EAP gives the employee access to a nationwide counseling network to help deal with personal and/or work-related problems. EAP counselors are licensed professionals that provide assistance in areas of relationship and domestic issues including domestic abuse.

With respect to the recommendations made in the report, the IRS notes the following.

The IRS continually updates training for public contact and enforcement employees and we will continue to focus on communication and interview skills. We are exploring opportunities at strengthening the Innocent Spouse program and updated the Innocent Spouse training (September 2011) to educate the examiners reviewing innocent spouse cases on communication and interview skills when contacting a spouse alleging abuse. This lesson was prepared with the assistance of a TAS Attorney Advisor and attorneys with the Low Income Taxpayer Clinics.

While we do not believe that it is appropriate to use the TAS course for all our employees, we will consider including key elements of the TAS training in future training curriculum updates and/or awareness sessions. Decisions on the method or form of any training would be based on the specific job duties of the employee.

With respect to the online resource page, the IRS already has available online resources to assist employees in dealing with a variety of personal issues including domestic violence. All IRS employees have access to the EAP. The EAP is a free benefit program that provides no-cost, confidential services to managers, employees, and their family members. EAP gives the employee access to a nationwide counseling network to help deal with personal and/or work-related problems. EAP counselors are licensed professionals. A prominent link to EAP information is included on the IRWeb home page.

With respect to the proposed electronic portal, we believe that the role of the IRS should be limited to assistance relating to federal tax matters. The IRS recognizes the importance of assisting victims of domestic violence with their federal tax matters, but additional full-service assistance on matters unrelated to taxes is more appropriately delivered outside of the agency.

The IRS continually evaluates whether additional outreach materials are necessary. It is possible that the information proposed to be developed could include tax-related issues and contact information for resolution of tax-related issues specific to taxpayers affected by domestic violence. However, it is unclear whether IRS.gov is an appropriate point for

a centralized clearinghouse on domestic violence and abuse. Nevertheless, the web page could provide a link for interested taxpayers to request the proposed TAS developed brochure on domestic violence and abuse.

## Taxpayer Advocate Service Comments

The National Taxpayer Advocate welcomes the IRS's acknowledgement that domestic violence and abuse produce real tax consequences, and its confirmation that IRS employees are trained on the substance of the tax laws and on how to be courteous to taxpayers. We believe many if not most employees respond appropriately when a taxpayer demonstrates, in a manner familiar to the employee, that the taxpayer is a victim of domestic violence or abuse.

However, the National Taxpayer Advocate is disappointed by the IRS's formulaic response to several of our preliminary recommendations, which appears to belie its commitment to this issue. The unaddressed problem is that unless taxpayers explicitly allege abuse, employees are not trained to recognize that it may be an issue.<sup>37</sup> The training TAS prepared and recommends is not designed to make IRS employees into professional counselors, but rather to raise awareness and suggest ways of eliciting information that would tend to show whether abuse is present and is relevant to the tax matter at hand.<sup>38</sup>

Employees are not currently trained to begin their analysis by believing a taxpayer who indicates that he or she is a victim of abuse and then considering what, if any, evidence is available to support the claim. On the contrary, the IRS's position is that such training would not be "appropriate" because it would require employees to "probe" and "make assumptions." The National Taxpayer Advocate believes the IRS can and should do more to train employees to listen actively and sensitively, especially in the domestic violence area. By listening to taxpayers in this way, IRS employees will be able to secure information that will produce the correct tax result. She finds it rather astonishing that the IRS views such training as not appropriate for its public contact employees, and will work toward including portions, if not all, of the Taxpayer Advocate Service's domestic violence training into the IRS's future training.

<sup>37</sup> A recently released report from the Centers for Disease Control found that one in four women in the United States have been victims of *severe physical violence* by an intimate partner while one in seven men experienced severe violence by an intimate partner. Centers for Disease Control and Prevention, *The National Intimate Partner and Sexual Violence Survey (NISVS)* (Nov. 2011) 43, available at [http://www.cdc.gov/ViolencePrevention/pdf/NISVS\\_Report2010-a.pdf](http://www.cdc.gov/ViolencePrevention/pdf/NISVS_Report2010-a.pdf). The survey found that 24.3 percent of women and 13.8 percent of men had experienced *severe physical violence* by an intimate partner. Severe physical violence includes being hurt by pulling hair, being hit with something hard, being kicked, being slammed against something, attempts to hurt by choking or suffocating, being beaten, being burned on purpose, and having a partner use a knife or gun against the victim. (NISVS at 10.) The continued prevalence of domestic violence and abuse makes it all the more urgent that the IRS train its employees to recognize and address the impact of domestic violence on tax administration.

<sup>38</sup> TAS has also developed a 15-minute version of the training and is developing a 45-60 minute version that would be suitable for front-line employees who do not handle technical matters, but who refer taxpayers to other IRS offices or divisions.

The National Taxpayer Advocate is perplexed by the IRS's reluctance to provide more comprehensive information for its employees on an internal website. The EAP is an important resource, but employees who are victims of abuse need one central web page with information about the *tax* issues they may consequently encounter. The IRS is better positioned than any other employer to provide this resource.

We are pleased that the IRS agrees to work with TAS to create an electronic portal to enable employees to assist victims of domestic violence and abuse, even with the proviso that "additional full service assistance on matters unrelated to taxes is more appropriately delivered outside of the agency." TAS agrees with this proviso. We do not propose that the IRS itself should supply counseling, medical, or other non-tax assistance, but rather that it provide links to nonprofit service providers, support organizations, and emergency hotlines for employees to share with taxpayers. The IRS does not reject our recommendation that it collaborate with us in developing a comprehensive communications strategy, and we hope that we will be able to work together on this project.

## Recommendations

The National Taxpayer Advocate recommends that the IRS:

1. Require all employees who handle innocent spouse claims, all Appeals employees, all Revenue Agents, all Revenue Officers, and all SB/SE Chief Counsel attorneys to take the domestic violence training prepared by the Taxpayer Advocate Service, *Recognizing and Working with Taxpayers Who Have Experienced Domestic Violence or Abuse*.
2. Work with TAS to incorporate portions, if not all, of the TAS training into all other front-line public contact employee training, at a minimum portions of the TAS training with information for employees who may be facing this issue themselves or know others who are.
3. Develop a resource page on the internal website with information and resources for IRS employees who may be experiencing domestic violence and abuse.
4. In collaboration with TAS, develop a comprehensive communication strategy for taxpayers and other government agencies, with information about domestic violence and abuse and how to resolve related tax issues. The strategy should include links to nonprofit support organizations and would involve distributing TAS's Consumer Tax Tips brochures on domestic violence and abuse and other related material.

## MSP #17

## The IRS Does Not Emphasize the Importance of Personal Taxpayer Contact as an Effective Tax Collection Tool

### RESPONSIBLE OFFICIALS

Richard E. Byrd Jr., Commissioner, Wage and Investment Division  
 Faris Fink, Commissioner, Small Business/Self-Employed Division

### DEFINITION OF PROBLEM

The IRS is responsible for collecting billions of dollars from millions of taxpayers who have delinquent tax accounts.<sup>1</sup> However, it does not attempt personal contact with these taxpayers (*i.e.*, by telephone or face-to-face) to find out why they are not paying and discuss collection alternatives until late in the collection process. While the current collection system has achieved moderate success (collecting \$64 out of every \$100 owed) by sending notices in the early stages of delinquency, this method is not effective for all taxpayers, particularly those with large debts or complex problems.<sup>2</sup>

The IRS annually sends over 34 million notices to taxpayers in the first stage of the collection process.<sup>3</sup> However, the average payment received from an individual taxpayer in response to a notice in fiscal year (FY) 2011 was just \$517 (which reflects mostly low-dollar cases).<sup>4</sup> In FY 2011, 3.7 million cases remained unresolved after this initial stage<sup>5</sup> and moved to the Automated Collection System (ACS), where the IRS traditionally spends only about three percent of its direct time making outgoing calls.<sup>6</sup> According to recent data, 60 percent of the cases in ACS have been there six months or longer.<sup>7</sup>

Cases unresolved after being processed by the ACS move into a queue where they remain until a field revenue officer is available to work them.<sup>8</sup> The dollar value of cases assigned to the queue has doubled in the last six years — to over \$56.2 billion at the end of FY 2011.<sup>9</sup> Making personal contact before sending the case to the queue could provide an opportunity

<sup>1</sup> At the beginning of fiscal year (FY) 2010, 4,031,093 taxpayers had delinquent accounts. Small Business/Self-Employed (SB/SE) division, Collection Activity Report NO-5000-2.

<sup>2</sup> IRS, Collection Activity Report NO-5000-242, *Taxpayer Delinquent Account Cumulative Report, Part 2 – Accounts Receivable Notices* (Oct. 2011).

<sup>3</sup> *Id.*

<sup>4</sup> IRS, Collection Activity Report NO-5000-8, *IMF Collection Yield Report FY 2011*. The IRS received approximately \$9.9 billion from individual taxpayers (IMF) through 19,185,673 payment transactions.

<sup>5</sup> During FY 2011, the IRS collected nearly \$9.5 billion on nearly 2.7 million taxpayer accounts during the notice stream, but the Automated Collection System (ACS) received 3,706,183 taxpayer cases. IRS, Collection Activity Report NO-5000-242, *Taxpayer Delinquent Account Cumulative Report, Part 2 – Accounts Receivable Notices* (Oct. 2011); IRS, Collection Activity Report NO-5000-2, *Taxpayer Delinquent Account Reports* (Oct. 2011).

<sup>6</sup> Treasury Inspector General for Tax Administration (TIGTA), Ref. No. 2010-30-046, *More Management Information is Needed to Improve Oversight of Automated Collection System Outbound Calls* 6 (Apr. 28, 2010).

<sup>7</sup> At the conclusion of FY 2011, 2,454,770 ACS modules were in ACS less than six months, out of a total inventory of 6,080,835. Collection Activity Report NO-5000-2 (Oct. 2011).

<sup>8</sup> Internal Revenue Manual (IRM) Exhibit 5.19.5-9 (Dec. 1, 2007).

<sup>9</sup> IRS, Collection Activity Report NO-5000-2, *Taxpayer Delinquent Account Reports* (Oct. 2011).