

2008 Annual Report to Congress

National Taxpayer Advocate

2008 Annual Report to Congress

**NATIONAL
TAXPAYER
ADVOCATE**

**2008 ANNUAL REPORT
TO CONGRESS**

Volume Two



Department of the Treasury
Internal Revenue Service

www.irs.gov

Publication 2104 (Rev. 12-2008)
Catalog Number 23655L

2008
Annual Report to Congress

December 31, 2008

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**A FRAMEWORK FOR
REFORMING THE
PENALTY REGIME**

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A Framework for Reforming the Penalty Regime

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Executive Summary

The number of civil tax penalties has increased from about 14 in 1954 to more than 130 today.¹ If structured properly, civil tax penalties can potentially increase voluntary tax compliance.² If structured improperly, however, penalties can reduce voluntary compliance, potentially endangering collection of the 84 percent of all taxes due that come in timely and voluntarily each year without any direct effort on the part of the government.³ So, the *sole* purpose of civil tax penalties should be to enhance voluntary compliance.⁴ An IRS task force expressly rejected other purposes, such as raising revenue, punishing noncompliant behavior, and reimbursing the government for the cost of compliance programs, because policies designed to fulfill other purposes may conflict with the goal of enhancing voluntary compliance.⁵

Penalties may deter noncompliance for some taxpayers by imposing costs on it. If such deterrence were the only consideration, however, penalty reform would be easy – we could simply increase the severity of all civil tax penalties and work to impose them in every instance of noncompliance. But, severe civil and criminal penalties already apply to intentional tax evasion.⁶ Even very high penalties may not improve compliance if the likelihood that the IRS will detect noncompliance and impose the penalty is small.

Moreover, severe penalties that are not well designed could reduce compliance if they provide a disincentive for noncompliant taxpayers to step forward, are so disproportionate or arbitrarily imposed that taxpayers feel they are unjust, or result in protracted disputes that

¹ See IRM 20.1.1.1.1 (Feb. 22, 2008). For a list of about 130 current law penalties, see Table 4, *The Number of FY 2007 Assessments for Selected Civil Tax Penalties by Internal Revenue Code Section*, Appendix A, *infra*.

² We use the term “penalty” to refer to civil monetary penalties and “additions to tax,” exclusive of interest charges and loss of tax benefits, for violating federal tax rules. For purposes of this report, a penalty does not include an increase in tax liabilities resulting from the failure to satisfy substantive requirements to obtain a tax benefit. For example, it excludes the so-called penalties for premature distributions from annuity contracts or individual retirement accounts. See, e.g., IRC §§ 72(q), (t). This report generally focuses on those penalties with some nexus to the federal income tax.

³ When the IRS last measured compliance, it found that taxpayers voluntarily and timely pay about 84 percent of all federal taxes due each year – about \$1.767 trillion out of \$2.112 trillion in 2001 – without any action by the government. See Internal Revenue Service U.S. Department of the Treasury, *Reducing the Federal Tax Gap, A Report on Improving Voluntary Compliance*, 10 (Aug. 2, 2007), at http://www.irs.gov/pub/irs-news/tax_gap_report_final_080207_linked.pdf (last visited Dec. 4, 2008). Only about one percent is collected via enforcement (i.e., \$24.3 billion). *Id.*

⁴ Both Congress and the IRS reached the same conclusion in the late 1980s after extensive study, research, and comment from the public. See, e.g., Executive Task Force for Internal Revenue Commissioner’s Penalty Study, *A Philosophy of Civil Tax Penalties* (Discussion Draft), reprinted in 111 DTR L-1 1988, 9-10 (June 9, 1988) (hereinafter “IRS Task Force Report I”); H.R. Conf. Rep. No. 101-386 at 661 (1989) (stating in connection with significant civil tax penalty reform, “the IRS should develop a policy statement emphasizing that civil tax penalties exist for the purpose of encouraging voluntary compliance.”).

⁵ See IRS Task Force Report I at 9-10.

⁶ See, e.g., IRC § 6651(f) (fraudulent failure to file); IRC § 6663 (fraudulent underpayment); IRC § 7201 (criminal sanction for willful tax evasion); IRC § 7203 (criminal sanction for willful failure to file, report, or pay).

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leave the IRS with few resources to impose them.⁷ Even seemingly moderate penalties may be seen as disproportionately severe and arbitrary if they apply (or the IRS proposes them) in situations where taxpayers reasonably believe they have done nothing wrong or have done their best to comply. Therefore, any legislative changes to the penalty regime need to be based on research, rather than a reflexive reaction to the abuse of the day.

Before we begin serious penalty reform, we need better data about whether and how penalties promote voluntary compliance. As early as 1989, Congress recommended that the IRS “develop better information concerning the administration and effects of penalties.”⁸ In addition, the IRS’s official policy is to collect information:

to determine the effectiveness of penalties in promoting voluntary compliance... [and recommend] changes when the Internal Revenue Code or penalty administration does not effectively promote voluntary compliance...⁹

However, the government still has no significant quantitative data to show how penalties affect voluntary compliance.¹⁰ As Table 4, *The Number of FY 2007 Assessments for Selected Civil Tax Penalties by Internal Revenue Code Section* in Appendix A shows, the IRS either does not assess or does not track assessments of many current penalties, much less study them in a comprehensive manner. As a result, policymakers lack the information they need to structure and administer tax penalties to maximize voluntary compliance or even to accurately estimate the budget effect of changes to the penalty rules.¹¹

⁷ One survey found that the strongest factors influencing compliance was personal integrity. See Roper ASW, *IRS Oversight Board 2005 Taxpayer Attitude Survey 7* (Feb. 21, 2006), at <http://www.ustreas.gov/irsob/releases/2006/02212006.pdf> (last visited Dec. 4, 2008) (finding that for 95 percent of the respondents personal integrity was somewhat of an influence or a great deal of influence on their compliance decision). Accord Marjorie E. Kornhauser, *Tax Compliance and the Education of John (and Jane) Q. Taxpayer*, 121 *Tax Notes* 737 (Nov. 10, 2008) (suggesting personal integrity and tax morale drive voluntary compliance). When a taxpayer feels the government (or the tax system) has become unjust, this sense of personal integrity may no longer require tax compliance – he or she may feel justified in evading the tax rules.

⁸ H.R. Conf. Rep. No. 101-386, at 661 (1989).

⁹ Policy Statement 20-1 (June 29, 2004).

¹⁰ See Treasury Inspector General for Tax Administration (TIGTA), Ref. No. 2001-40-069, *Management Advisory Report: Ineffective Administration of the Individual Taxpayer Penalty Program Creates Inequity* 9 (Apr. 2001) (stating “[T]he IRS does not know if the individual taxpayer penalty program is achieving its objective of encouraging voluntary compliance;” and finding that the IRS lacked systems to assess whether it was assessing and abating penalties consistently or following up on recommended improvements).

¹¹ Revenue generated directly from new penalties can be taken into account in connection with the federal budget “scoring” process, but any resulting effect on voluntary compliance can probably not be taken into account given the lack of quantitative research in this area. Because the scoring process takes the IRS’s tendency not to enforce an unduly harsh penalty into account, a focus on budget scoring may provide an incentive for legislators to enact penalties that cannot be waived by the IRS even if such penalties might ultimately reduce voluntary compliance and tax revenues in ways that are difficult to measure. See Joint Committee on Taxation, JCX-1-05, *Overview of Revenue Estimating Procedures and Methodologies Used by the Staff of the Joint Committee on Taxation* (Feb. 2, 2005) (stating, “the effectiveness of the applicable penalty regime and the IRS enforcement posture (i.e., whether the IRS routinely waives penalties for a particular issue and how frequently they audit an issue) that would be associated with a proposal are also taken into account.”). However, as one commentator has observed: “[t]he best penalties are those that don’t raise any revenue [directly] because they encourage the conduct that the penalty is designed to encourage.” Jeremiah Coder, *Tax Shelter Penalties Are Unclear and Weakly Enforced, Panelists Say*, 2008 *TNT* 145-3 (July 28, 2008) (quoting N. Jerold Cohen).

Recommendations

Our primary recommendation is for Congress to have the IRS (1) collect and analyze more detailed penalty data on a regular basis, and (2) conduct an empirical study to quantify the effect of each penalty on voluntary compliance. This quantitative research should also identify changes to penalty laws and penalty administration that would improve voluntary compliance. Congress should appropriate additional funds for this research, as necessary.

Without such research, any penalty analysis will be somewhat subjective and superficial. Nonetheless, the limited data and analysis that is available suggests the following changes to the major penalty provisions would promote voluntary compliance, as further discussed below:

1. Prevent IRS systems from automatically assessing accuracy-related penalties without considering all of the facts and circumstances;
2. Consider the feasibility of clarifying the definition of a “tax shelter” for purposes of the substantial understatement penalty;
3. Restructure the penalty for failure to file a “reportable transaction” information disclosure;
4. Improve the proportionality and effectiveness of the failure to file penalty for those who are more than six months late;
5. Reduce the penalty for late filers who timely pay within a period of extension;
6. Reduce the number of failure to pay penalty rates and eliminate interaction with the failure to file penalty;
7. Simplify the prior year estimated tax payment safe harbor and encourage taxpayers to use it;
8. Simplify the estimated tax penalty computation and provide an automatic waiver of *de minimis* estimated tax penalties;
9. Allow the IRS to abate estimated tax penalties for first-time estimated tax payers who have reasonable cause;
10. Make the Trust Fund Recovery Penalty more effective by clarifying that it covers third party payers; and
11. Reduce the penalty for failure to make tax deposits in the prescribed manner.

Introduction

Penalty reform in the late 1980s

The number of civil tax penalties has increased from about 14 in 1954 to more than 130 today.¹² By 1987, stakeholders were complaining that penalties were enacted in an *ad hoc* fashion; they were sometimes used as a revenue source in lieu of substantive tax provisions; they were increasingly complex; multiple penalties could apply to the same infraction as a result of “stacking;” and the magnitude of the penalty (or penalties) sometimes bore no relation to the severity of the infraction.¹³ In response to these concerns, the Joint Committee on Taxation issued a report and an IRS task force issued three more (collectively the “IRS Task Force Reports”).¹⁴

The IRS Task Force Reports concluded that tax penalties should exist solely to encourage voluntary compliance by (1) helping taxpayers understand what conduct is acceptable, (2) deterring noncompliance by imposing costs, and (3) establishing the fairness of the tax system.¹⁵ Based on extensive interviews with stakeholders, the task force developed four broad principles for evaluating whether penalties encourage voluntary compliance: fairness, comprehensibility, effectiveness, and ease of administration, summarized below.¹⁶

Perception of “fairness”

According to the IRS Task Force Reports, the perception that the tax system is fair promotes voluntary compliance.¹⁷ They discussed three main components of fairness: horizontal equity, proportionality, and procedural fairness.

Horizontal equity – “treating similarly situated taxpayers similarly”

Horizontal equity requires that similarly situated taxpayers be treated similarly. It does not require that we blindly apply the same penalty to all taxpayers who fail to comply because

¹² See IRM 20.1.1.1.1 (Feb. 22, 2008). Table 4, *The Number of FY 2007 Assessments for Selected Civil Tax Penalties by Internal Revenue Code Section*, in Appendix A, lists about 130 provisions.

¹³ See, e.g., Laurence Keiser, *IRS Penalty Reform Under the 1989 Act (The Revenue Reconciliation Act of 1989)*, The CPA Journal Online (June 1990).

¹⁴ See IRS Task Force Report I; Executive Task Force for the Commissioner’s Penalty Study, *Report on Civil Tax Penalties* (Working Draft of Chapters 1-4 and 8), reprinted in 237 DTR L-10 (Dec. 9, 1988) (hereinafter “IRS Task Force Report II”); Executive Task Force for the Commissioner’s Penalty Study, *Report on Civil Tax Penalties*, reprinted in 89 TNT 45-36 (Feb. 27, 1989) (hereinafter “IRS Task Force Report III”); Joint Committee on Taxation, JCS-9-88, *Description of Tax Penalties* (Mar. 24, 1988). See also Thomas R. Hoffman, *Studies of the Code’s Tax Penalty Structure: A Fitful Step Toward Reform*, 43 Tax. Law. 201 (Fall 1989); Internal Revenue Service Commissioner Lawrence Gibbs’ Prepared Statement on Civil Tax Penalties, Including Executive Summary of Report by IRS Task Force on Civil Penalties, Hearing Before the House Ways and Means Oversight Subcommittee (Feb. 21, 1989), reprinted in 34 DTR L-18, 1989 (Feb. 22, 1989).

¹⁵ The IRS incorporated these principles into Policy Statement P-1-18 (Aug. 20, 1998).

¹⁶ The discussion in this section is drawn, in large part, from the IRS Task Force Reports.

¹⁷ See, e.g., Task Force Report III at 13. Various studies support this conclusion. See, e.g., Kim M. Bloomquist, *Income Inequality and Tax Evasion: A Synthesis*, Second Edition of the OECD Jan Francke Tax Research Award (Mar. 20, 2003) (citing studies suggesting that growing dissatisfaction with the tax system and the perception of unfair treatment may be causes of noncompliance).

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not everyone is similarly situated.¹⁸ Rather, a horizontally equitable penalty does not apply to a taxpayer who puts forth the expected level of effort to comply, even if he or she did not actually succeed. Horizontal equity may require the IRS to evaluate factors such as the willfulness of the noncompliance, and the taxpayer’s level of sophistication and prior compliance history, to determine if a penalty should apply.

These types of inquiries (*e.g.*, exceptions for “reasonable cause”) are more important for more severe penalties. For example, the government does not inquire about mitigating circumstances or a person’s state of mind before imposing a minor parking fine to the same extent that it does before sending the person to prison. These inquiries may also become more important when the substantive rules are so complex that the taxpayer could have unintentionally violated them without being negligent.¹⁹

Proportionality – “the punishment should fit the crime”

A fundamental constitutional principle, which also contributes to perceptions of fairness, is the concept of proportionality.²⁰ A proportionate penalty bears some relation to the culpability of the taxpayer and the harm caused by the infraction. Even if courts do not strike down a civil tax penalty on the grounds that it is disproportionate, the public is likely to regard a disproportionate penalty as unfair.²¹

Procedural fairness – don’t “shoot first and ask questions later”

Even moderate penalties are perceived as unfair, arbitrary, or disproportionate when proposed against taxpayers that have not done anything wrong. Procedural fairness, thus, requires the government to avoid asserting penalties against taxpayers that have not violated

¹⁸ In 1998, when Congress urged the IRS to use its authority to compromise tax liabilities more liberally, allowing some taxpayers who failed to comply with the law to pay less tax than other taxpayers, it reiterated the belief that such compromises “enhance taxpayer compliance.” H.R. Conf. Rep. 105-599, at 288-89 (1998) (stating that “[t]he Senate amendment provides that the IRS will adopt a liberal acceptance policy for offers-in-compromise to provide an incentive for taxpayers to continue to file tax returns and continue to pay their taxes.... The conferees believe that the ability to compromise tax liability ... enhances taxpayer compliance.”).

¹⁹ *Accord* Restatement (Second) of Torts § 328D (2008) (permitting an inference of negligence in a civil context under the doctrine of *Res Ipsa Loquitur*, if among other things, the “event is of a kind which ordinarily does not occur in the absence of negligence ... [and] other responsible causes... are sufficiently eliminated by the evidence”).

²⁰ In a criminal context, the Eighth Amendment prohibition on cruel and unusual punishment prohibits sentences that are disproportionate to the crime. See, *e.g.*, *Harmelin v. Michigan*, 501 U.S. 957 (1991) (recognizing limits on disproportionate sentences). In a civil context, courts also may strike down or reduce disproportionate punitive damages on due process grounds. See, *e.g.*, *State Farm v. Campbell*, 538 U.S. 408 (2003). A fine may also violate the Excessive Fines Clause if it is “punishment” and grossly disproportionate when compared to the gravity of the offense. See, *e.g.*, *United States v. Bajakajian*, 524 U.S. 321 (1998). Although the Supreme Court has suggested that it is very difficult for a penalty denominated as “civil” to rise to the level of a punishment, it may not have entirely closed the door on the possibility. Compare *United States v. Halper*, 490 U.S. 435, 447-48 (1989) (holding that a disproportionate civil penalty imposed after a conviction for the same conduct can constitute “punishment” in the context of double jeopardy) with *Hudson v. U.S.* 522 U.S. 93 (1997) (abrogating *Halper* on the basis that it “bypassed the traditional threshold question whether the legislature intended the particular successive punishment to be ‘civil’ or ‘criminal’ in nature;” the *Hudson* court placed more weight on whether the penalty was denominated as civil or criminal).

²¹ Even relatively high civil tax penalties have been upheld on constitutional grounds. See, *e.g.*, *Helvering v. Mitchell*, 303 U.S. 391, 398-401 (1938) (concluding that the civil fraud penalty was not intended as punishment but as a remedial exaction to reimburse the government for the heavy expense of investigation and loss resulting from the taxpayer’s fraud); *United States v. Alt*, 83 F.3d 779 (6th Cir. 1996) (same).

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the rule.²² Procedural fairness may sometimes require an IRS decision maker to communicate with the taxpayer and consider any mitigating facts and circumstances before assessing the penalty.²³ It may also require the IRS to provide taxpayers with an effective process for administratively appealing penalty assessments.²⁴

Comprehensibility

To promote voluntary compliance, taxpayers of varying levels of education and limited amounts of time must be able to understand what conduct is expected, and how to compute the penalty for failure to meet the expectation.²⁵ The applicability of more than one penalty to the same conduct (*i.e.*, “stacking”) can multiply any complexity. Penalties cannot promote voluntary compliance if taxpayers do not understand them.

Effectiveness

To be effective, a penalty must be severe enough to eliminate the noncompliance without being so severe as to be difficult to enforce or perceived as disproportionate or unfair. For some taxpayers, a nominal penalty is sufficient because of the social, personal, or moral stigma attached to a penalty of any magnitude. The possibility of triggering an audit or criminal investigation may provide additional deterrence in some cases. For other taxpayers, the penalty may need to impose costs that eliminate the expected economic benefits of noncompliance. In some cases, the potential for penalties may help tax advisors convince clients not to engage in aggressive transactions. For this group of taxpayers, a larger penalty may be needed if the noncompliance may go undetected. Regardless of a penalty’s severity, it is likely to be more effective in encouraging remedial action if it is graduated (or reduced) based on the taxpayer’s efforts to correct any initial noncompliance, provided such graduations do not produce excessive complexity.

Ease of administration

A penalty is administrable if it is easy for the IRS to determine when it should be imposed while still allowing the IRS to exercise discretion in determining whether to waive it. Such

²² See IRS Task Force Report II at L-18 (noting “the Task Force believes that, at the fringes, penalizing those who should not be penalized creates more negative attitudes and more problems than providing a slight tilt toward allowing some taxpayers who have violated a standard of behavior to avoid penalties”).

²³ As early as 1989, Congress recommended: “In the application of penalties, the IRS should make a correct substantive decision in the first instance rather than mechanically assert penalties with the idea that they will be corrected later.” H.R. Conf. Rep. No. 101-386, at 661 (1989).

²⁴ See IRS Task Force Report II at L-19 and L-20; IRS Task Force Report III at 13-15. According to the Supreme Court: “taxes are the lifeblood of government, and their prompt and certain availability an imperious need. Time out of mind, therefore, the sovereign has resorted to more drastic means of collection... [therefore] the statutes, in a spirit of fairness, invariably afford the taxpayer an opportunity at some stage to have mistakes rectified.” *Bull v. U.S.*, 295 U.S. 247, 259-260 (1935).

²⁵ Comprehensibility may also improve effectiveness, fairness, and ease of administration. For example, in a criminal context, due process requires that a penal statute define a criminal offense with sufficient definiteness that “ordinary people can understand what conduct is prohibited and in a manner that does not encourage arbitrary and discriminatory enforcement.” *Kolender v. Lawson*, 461 U.S. 352, 357 (1983). The Supreme Court explained: “It would certainly be dangerous if the legislature could set a net large enough to catch all possible offenders, and leave it to the courts to step inside and say who could be rightfully detained, and who should be set at large. This would, to some extent, substitute the judicial for the legislative department of government.” *Id.* at 358 n.7 (quoting *United States v. Reese*, 92 U.S. 214, 221 (1875)).

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discretion is most important when the rule is complicated or the penalty is severe.²⁶ Overly detailed guidance or rigid rules regarding the assertion or waiver of a severe penalty may be difficult to administer or cause the IRS (or the judiciary) to use strained interpretations to reach a reasonable result in a given case. As a practical matter, IRS employees may find reasons not to enforce penalties perceived to be unfairly harsh. Such penalties are also difficult to administer, in part, because they lead to controversy, which drains IRS resources, limiting the number of taxpayers the IRS will be able to impose the penalty against.

The IRS Task Force Reports recognized that these four principles – fairness, comprehensibility, effectiveness, and ease of administration – were not always consistent with one another. Nonetheless, because the IRS had no quantitative data on the characteristics of penalties that best promote voluntary compliance, the reports applied these principles, which were developed with input from stakeholders, to identify improvements to the major civil tax penalties. In 1989, after extensive hearings,²⁷ Congress reformed information reporting penalties, accuracy-related penalties, preparer, promoter, and protester penalties, and penalties for failure to file, pay, withhold, and make timely tax deposits.²⁸

Penalty reform efforts in the late 1990s

In 1998, Congress required the Joint Committee on Taxation (JCT) and the Secretary of the Treasury to obtain comments from the public and make legislative and administrative recommendations to simplify penalty and interest provisions, reduce taxpayer burden, and ensure the provisions promote voluntary compliance.²⁹ These analyses were based on many of the same principles established by the IRS Task Force Reports. Congress held

²⁶ A small strict liability penalty may be appropriate when the rule is simple, a violation is easy to identify, and the penalty is proportionate to the harm caused by the violation. For example, some banks automatically charge a nominal penalty when a customer bounces a check.

²⁷ See, e.g., *Review of the Civil Penalty Provisions Contained in the Internal Revenue Code, Hearings Before the Subcommittee on Oversight of the Committee on Ways and Means*, 100th Cong., 2nd Sess. (Mar. 31, 1988); *Review of the Civil Penalty Provisions Contained in the Internal Revenue Code, Hearings Before the Subcommittee on Oversight of the Committee on Ways and Means*, 100th Cong., 2nd Sess. (July 28, 1988); *Recommendations for Civil Tax Penalty Reform and H.R. 2528 to Revise the Civil Penalty Provisions of the Internal Revenue Code of 1986, Hearings Before the Subcommittee on Oversight of the Committee on Ways and Means*, 101st Cong., 1st Sess. (Feb. 21, 1989); *Recommendations for Civil Tax Penalty Reform and H.R. 2528 to Revise the Civil Penalty Provisions of the Internal Revenue Code of 1986, Hearings Before the Subcommittee on Oversight of the Committee on Ways and Means*, 101st Cong., 1st Sess. (June 6, 1989).

²⁸ See Omnibus Budget Reconciliation Act of 1989 (OBRA), Pub. Law No. 101-239 §§ 7701-7743 (Dec. 19, 1989). OBRA incorporated penalty reform legislation entitled the “Improved Penalty Administration and Compliance Tax Act” (IMPACT). See H.R. Conf. Rep. No. 101-386 at 647-55 (1989).

²⁹ Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98), Pub. L. No. 105-206 (1998); H.R. Conf. Rep. No. 105-599 at 323 (1998) (requiring the reports to examine “whether the current penalty and interest provisions encourage voluntary compliance.”). See also Notice 99-4, 1999-1 C.B. 318; Department of Treasury, Office of Tax Policy, *Report to the Congress on Penalty and Interest Provisions of the Internal Revenue Code* 13 (Oct. 1999) (hereinafter “Treasury Study”); Department of Treasury, *The Problem of Corporate Tax Shelters Discussion, Analysis and Legislative Proposals* (July 1999) (incorporated into the Treasury Study by reference); Joint Committee on Taxation, JCS-3-99, *Study of Present-Law Penalty and Interest Provisions as Required by Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1988 (Including Provisions Relating to Corporate Tax Shelters)* 3-9 (July 22, 1999) (hereinafter “JCT Study”). For a comparison of Treasury and Joint Committee recommendations, see Joint Committee on Taxation, JCX-79-99, *Comparison of Joint Committee Staff and Treasury Recommendations Relating to Penalty and Interest Provisions of the Internal Revenue Code* (Nov. 5, 1999).

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hearings to discuss penalty recommendations, but did not enact sweeping reform as it had in 1989.³⁰

Penalty philosophy in the early 2000s – a shift from voluntary compliance to economic deterrence

In the early 2000s, as the government redoubled its efforts to curb tax shelter activities, build up enforcement actions, and reduce the tax gap, its approach to penalties shifted. The IRS’s policy of using penalties solely to enhance voluntary compliance, in part by “helping taxpayers understand” the proper standards of conduct, was replaced by a policy of ensuring that penalties are always developed and applied, especially if “a significant purpose” of the transaction was the avoidance or evasion of federal tax, as shown on the following table.

Table 1, A Comparison of IRS Penalty Policy Statements

Policy Statement P-1-18 (Aug. 20, 1998)	Policy Statement 20-1 (June 29, 2004)
Penalties support the Service’s mission only if penalties enhance voluntary compliance. (Emphasis in original).	Penalties are used to enhance voluntary compliance.
... the Service will design, administer, and evaluate penalty programs solely on the basis of whether they do the best possible job of encouraging compliant conduct. (Emphasis added).	In order to make the most efficient use of penalties, the Service will design, administer, and evaluate penalty programs based on how those programs can most efficiently encourage voluntary compliance.
In the interest of an effective tax system, the Service uses penalties to encourage voluntary compliance by: (1) helping taxpayers understand that compliant conduct is appropriate and that non-compliant conduct is not; (2) deterring noncompliance by imposing costs on it; and (3) establishing the fairness of the tax system by justly penalizing the non-compliant taxpayer. (Emphasis added).	Penalties encourage voluntary compliance by: (1) demonstrating the fairness of the tax system to compliant taxpayers; and (2) increasing the cost of noncompliance.
	... examiners and their managers must consider the elements of each potentially applicable penalty and then fully develop the facts ... (Emphasis added).
	...Consistent development and proper application of ... [various penalties] in abusive transaction cases will help curb this activity by imposing tangible economic consequences.... An abusive transaction is one where a significant purpose of the transaction is the avoidance or evasion of Federal tax. (Emphasis added).
	...The Service will fully develop accuracy-related or fraud penalties in all cases where an underpayment of tax is attributable to a listed transaction.... (Emphasis added).
	In limited circumstances where doing so will promote sound and efficient tax administration , the Service may approve a reduction of otherwise applicable penalties or penalty waiver for a group or class of taxpayers as part of a Service-wide resolution strategy to encourage efficient and prompt resolution of cases of noncompliant taxpayers. (Emphasis added). ³¹

³⁰ See, e.g., *Hearing Before the House Ways and Means Subcommittee on Oversight on the Penalty and Interest Provisions in the Internal Revenue Code*, 106th Cong., 2nd Sess. (Jan. 27, 2000); *Hearing Before the House Ways and Means Committee on Corporate Tax Shelters*, 106th Cong. 1st Sess. (Nov. 10, 1999); *Hearing Before the Senate Finance Committee on Penalty and Interest Provisions in the Internal Revenue Code*, 106th Cong. 1st Sess. (Mar. 8, 2000), at <http://www.senate.gov/~finance/w3-8-0.htm> (last visited Dec. 16, 2008).

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Because many tax practitioners believe every transaction that could benefit from tax advice involves “a significant purpose” of tax avoidance (as further discussed below), the IRS’s current policy statement could encourage IRS employees to seek to impose penalties in more situations where taxpayers believe they have done nothing wrong.³² During the same period, Congress enacted a number of new penalty provisions to address abusive transactions.³³ Given the recent shift in focus from voluntary compliance to deterrence, the enactment of new penalties, and the time that has elapsed since the last major penalty review, it may be helpful to reevaluate the penalty regime in light of the way in which the IRS is now administering penalties and principles set forth above.

Where does the data suggest we should focus penalty reform efforts today?

Other than looking at new or recently revised penalties, such as the substantial understatement penalty and the penalty for failure to properly report certain transactions to the IRS office of tax shelter analysis, it may be difficult to identify areas in need of reform without additional data on how penalties affect voluntary compliance.³⁴ Nonetheless, we do have some potentially relevant data, as discussed below.

Tax gap data

The largest parts of the tax gap result from taxpayers who:

- Underreport their income, accounting for \$285 billion or about 83 percent of the gap;
- Do not pay taxes reported as due, accounting for \$33.3 billion or about ten percent of the gap; and
- Do not pay amounts associated with unfiled returns, accounting for \$27 billion or about eight percent of the gap.³⁵

³¹ Interestingly, one internal memo suggests that in the absence of express statutory authority to abate a penalty, any penalty abatement must be based on the IRS’s determination that the abatement would promote voluntary compliance, rather than “sound and efficient tax administration” or an “efficient and prompt resolution of cases.” Authority of the Commissioner to Waive/Abate Civil Tax Penalties (Mar. 1999).

³² See, e.g., Nathan Giesselman, *A Significant Problem Defining a ‘Significant Purpose’ and the Significant Difficulties that Result*, 111 Tax Notes 1119 (June 5, 2006); Sheryl Stratton, *Lawyers Discuss Postshelter Assault on Privilege*, 2005 TNT 71-5 (Apr. 13, 2005).

³³ For example, the American Jobs Creation Act of 2004 (AJCA), Pub. L. No. 108-357, 118 Stat. 1578 (Oct. 22, 2004), enacted or strengthened a number of penalties, such as the new penalties applicable to reportable transactions, and revisions to the accuracy-related penalty, among others. See, e.g., IRC §§ 6707A, 6708, 6700, 6662A, 6662(d)(2)(C), and 6717. In addition, Pub. L. No. 110-28, Title VIII, § 8247(a), 121 Stat. 204 (2007) recently added IRC § 6676.

³⁴ See, e.g., IRC §§ 6707A, 6662(d)(2)(C).

³⁵ See IRS, *Tax Gap Map for Year 2001* (Feb. 2007), at http://www.irs.gov/pub/irs-utl/tax_gap_update_070212.pdf (last visited Dec. 4, 2008) (providing estimates of the tax gap). These percentages do not equal 100 due to rounding. About 63 percent of all returns were signed by paid tax preparers in tax year 2006. IRS, *Tax Year 2006 Taxpayer Usage Study* (Aug. 24, 2007), at <http://www.irs.gov/taxstats/article/0,,id=96629,00.html> (last visited Dec. 4, 2008). These statistics may suggest that a focus on the tax gap may also require a focus on preparer penalties. However, this document does not focus on preparer penalties because of recent revisions to the preparer penalty rules. See, e.g., Small Business and Work Opportunity Tax Act of 2007, Pub. L. No. 110-28 § 8246 (2007) (codified as amended at IRC § 6694); Tax Extenders and Alternative Minimum Tax Relief Act of 2008, Pub. L. No. 110-343 § 506 (2008) (same). See also NPRM REG-129243-07, 73 Fed. Reg. 34,560 (June 17, 2008) (rendered partially obsolete by Pub. L. No. 110-28). For prior recommendations in this area, see, e.g., National Taxpayer Advocate 2003 Annual Report to Congress 270 (Key Legislative Recommendation, *Federal Tax Return Preparer Oversight and Compliance*).

This data may suggest penalty reform should focus on penalties for underreporting (called “accuracy-related” penalties), failure to pay, and failure to file.³⁶ However, it may be difficult to improve these or other penalties without additional information about whether and how they are effective in promoting voluntary compliance.

Litigation data

The following penalties are among the top ten most litigated tax issues in 2008:

- The accuracy-related penalty was the fifth most litigated issue, accounting for about nine percent of the cases.
- Failure to file and estimated tax penalty issues were the seventh most litigated issue, accounting for about seven percent of the cases; and
- The frivolous issues penalty was the ninth most litigated issue, accounting for about five percent of the cases.³⁷

Notably, taxpayers prevailed, in whole or in part, in about 43 percent of the accuracy-related penalty cases when they were represented (more than in any other category) and in 17 percent of the cases when they were *pro se* (without counsel).³⁸

Although penalties may be the frequent subject of litigation for many different reasons, the most successful penalties – those that deter noncompliance – should not need to be proposed or litigated very often. Frequent litigation could be a sign that taxpayers are not satisfied with the fairness of a penalty. Alternatively, the litigation may simply reflect frequent assessments (*e.g.*, the failure to file penalty) or assessments against taxpayers who often litigate (*e.g.*, frivolous issues penalty or accuracy-related penalties). Moreover, some penalties that need improvement may rarely be the subject of litigation because they are either too low to be a priority or too harsh for the government to enforce.

Assessment and abatement data

As shown in Table 4, *The Number of FY 2007 Assessments for Selected Civil Tax Penalties by Internal Revenue Code Section* in Appendix A, many penalties are rarely assessed. However, this data does not show whether they are really rarely imposed on a relative basis or how many transactions could have been subject to the penalty. Even if a penalty is rarely assessed on a relative basis, it may be difficult to determine if this is because taxpayers are complying with the rules or because the IRS is not enforcing them.

The ten most frequently assessed penalties, which are also frequently abated, are shown in the following table.

³⁶ See, *e.g.*, IRC §§ 6662, 6651.

³⁷ See Introduction to Most Litigated Issues, *supra*.

³⁸ *Id.*

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Table 2, Top Ten Civil Penalties Assessed During FY 2003-2005 and Abated as of March 2008³⁹

	Assessed		Abated		Percent abated	
	Number	Amount (\$1,000s)	Number	Amount (\$1,000s)	Number	Amount
Failure to pay (§ 6651(a)(2), (3))	47,337,508	\$11,001,879	5,877,006	\$3,209,028	12%	29%
Failure to file (§ 6651(a)(1))	14,161,272	\$12,570,853	1,873,190	\$5,108,146	13%	41%
Failure to deposit (§ 6656)	7,742,953	\$12,325,807	1,135,163	\$7,780,072	15%	63%
Estimated tax - individual (§ 6654)	6,066,799	\$1,761,347	388,184	\$383,270	6%	22%
Bad check (§ 6657)	863,262	\$115,642	45,766	\$64,148	5%	55%
Accuracy-related (§ 6662)	729,808	\$2,419,503	82,609	\$906,309	11%	37%
Trust Fund Recovery (§ 6672) ⁴⁰	628,359	\$6,050,255	313,896	\$2,242,780	50%	37%
Failure to file info. returns (§ 6721) ⁴¹	416,165	\$7,295,919	162,688	\$6,284,441	39%	86%
Estimated tax - corporate (§ 6655)	251,665	\$382,596	25,243	\$244,161	10%	64%
Daily delinquency (§ 6652(c)) ⁴²	246,689	\$712,338	179,686	\$599,266	73%	84%
Other	86,879	\$1,821,397	16,251	\$1,206,338	19%	66%

It is difficult to draw conclusions from these figures alone, however. Although penalties that the IRS frequently assesses are not so severe or complicated that the IRS avoids proposing them, the frequency with which the IRS assesses a penalty is not necessarily meaningful unless it is adjusted to take into account the number of transactions that could potentially have been subject to the penalty and the number of transactions in which the IRS considered a penalty. Even if the IRS assesses a penalty frequently on a relative basis, however, it could still be too severe or too complicated for taxpayers who are inadvertently

³⁹ IRS Enforcement Revenue Information System (ERIS) (Mar. 2008). Because additional abatements may be granted for FY 2003-2005 assessments after March 2008, these figures may understate the actual abatement rate.

⁴⁰ According to the IRS, many of the Trust Fund Recovery Penalty abatements - 82 percent in FY 2006 - are actually adjustments to accounts because of payments on related responsible persons' assessments or on the underlying corporate trust fund liability. National Taxpayer Advocate 2007 Annual Report to Congress 404 (IRS response to Most Serious Problem, *Assessment and Processing of the Trust Fund Recovery Penalty*).

⁴¹ About 75.8 percent of these information return penalties are imposed pursuant to IRC § 6721(e) for intentional failures (i.e., a continuing failure after a letter from the IRS) to file correct Forms W-2. IRS, ERIS (Sept. 2008). We do not discuss the information return penalty in the text below because it is largely an administrative problem resulting from the difficulty in tying information reported on employment tax forms such as Form 941, *Employer's Quarterly Federal Tax Return*, with similar information reported to employees and the Social Security Administration on Forms W-2 and W-3. For further discussion of this problem, see Most Serious Problem, *Inefficiencies in the Administration of the Combined Annual Wage Reporting Program Impose Substantial Burden on Employers and Waste IRS Resources, supra*.

⁴² We do not discuss the "daily delinquency" penalty - the penalty for failure of an exempt organization to file an information return - in the text below because the IRS has recently taken a number of steps to address the problem. The National Taxpayer Advocate recommended legislation to establish a voluntary compliance program in her 2007 report. See National Taxpayer Advocate 2007 Annual Report to Congress 537 (Key Legislative Recommendation, *Require the IRS to Establish a Voluntary Compliance Program for Exempt Organizations*). The IRS agreed to do so and recently circulated draft procedures. See IRS, *FY 2008 Exempt Organizations Implementing Guidelines* 9 (Dec. 13, 2007); Fred Stokeld, *EO Division Close To Completing Voluntary Compliance Program*, 2008 TNT 179-14 (Sept. 12, 2008). In her 2006 report, the National Taxpayer Advocate also recommended increasing the EO information return filing threshold from \$25,000 to \$50,000. See National Taxpayer Advocate 2006 Annual Report to Congress 483-95 (Key Legislative Recommendation, *Increase the Exempt Organization Information Return Filing Threshold*). The IRS announced in December 2007 that it would raise the information return filing threshold to \$50,000 beginning with the 2010 tax year. IRS News Release IR-2007-204, *IRS Releases Final 2008 Form 990 for Tax-Exempt Organizations, Adjusts Filing Threshold to Provide Transition Relief* (Dec. 20, 2007). In addition, recent changes to Form 990, *Return of Organization Exempt from Income Tax*, may affect daily delinquency penalty assessments and abatements.

violating the rule. Moreover, if taxpayers frequently violate the rule, the penalty may not be promoting voluntary compliance very effectively.

Penalties that the IRS frequently abates may benefit from reform, but high abatement rates are not conclusive evidence of a problem with the penalty. Frequent abatements could be evidence that the IRS is properly allowing taxpayers to demonstrate that they have a reasonable cause for violating the rule. Alternatively, the IRS may abate some penalties frequently if it is frequently abating underlying tax assessments. Thus, frequent penalty abatements could reflect a problem in the underlying tax assessment process.

On the other hand, some penalties the IRS frequently abates may need to be modified to promote more efficient administration and avoid burdening taxpayers and the IRS with unnecessary assessments. Frequent abatements could also be evidence that the IRS has difficulty determining when a taxpayer has violated a rule, or is taking shortcuts when making assessments.

When the IRS assesses and then abates a penalty, a taxpayer generally must produce factual information to justify the abatement, which the IRS must evaluate on a case-by-case basis. The data in Table 2, *Top Ten Civil Penalties Assessed During FY 2003-2005 and Abated as of March 2008*, above, show the percentage of dollars abated is generally higher than the percentage of penalties abated, suggesting that taxpayers more often obtain abatements when larger dollar amounts are at stake, perhaps because they are willing to expend more resources to do so. This data may suggest that taxpayers chose to pay small penalties rather than produce the documentation needed to obtain abatements, even if they would otherwise be eligible for them. If true, these penalties (or the IRS's administration of them) may violate notions of horizontal equity and procedural fairness.

However, an alternative explanation may be that larger entities, which would be more likely to trigger larger penalties, are more likely have a reasonable cause to excuse the violation than smaller taxpayers who are likely to have fewer resources devoted to tax compliance. If that is the case, perhaps we should be looking for ways to make compliance easier for small businesses and individuals.

Because we have no better data by which to measure the effect of penalties on voluntary compliance, this document focuses on selected penalties that rank highly based on these measures (*i.e.*, data on assessments, abatements, litigation, and the tax gap) and others that practitioners have identified as problematic. Our recommendations are summarized below.

Specific Recommendations

1. Prevent IRS systems from automatically assessing accuracy-related penalties without considering all of the facts and circumstances.

*Problem*⁴³

IRS systems sometimes automatically assess certain accuracy-related penalties. Any apparent administrative efficiencies of this automated process may be illusory because of the downstream consequences and rework they often require. This rework drains resources that the IRS (and taxpayers) could use more productively. Consistently imposing a penalty may generally increase economic deterrence. However, the process of automatically imposing a penalty without sufficient inquiry and then abating it after receiving more information is unlikely to foster voluntary compliance.

While there may be instances where automatically assessing a penalty could be appropriate, such as when a taxpayer fails to pay amounts he or she reported as due, the negligence penalty requires a deeper inquiry into the taxpayer's specific facts and circumstances, as further described below. Indeed, an IRS employee generally may not assess a penalty unless his or her supervisor personally pre-approves the penalty in writing.⁴⁴ However, an IRS employee may assess certain penalties "automatically calculated through electronic means," such as those for the failure to file and pay without managerial approval.⁴⁵ The IRS interprets this exception as allowing its computers to automatically compute and propose the negligence penalty in connection with its Automated Underreporter (AUR) Program.⁴⁶

Accuracy-related penalties may require a facts and circumstances inquiry

The accuracy-related penalty for negligence applies when a taxpayer fails to make a reasonable attempt to comply with the tax law.⁴⁷ Negligence generally involves the failure to use reasonable care by taking a position on a return which does not have a reasonable basis.⁴⁸ Negligence also arises if the taxpayer carelessly, recklessly, or intentionally disregards a rule

⁴³ For a more detailed description of the problem, including administrative recommendations, see National Taxpayer Advocate 2007 Annual Report to Congress 275.

⁴⁴ IRC § 6751.

⁴⁵ IRC § 6751(b)(2)(B). See also IRC § 6751(b)(2)(A) (providing that supervisory approval is not required before assessing the penalties for failure to file, failure to pay, failure by an individual to pay estimated income tax, or failure of a corporation to pay estimated income tax).

⁴⁶ Memorandum from Martha Sullivan, Deputy Director, Compliance Policy, *Revision to Memorandum (Aug. 14, 2000) Restructuring and Reform Act of 1998 (RRA 98) Section 3306 - Managerial Approval and Notice Requirements of Penalties* (Apr. 24, 2001).

⁴⁷ IRC § 6662(c); Treas. Reg. § 1.6662-3(b). There are a number of accuracy-related penalties. See IRC § 6662(b). However, because the negligence and substantial understatement penalties generate much more controversy than the other accuracy-related penalties, they are the focus of our discussion. See Most Litigated Issue, *Accuracy-Related Penalty Under Internal Revenue Code Sections 6662(b)(1) and (2)*, *supra*.

⁴⁸ IRC § 6662(c); Treas. Reg. § 1.6662-3(b)(3) ("negligence includes any failure to make a reasonable attempt to comply with the provisions of the internal revenue laws or to exercise ordinary and reasonable care in the preparation of a tax return....[It] also includes any failure by the taxpayer to keep adequate books and records or to substantiate items properly").

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or regulation without reasonable cause.⁴⁹ These determinations are based on the taxpayer's specific facts and circumstances.⁵⁰

Automated processes do not consider all relevant facts and circumstances.

As part of the AUR program, IRS systems compare income reported by third parties on information returns (*e.g.*, Form 1099, *U.S. Information Return*) to the income reported by taxpayers on tax returns.⁵¹ These systems send notices to taxpayers, explaining the discrepancy between the information provided by the taxpayer and the information reflected on a third party's information return. If the taxpayer fails to respond to the notice and has a mismatch (*e.g.*, failure to report income shown on an information return) in more than one year (*e.g.*, a prior year and the current year), the AUR program automatically assesses a negligence penalty (after sending a notice of deficiency) without evaluating any other facts or circumstances.⁵²

Mismatches are poor indicators of negligence.

These mismatches occur fairly frequently in situations where no penalty is warranted. Most taxpayers respond to the notice and provide documentation sufficient to demonstrate to the IRS that the penalty does not apply. In FY 2007, the IRS actually assessed only about 37 percent of the accuracy-related penalties initially proposed through the AUR program because taxpayers provided such documentation.⁵³

Automated penalty assessments need to be abated more often than manual penalty assessments. In FY 2007, the IRS abated about 16 percent of the accuracy-related penalty assessments it made using the automated AUR program, compared to only approximately three to six percent of assessments it made using less automated processes.⁵⁴ This data may suggest AUR systems propose unjustified accuracy-related penalties more frequently than IRS employees, in contravention of the principles of procedural fairness and efficiency described above.⁵⁵ Further, when represented taxpayers disputed the accuracy-related penalty in court, they prevail, at least in part, in about 43 percent of the cases decided during the

⁴⁹ Treas. Reg. § 1.6662-3(b)(2).

⁵⁰ See, *e.g.*, Treas. Reg. § 1.6664-4(b)(1).

⁵¹ See IRM 4.19.3.1 (Sept. 1, 2008).

⁵² See *generally* IRM 4.19.3.16.7 (Sept. 1, 2008) (noting that the AUR program automatically computes the negligence penalty); IRM 4.19.7.8.22.18 (Sept. 1, 2007) (same); IRM 4.19.3.20.1.4(3) (Sept. 1, 2008) (explaining that the penalty is automatically imposed without managerial review if the taxpayer does not explain an information reporting discrepancy occurring in more than one year). See *also* National Taxpayer Advocate 2007 Annual Report to Congress 275-86 (further describing the automated AUR processes).

⁵³ IRS response to TAS information request (Oct. 20, 2008) (providing SB/SE data for tax year 2005 which corresponds to FY 2007, the most recent period for which full-year data is available); IRS response to TAS information request (Oct. 17, 2008) (providing similar W&I data).

⁵⁴ IRS response to TAS information request (Oct. 20, 2008); IRS response to TAS information request (Oct. 17, 2008). About three percent of the assessments resulting from field examinations and about six percent of the assessments resulting from correspondence examinations were abated. *Id.* These are less automated processes than AUR.

⁵⁵ This process seems inconsistent with conference report to the 1989 OBRA, quoted above, which recommended the IRS "make a correct substantive decision in the first instance rather than mechanically assert penalties with the idea that they will be corrected later." H.R. Conf. Rep. No. 101-386, at 647-65 (1989).

period beginning on June 1, 2007 and ending on May 31, 2008.⁵⁶ In addition, the resources required to manually correct unjustified computer assessments and, if necessary, litigate them in court, reduce the resources the IRS can use to assess penalties in instances where they are justified.

*Example*⁵⁷

For two years, a taxpayer who was experiencing financial difficulties negotiated with lenders to cancel certain debts. The lenders reported the cancelled debts on Form 1099-C in both years. Because of certain technical rules, the taxpayer was not required to report the cancellations as income.⁵⁸ However, the IRS's AUR program detected the two mismatches and sent the taxpayer a letter proposing additional tax as well as the negligence penalty. Because of his financial difficulties, the taxpayer moved and did not receive the AUR notice. IRS computers automatically assessed additional tax and the 20 percent accuracy-related penalty.

Recommendation

Amend IRC § 6751 to prevent the IRS from automatically assessing accuracy-related penalties without managerial review. This change would apply the same rule to accuracy-related penalties that applies to penalties that are not “automatically calculated through electronic means.”⁵⁹

2. Consider the feasibility of clarifying the definition of a “tax shelter” for purposes of the substantial understatement penalty.

Problem

For purpose of the substantial understatement penalty rules, a “tax shelter” is broadly defined to include any partnership, entity, investment plan or arrangement having “a significant purpose” of tax avoidance or evasion.⁶⁰ Prior to 1997, a “tax shelter” had to have

⁵⁶ Most Litigated Issue, *Accuracy-Related Penalty Under Internal Revenue Code Section 6662(b)(1) and (2)*, *supra*.

⁵⁷ This is a hypothetical example is drawn from the IRS's procedures for handling information returns that reflect cancellation of indebtedness income. For a more complete discussion of these issues, see National Taxpayer Advocate 2007 Annual Report to Congress 13 (Most Serious Problem, *Understanding and Reporting the Tax Consequences of Cancellation of Debt Income*).

⁵⁸ See generally IRC § 108.

⁵⁹ See IRC § 6751(b)(2)(B).

⁶⁰ IRC § 6662(d)(2)(C).

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“the principal purpose” of tax avoidance or evasion.⁶¹ Given the government’s subsequent experience with these rules and legislative responses to abuses that it has identified, the government should evaluate whether it is now feasible to provide additional guidance about what constitutes a tax shelter, especially given the consequences of existing uncertainty, as further described below.

Unlike the negligence penalty, the substantial understatement penalty may apply even if the taxpayer makes a reasonable attempt to comply if he or she fails by a significant margin.⁶² If the IRS finds an understatement of sufficient magnitude, the penalty generally applies unless the understatement is attributable to (1) undisclosed tax positions for which there was “substantial authority,”⁶³ or (2) disclosed positions with respect to which there was a “reasonable basis.”⁶⁴ These exceptions provide an incentive for taxpayers to ensure that with respect to every position on their returns, they either have substantial authority or make a special disclosure to the IRS.

These exceptions, however, do not apply to “tax shelters.”⁶⁵ Therefore, the substantial understatement penalty does not provide the same good incentives for taxpayers to find substantial authority for or disclose transactions the IRS might characterize as tax shelters.

⁶¹ The Taxpayer Relief Act of 1997, Pub. L. No. 105-34 § 1028(c)(2) (Aug. 5, 1997) substituted the phrase “a significant purpose” for “the principal purpose.” This change was made to conform the definition of tax shelter in the accuracy-related penalty rules with a new definition provided in the “reportable” transaction rules – transactions subject to special reporting requirements. H.R. Conf. Rep. No. 105-220, at 541-42 (1997). To be treated as a tax shelter under the reportable transaction rules, however, a transaction also had to be offered to potential participants under conditions of confidentiality and the promoter had to receive fees in excess of \$100,000. IRC § 6111(d) (before amendment in 2004 by Pub. L. No. 108-357). Congress later eliminated specific reference to transactions with “a significant purpose” in the reportable transaction rules. The American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 815(a) (Oct. 22, 2004) defined tax shelters for purposes of the reportable transaction rules by reference to “reportable” transactions under new IRC § 6707A(c), which now simply cross references Treasury regulations under IRC § 6011. Those regulations do not use the term “a significant purpose.” See Treas. Reg. § 1.6011-4. However, both the accuracy-related penalty applicable to “reportable” transactions and the regulations governing practitioners (called Circular 230) now also use the phrase “a significant purpose” of tax avoidance, without providing any clarifying guidance as to its meaning. See IRC § 6662A; Treasury Department Circular No. 230 § 10.35 (Rev. 4-2008).

⁶² It applies when the amount of tax that the taxpayer reported differs by the greater of \$5,000 or ten percent from the correct amount of tax that the taxpayer should have reported. IRC § 6662(d). If the IRS establishes that a taxpayer was both negligent and substantially understated the tax, the maximum accuracy-related penalty is capped at 20 percent of the understated tax. IRC § 6662(a).

⁶³ According to regulations:

The substantial authority standard is less stringent than the more likely than not standard (the standard that is met when there is a greater than 50-percent likelihood of the position being upheld), but more stringent than the reasonable basis standard ... the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment.” Treas. Reg. § 1.6662-4(d)(2).

These regulations specifically identify the types of authorities that can establish substantial authority.

⁶⁴ IRC § 6662(d)(2). By “undisclosed,” we do not mean the position was unreported. It may have been plainly reflected on the face of the return. Rather, we use the term “undisclosed” to refer to situations where the taxpayer did not take additional steps to make a special disclosure. See, e.g., Treas. Reg. § 1.6662-4(f). According to regulations:

Reasonable basis is ... significantly higher than not frivolous or not patently improper. The reasonable basis standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim. If a return position is reasonably based on one or more of the authorities set forth in § 1.6662-4(d)(3)(iii) (taking into account the relevance and persuasiveness of the authorities, and subsequent developments), the return position will generally satisfy the reasonable basis standard even though it may not satisfy the substantial authority standard.... Treas. Reg. § 1.6662-3(b)(3).

⁶⁵ IRC § 6662(d)(2)(C).

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As noted above, “tax shelters” are broadly defined as any partnership, entity, investment plan, or arrangement having “a significant purpose” of tax avoidance.⁶⁶ Since tax minimization (or avoidance) is the point of most tax advice, the term “a significant purpose” of tax avoidance does not help taxpayers identify transactions that can reasonably be called tax shelters. Articles in the press suggest that the tax practitioner community is confused.⁶⁷ As a result, the tax shelter exception dilutes the good incentives created by the substantial understatement penalty for all taxpayers. Well-advised taxpayers may decide there is no point in paying an advisor to determine if there is “substantial authority” for their return positions, or to disclose questionable transactions to the IRS, if penalties may apply in any event. Any incentive for these taxpayers to flag questionable issues for the IRS in order to avoid a penalty will decline if taxpayers and their advisors believe such disclosures may increase the risk of an audit without reducing the risk that a penalty will apply.

Other taxpayers have no idea they have engaged in transactions that could be considered tax shelters and are likely to feel unfairly penalized, especially if they had substantial authority for a position ultimately determined to be a tax shelter. The definition of a tax shelter should not be so broad that taxpayers become tax shelter investors by reason of claiming tax benefits that Congress intended them to have. A taxpayer should not have to wonder if he or she will be accused of participating in a tax shelter by reason of hiring an independent contractor, deducting a contribution to charity, opening an IRA, or buying a house and deducting the interest. Thus, additional guidance might improve the substantial understatement penalty’s effectiveness by encouraging appropriate disclosures and also reduce the potential for arbitrary enforcement against taxpayers who have no idea the IRS might conclude they have invested in tax shelters.

The idea that we should subject tax shelters to heightened standards of conduct, but define them vaguely to deter taxpayers from taking any aggressive positions, has superficial appeal. However, vague standards do not provide appropriate guidance for unsophisticated taxpayers and are also difficult for IRS employees to administer. As a result, penalties for

⁶⁶ IRC § 6662(d)(2)(C). A taxpayer must also determine the meaning of this phrase to identify the level of certainty required to avoid a penalty with respect to a “reportable” transaction – a type of transaction identified by the IRS as having the potential for tax avoidance – because a separate accuracy-related penalty may apply to reportable transactions that have “a significant purpose” of tax avoidance. IRC § 6662A(b)(2). In addition, the reasonable cause and good faith defense is not applicable to reportable transaction understatements unless the taxpayer made special disclosures with respect to them, had substantial authority for the position, and reasonably believed that his or her position was more likely than not correct. IRC § 6664(d)(2).

⁶⁷ Compare Nathan Giesselman, *A Significant Problem Defining a ‘Significant Purpose’ and the Significant Difficulties that Result*, 111 Tax Notes 1119 (June 5, 2006) (voicing confusion about the meaning of “a significant purpose” after analyzing its meaning in various code and regulation sections, and concluding that it could be interpreted broadly) Sheryl Stratton, *Lawyers Discuss Postshelter Assault on Privilege*, 2005 TNT 71-5 (Apr. 13, 2005) (reporting one practitioner as stating that “[o]ne of the most troublesome aspects of defining a tax shelter [which is carved out of the accountant’s privilege under IRC § 7525 by cross reference to IRC § 6662(d)] as any transaction that has as a significant purpose the avoidance of tax is that all meetings with tax advisers have a significant purpose of tax avoidance”), and Gregory M. Fowler, *The Valero Cases: New Meaning for ‘Significant Purpose’ Definition?*, 121 Tax Notes 677 (Nov. 10, 2008) (noting that more “prudent boundaries” would be helpful) with Kip Dellinger, *Circular 230: How Broad Is the Scope of ‘Significant Purpose’?* 111 Tax Notes 1503 (June 26, 2006) (speculating that practitioners may be overreacting because the phrase “a significant purpose” could be interpreted narrowly, at least in the context of Circular 230). As the administration’s 2009 budget proposal acknowledges, “the determination as to whether a transaction has a significant purpose of tax avoidance or evasion is inherently subjective to the taxpayer...” Treasury Department, *General Explanations of Revenue Proposals in Administration’s Fiscal Year 2009 Budget* 93 (Feb. 2008), at <http://www.treas.gov/offices/tax-policy/library/bluebk08.pdf> (last visited Dec. 16, 2008).

failing to meet a vague standard are more likely to be enforced inconsistently. If these penalties are enforced, taxpayers are likely to feel they are being singled out and unfairly and disproportionately penalized, which may reduce respect for the tax system and increase costly litigation. An overly broad definition may also eliminate any stigma associated with the term “tax shelter.”

Example

A small business taxpayer hired workers under terms that it believed caused them to be treated as independent contractors rather than employees for federal income tax purposes.⁶⁸ An IRS examiner might reasonably believe “a significant purpose” of the “arrangement” was to “avoid” taxes. As a result, an examiner could take the position that the arrangement is a “tax shelter” for purposes of the substantial understatement penalty, and that any substantial authority for the taxpayer’s position and any special disclosure to the government could not be used as a defense.⁶⁹

This interpretation would reduce the incentive for taxpayers to disclose positions for which they are unsure. Moreover, another examiner might view a similar arrangement implemented by a competitor as one that does not have “a significant purpose” of tax avoidance because there is little guidance regarding the meaning of “significant,” especially if the tax purpose of the arrangement could be viewed as insignificant when compared to the non-tax business purposes. Such inconsistent enforcement would violate horizontal equity principles.

Recommendation

Consider the feasibility of defining “tax shelter” (or “a significant purpose” of tax avoidance) more specifically.⁷⁰

3. Restructure the penalty for failure to file a “reportable transaction” information disclosure.⁷¹

Problem

Every taxpayer that has participated in a “reportable” transaction and who is required to file a tax return must file a Form 8886, *Reportable Transaction Disclosure Statement*, with the return and send a copy to the IRS Office of Tax Shelter Analysis.⁷² The definition of a reportable transaction includes transactions that are not necessarily aggressive, such as transactions that result in significant losses, are subject to conditions of confidentiality, or

⁶⁸ For a discussion of the difficulties in making the determination regarding whether a worker is an employee or an independent contractor and recommendations for reform, see Legislative Recommendation, *Worker Classification*, *supra*.

⁶⁹ To qualify for abatement, the taxpayer would need to demonstrate that the reasonable cause and good faith exception applied. IRC § 6664(c).

⁷⁰ The guidance could also clarify the meaning of “a significant purpose” under IRC § 6662A and in Circular 230.

⁷¹ A similar recommendation is include in volume I of this report. See Legislative Recommendation, *Modify Internal Revenue Code Section 6707A to Ameliorate Unconscionable Impact*, *supra*.

⁷² Treas. Reg. § 1.6011-4(a); Treas. Reg. § 1.6011-4(e).

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are “listed” – transactions that are the same as or *substantially similar* to one of the types of transactions that the IRS has identified (or “listed”) in published guidance.⁷³ Taxpayers who do not satisfy these information reporting requirements may be subject to penalties ranging from \$10,000 to \$200,000.⁷⁴ Public companies may also be required to report these penalties in any public filings.⁷⁵

Because it is sometimes difficult for taxpayers to determine if one transaction is “substantially similar” to another or otherwise reportable, some taxpayers may be reasonably unaware they are subject to this special information reporting requirement. They may be particularly surprised if they believe they are properly claiming legitimate tax benefits as intended by Congress. Other taxpayers may fail to contemplate that run-of-the-mill transactions properly and fully reported to the IRS on tax return forms designed by the IRS, or otherwise expressly disclosed to the IRS on special disclosure forms for use in avoiding accuracy-related penalties (described above), may be subject to additional reporting requirements, sometimes long after the return is due (*e.g.*, when the IRS “lists” a transaction for the first time).⁷⁶ They may also be surprised that no statute of limitations applies to the failure.⁷⁷

In fact, if a transaction correctly reported on a return later becomes a reportable transaction (*e.g.*, because it is substantially similar to a transaction that the IRS decides to “list” or because the transaction ultimately results in a loss of significant magnitude), then the taxpayer is subject to the special reporting requirements at that time.⁷⁸ To comply, taxpayers must continually monitor the IRS’s list of transactions along with a list of all of the transactions they have participated in to determine if they need to provide the IRS with additional disclosures potentially with respect to run-of-the-mill transactions that were properly reported on a tax return.

The IRS has a policy of fully developing the penalty for failure to comply with these special reporting requirements, and the IRS is not authorized to abate the penalty if it relates to a

⁷³ Treas. Reg. § 1.6011-4(b). The regulations explain:

The term substantially similar includes any transaction that is expected to obtain the same or similar types of tax consequences and that is either factually similar or based on the same or similar tax strategy. Receipt of an opinion regarding the tax consequences of the transaction is not relevant to the determination of whether the transaction is the same as or substantially similar to another transaction. Further, the term substantially similar must be broadly construed in favor of disclosure. For example, a transaction may be substantially similar to a listed transaction even though it involves different entities or uses different Internal Revenue Code provisions. Treas. Reg. § 1.6011-4(c)(4).

⁷⁴ IRC § 6707A. The penalty for failure to report a “listed” transaction is \$100,000 for natural persons and \$200,000 for other taxpayers. IRC § 6707A(b)(2). In the case of other types of “reportable” transactions, it is \$10,000 for natural persons and \$50,000 for other taxpayers. IRC § 6707A(b)(1). Reportable transactions may also be subject to greater substantial underpayment penalties of 20 percent for transactions that are properly disclosed and 30 percent for those that are not. See IRC § 6662A.

⁷⁵ IRC § 6707A(e).

⁷⁶ For example, a taxpayer may specifically disclose positions contrary to administrative guidance on Form 8275, *Disclosure Statement*, and positions contrary to regulations on Form 8275-R, *Regulation Disclosure Statement*. These disclosures do not satisfy the “reportable transaction” disclosure requirements. See Treas. Reg. § 1.6011-4(d) (requiring taxpayers to include disclosure on “Form 8886, ‘Reportable Transaction Disclosure Statement’ (or a successor form)” with the return and also to send a copy to the Office of Tax Shelter Analysis (OTSA)); Prop. Treas. Reg. § 1.6011-4(e)(2)(iii).

⁷⁷ See IRC § 6501(c)(10); Rev. Proc. 2005-26, 2005-1 C.B. 965.

⁷⁸ Treas. Reg. § 1.6011-4(e).

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listed transaction.⁷⁹ So, IRS employees have little discretion in administering the penalty.⁸⁰ Moreover, if a taxpayer engaged in a transaction using a flow-through entity such as an S corporation, he or she could be subject to the penalty at both the individual and entity levels.⁸¹

Example

In 2004, a small business owned by an individual and operated through an entity purchased a life insurance policy. Like many policies, this one was touted as having certain tax benefits, which were worth about \$45,000 over three years. Although the taxpayer was reasonably diligent in evaluating the transaction, he was unaware that it was substantially similar to a listed transaction and subject to special reporting requirements. Consequently, he did not file Form 8886, *Reportable Transaction Disclosure Statement*, with his return or send a copy to the IRS Office of Tax Shelter Analysis. On audit, although the IRS did not disallow the tax benefits with respect to the insurance, it determined the transaction was subject to the special reporting requirements applicable to listed transactions. Because he did not file Form 8886, the taxpayer was subject to a \$900,000 penalty, consisting of three \$200,000 penalties at the entity level and three \$100,000 penalties at the individual level.⁸² The IRS would like to abate the penalties, but is not authorized to do so.

This penalty is unlikely to promote the ultimate goal of increasing voluntary compliance under the circumstances described above. A \$900,000 penalty for a failure to specifically identify a transaction that generated a \$45,000 tax benefit and was correctly reported on the taxpayer's return can reasonably be viewed as disproportionate. Not even the 75 percent accuracy-related penalty applicable to tax fraud is this severe.⁸³

In addition, after reasonable diligence the taxpayer did not know that the transaction was subject to special information reporting. Because the penalty is not subject to a reasonable cause exception, it does not treat taxpayers who made similar efforts to comply similarly – those who fail through no fault of their own are penalized to the same extent as those who intentionally fail disclose a transaction – arguably failing to achieve horizontal equity.

⁷⁹ See Policy Statement 20-1 (June 29, 2004) (providing that “examiners and their managers must consider the elements of each potentially applicable penalty and then fully develop the facts to support the application of the penalty, or to establish that the penalty does not apply, when initial consideration indicates that penalties should apply.”); Memorandum for all SB/SE Examination Personnel, from Director Examination, SBSE-04-0808-039, *Interim Guidance on Applying §6707A Penalty*, Attachment 1, Processing Procedures for IRC § 6707A Penalty, § III(F)(7) (Sept. 5, 2008) (stating “The § 6707A penalty has no reasonable cause exception and the penalty must be developed wherever it appears legally applicable”); IRC § 6707A(d). See also Memorandum for Large and Mid-Size Business Division Executives, Managers, & Examiners from Commissioner, Large and Mid-Size Business Division, *Consideration of Penalties in Listed Transactions and other Abusive Tax Shelter Cases* (instructing that “[i]n all cases in which there is an underpayment attributable to a listed transaction, the Director of Field Operations (DFO) must approve the decision to impose or not to impose the accuracy-related penalty”).

⁸⁰ The IRS has a process for seeking rescission of the penalty with respect to reportable transactions that are not listed. See, e.g., Temp. Treas. Reg. § 301.6707A-1T; Rev. Proc. 2007-21, 2007-1 C.B. 613.

⁸¹ See, e.g., Prop. Treas. Reg. § 1.6011-4(c)(3).

⁸² The failure to make special disclosures with respect to a “listed transaction” is subject to a \$100,000 penalty for individuals and a \$200,000 penalty for entities. IRC § 6707A(b)(2). A “listed transaction” is a transaction that is “[t]he same as or substantially similar to, a transaction specifically identified by the Secretary as a tax avoidance transaction for purposes of section 6011.” IRC § 6707A(c)(2).

⁸³ See IRC § 6663.

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Because we are aware of instances in which the IRS is seeking the penalty even against taxpayers who timely filed Form 8886, either because they did not file it in two places or because it did not contain enough specific information about the transaction, there may be little incentive for some taxpayers to file this form in the first instance. Moreover, the penalty provides no relief to taxpayers who inadvertently failed to meet the initial disclosure deadline to file a late disclosure. With no possibility that the failure will be waived on the basis of reasonable cause and no opportunity to mitigate the penalty by filing late, the penalty provides little incentive to do so. Rather, some delinquent taxpayers may simply hope they will not be audited. As a result, the penalty may reduce rather than increase voluntary compliance, especially for taxpayers who inadvertently fail to file a timely reportable transaction disclosure statement or inadvertently fail to file it in two places.

Recommendations

- A. Authorize the IRS to waive the penalty under IRC § 6707A for failure to file the special disclosure with respect to listed transactions based on a showing of reasonable cause and good faith or another appropriate standard, at least if the taxpayer is not a publicly traded entity.⁸⁴
- B. Consider ways to prevent “stacking” of multiple penalties under IRC § 6707A on closely related taxpayers who fail to report a single transaction on multiple returns for the same reasons. One alternative would be to place a cap on the penalty for failure to report the same transaction, whether the failure is associated with multiple returns of closely related taxpayers or with more than one return reporting period. One option for implementing a cap would be to apply only one penalty for the first year of the failure and then apportion it among the group of related taxpayers rather than applying a separate penalty against each taxpayer for each period. Another option would be to apply a penalty cap to each taxpayer. An appropriate cap might be 75 percent of the underpayment for the year in which an information return was required – the penalty that would apply to a fraudulent failure to file.⁸⁵ Any of these changes would help to reduce the type of stacking illustrated above, and make the penalty more proportionate to the noncompliance.
- C. Reduce or eliminate the IRC § 6707A penalty in cases where the transaction was reported on the taxpayer’s return and the IRS does not propose to disallow the tax benefits of the transaction on audit. The failure to file a special disclosure with respect to a transaction that the government does not find abusive is more damaging to the tax

⁸⁴ The IRS is authorized to rescind the penalty for reportable transactions other than listed transactions if it determines that rescinding the penalty would promote compliance and effective tax administration. See IRC § 6707A(d). While horizontal equity principles suggest that no taxpayer with a reasonable cause should be subject to such a severe penalty, we recognize that Congress enacted this strict liability penalty to address abusive tax shelter activity, especially for large publicly traded entities. This goal can be accomplished by retaining the strict liability standard for publicly traded entities. This change should not undercut the effectiveness of the penalty because those non-public taxpayers who are actively playing the “audit lottery” would not have a reasonable cause for failing to disclose reportable transactions. Any willful failure would also remain subject to the penalty for fraud, and possibly even criminal sanctions. See, e.g., IRC § 6651(f) (fraudulent failure to file); IRC § 6663 (fraudulent underpayment); IRC § 7201 (criminal sanction for willful tax evasion); IRC § 7203 (criminal sanction for willful failure to file, report, or pay).

⁸⁵ See IRC § 6651(f).

system than the failure to make such a disclosure with respect to an abusive transaction. This change would also help to make the penalty easier to administer and more proportionate to the seriousness of the noncompliance. It would be unnecessary, however, if we capped the penalty at 75 percent of any underpayment attributable to the transaction, because there would be no underpayment.

4. Improve the proportionality and effectiveness of the failure to file penalty for those who are more than six months late.

Problem

A taxpayer who files late (or not at all) is subject to a penalty equal to five percent of the net amount of unpaid tax for each month that the return is late for up to five months and a maximum of 25 percent.⁸⁶ As a result, a taxpayer filing six months late is subject to the same penalty as a taxpayer who files one year late or not at all. About 53 percent of all late filers for tax year (TY) 2006 filed from six to 13 months late, as shown in the following table.

Table 3, Length of Delinquency by TY 2006 Late Filers⁸⁷

Months	Count	Percent ⁸⁸
1	216,186	17
2	108,101	8
3	59,328	5
4	59,603	5
5	51,692	4
6	77,562	6
7	71,030	5
8	43,613	3
9	70,612	5
10	71,831	6
11	75,510	6
12	140,447	11
13	142,328	11
14	50,506	4
15	41,801	3
16	24,361	2
Total	1,304,511	

⁸⁶ IRC § 6651(a)(1); IRC § 6651(b)(1) (addressing the net amount computation). If the failure to file is fraudulent, the penalty is increased to 15 percent per month, up to a maximum of 75 percent. IRC § 6651(f). Information returns, estimated tax payments, and partnership returns are subject to separate rules. See, e.g., IRC § 6031(a) (partnership returns); IRC § 6721 (information returns).

⁸⁷ IRS Compliance Data Warehouse (Oct. 9, 2008) (Tax Year 2006 returns received after April 15, 2007 as of August 2008 that were subject to a failure to file penalty). This data does not include nonfilers.

⁸⁸ Percentages may not equal 100 due to rounding.

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The penalty could be more effective if it provided an incentive for taxpayers who are more than five months late to file a return promptly.⁸⁹ Principles of proportionality and effectiveness suggest that longer delinquencies should be penalized more severely than short ones.

One response might be to eliminate the cap on the failure to file penalty. However, increasing the penalty (or the cap) could encourage some late filers to become nonfilers, especially if filing would trigger an assessment that would be difficult to pay. Practitioners have suggested that an inability to pay the tax required to be shown on the return is one reason that some taxpayers avoid filing.⁹⁰ Moreover, some taxpayers may have the perception that the IRS is more likely to detect late filing than nonfiling.⁹¹ This perception may increase the incentive for taxpayers to avoid filing returns reflecting assessments they cannot pay. Because the number of nonfilers exceeds the number of late filers by more than six to one, even a small percentage increase in nonfilers could eliminate the benefits of encouraging late filers to file earlier.⁹² The challenge is to structure the penalty to provide a continuing incentive for taxpayers to file returns that are more than five months late without increasing the incentive to avoid filing altogether.

Example

Assume a taxpayer with a net amount due of \$1,000 does not file a return (or seek a filing extension) within six months after the due date. The failure to file penalty does not increase even if the taxpayer files one year late or never files at all.

Recommendation⁹³

Revise the failure to file penalty so that it is more proportionate to the length of the delinquency, without increasing the rate to such an extent that the penalty itself discourages filing. One approach might be to retain the five percent per month penalty for the first three months of the delinquency and then apply a one percent per month rate for the next ten months (rather than five percent per month for the next two months) until reaching the maximum at 13 months. As noted above, most late filers for TY 2006 were from six to 13 months late. This change would provide an incentive for those late filers to file earlier.

⁸⁹ The Treasury Department has recommended that the failure to file penalty be reduced to 0.5 percent for the first six months, and one percent a month thereafter, up to a maximum of 25 percent to provide a continuing incentive for taxpayers to file. Department of Treasury, Office of Tax Policy, *Report to the Congress on Penalty and Interest Provisions of the Internal Revenue Code* 67 (Oct. 1999).

⁹⁰ SB/SE Research, Project 04.01.014.06, *Literature Review and Preliminary Recommendations on Measuring the Impact of Outreach on Non-filers* 10 (Jan. 2006) (internal citations omitted).

⁹¹ Some tax researchers refer to nonfilers as “ghosts” because of the IRS’s difficulty in identifying them. See SB/SE Research, Project 04.01.014.06, *Literature Review and Preliminary Recommendations on Measuring the Impact of Outreach on Non-filers* 8-10 (Jan. 2006) (internal citations omitted).

⁹² IRS Compliance Data Warehouse (Oct. 9, 2008) (reflecting 1,304,511 late filers for TY 2006 as of August 2008); W&I, Payment Compliance, Response to TAS information request (Oct. 16, 2008) (indicating there were 8,402,579 nonfilers for TY 2006 as of November 2007).

⁹³ The National Taxpayer Advocate previously recommended a one-time abatement of the failure to file and failure to pay penalties for first-time filers and taxpayers with a history of consistent compliance and no countervailing factors, see National Taxpayer Advocate 2001 Annual Report to Congress 188. This recommendation was included in the House-passed Taxpayer Protection and IRS Accountability Act of 2003, but did not become law. See H.R. 1528, 108th Cong. § 106 (2003). The IRS recently issued administrative guidance adopting this recommendation with respect to failure to file, failure to pay, and failure to deposit penalties. See IRM 20.1.1.3.5.1 (Feb. 22, 2008) (first time abatement (FTA) guidance).

5. Reduce the penalty for late filers who timely pay within a period of extension.

Problem

A late filer may be subject to an unexpected and disproportionate penalty for failure to file if he or she timely pays his or her tax in full on extension (*i.e.*, after the date initially prescribed for payment but within the period of extension). The five percent per month failure to file penalty is generally based on the amount of any net unpaid tax.⁹⁴ The net unpaid tax is the amount of tax required to be shown on the return (net of any credit that may be claimed on the return), reduced by the amount paid on or before the “date prescribed for payment.”⁹⁵ So if a taxpayer timely pays his or her tax in full by the original due date, no failure to file penalty applies. In this way, the failure to file penalty is proportionate to the harm to the tax system of not filing. The failure to file presents more harm to the tax system when the taxpayer has not fully and timely paid all of the tax required to be shown as due. If he or she has fully paid the tax, the failure to file a return is analogous to the failure to file an information return.

However, significantly different rules apply when a taxpayer fully and timely pays the tax required to be shown as due pursuant to a valid extension to pay (as opposed to the original due date).⁹⁶ Such a taxpayer is subject to a penalty for failure to file based on the amount unpaid as of the due date of the return, even if he or she timely paid pursuant to a valid extension.

This result – a significantly higher penalty for failure to file applies to taxpayers who fully and timely pay on extension as compared to other taxpayers who timely pay without an extension – belies the intuitive notion that a taxpayer is not penalized for timely and fully paying pursuant to a valid extension. The IRS forms that taxpayers use to request a payment extension do not provide any warning of this counterintuitive result.⁹⁷ Even tax professionals sometimes overlook the rule.

Example

After a taxpayer’s parents died, as executor of the estate, he estimated and timely paid the estate tax and received an extension of time to file. The taxpayer filed the return more than five months late. Because the failure to file penalty is computed based on the net amount

⁹⁴ IRC § 6651(a)(1).

⁹⁵ IRC § 6651(b)(1).

⁹⁶ According to a longstanding Revenue Ruling, the “date prescribed for payment” in IRC § 6651(b)(1) means the “last day fixed for such payment (determined without regard to any extension of time for paying the tax).” Rev. Rul. 81-237, 1981-2 C.B. 245. See also Non-Docketed Service Advice Review 1988 WL 1092648 (July 22, 1988).

⁹⁷ See Form 4768, *Application for Extension of Time to File a Return and/or Pay U.S. Estate (and Generation-Skipping Transfer) Taxes* (July 2008); Form 1127, *Application for Extension of Time for Payment of Tax* (March 1993); Form 1138, *Extension of Time for Payment of Taxes by a Corporation Expecting a Net Operating Loss Carryback* (Dec. 2005).

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of any unpaid tax as of the original due date (without regard to any extension), which was zero, the estate was not subject to any significant penalty for failure to file a timely return.⁹⁸

In contrast, a similarly situated taxpayer timely paid the tax in full within the time allotted by an extension to pay. A tax professional incorrectly advised the taxpayer to spend the time to file correctly, even if the return would be late, because no late filing penalty would apply. The estate filed late and was subject to penalty equal to 25 percent of the tax. The tax professional's bad advice did not constitute "reasonable cause" to excuse the late filing.⁹⁹

Recommendation

Modify IRC § 6651(b)(1) so the failure to file penalty is based on the net unpaid tax after taking into account amounts timely paid pursuant to an extension.

6. Reduce the number of failure to pay penalty rates and eliminate interaction with the failure to file penalty.

Problem

The failure to pay penalty is difficult to understand and compute. In a 2004 report, the Treasury Inspector General for Tax Administration (TIGTA) found IRS employees made errors in manually computing the failure to pay penalty in 24 percent of the cases it sampled.¹⁰⁰ In 2008, TAS determined the IRS's overall error rate in computing failure to pay penalties and interest was 8.3 percent.¹⁰¹ The failure to pay penalty computations are probably just as confusing for taxpayers. The penalty is imposed upon different taxpayers at a number of different rates and is coordinated with the failure to file penalty, as described below.

Shifting penalty rates generate complexity

The failure to pay penalty is 0.5 percent of the net amount of unpaid tax for each month it remains unpaid, up to a maximum of 25 percent.¹⁰² As noted above, the five percent per month failure to file penalty is also subject to a 25 percent maximum.¹⁰³ If the failure to

⁹⁸ The taxpayer would only be subject to a flat \$100 failure to file penalty pursuant to IRC § 6651(a).

⁹⁹ A taxpayer generally has a non-delegable duty to timely file a tax return. See, e.g., *United States v. Boyle*, 469 U.S. 241 (1985). While reliance on the advice of counsel can sometimes constitute "reasonable cause" for failure to file, advice that a taxpayer should take the time to file a complete and correct return has been held not to constitute reasonable cause. See, e.g., *Estate of Campbell v. Comm'r*, T.C. Memo. 1991-615. Moreover, advice that a return is required but that there would be no penalty for late filing does not generally constitute reasonable cause. See, e.g., *Ballard v. Comm'r*, 854 F.2d 185, 189 (7th Cir. 1988).

¹⁰⁰ TIGTA, Ref. No. 2004-30-184, *Errors in Failure to Pay Penalty Amounts Occur When the Penalty Is Computed Manually* 1 (Sept. 2004).

¹⁰¹ See Most Serious Problem, *The IRS Miscalculates Interest and Penalties but Fails to Correct These Errors Due to Restrictive Abatement Policies*, *supra*. The sample size was sufficient to allow TAS researchers to project with a 95 percent level of confidence that the IRS's overall error rate was within 2.8 percent of the projected 8.3 percent error rate that it found in the sample. *Id.*

¹⁰² IRC § 6651(a)(2), (3).

¹⁰³ IRC § 6651(a)(1).

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file and failure to pay penalties both apply to the same month, however, the failure to file penalty is generally reduced by the amount of the failure to pay penalty for that month.¹⁰⁴

The failure to pay penalty rate increases to one percent per month once the IRS proceeds to collect the tax by issuing a notice of intent to levy or jeopardy assessment.¹⁰⁵ On the other hand, the penalty is only 0.25 percent for any month an installment agreement is in effect if the taxpayer timely filed his or her original return (taking extensions into account).¹⁰⁶

Abatement difficulties driven by complexity

The IRS may abate the failure to pay penalty if the taxpayer shows the failure is due to reasonable cause and not willful neglect.¹⁰⁷ However, the IRS will not consider abating the penalty until the taxpayer fully pays the tax.¹⁰⁸ Because the penalty continues to accrue and interact with the failure to file penalty, if any, until the taxpayer pays the tax in full, the IRS's concern is that considering abatement requests submitted before the tax is fully paid would add complexity.¹⁰⁹

Such concerns may be compounded by the IRS's practice of using automated computer programs to assess tax and penalties (*i.e.*, the IRS's Math Error, AUR, and Automated Substitute for Return programs). These programs likely increase the number of failure to file and failure to pay penalties the IRS imposes and subsequently abates.¹¹⁰

Example

A taxpayer is in an automobile accident that prevents him from timely filing and paying his taxes and other bills. During his hospitalization, the IRS sends him a notice of intent to levy. The IRS assesses the failure to pay penalty during different periods at two different

¹⁰⁴ IRC § 6651(c)(1); Treas. Reg. § 301.6651-1(a)(1); *Smith v. United States*, 571 F. Supp. 664 (S.D.N.Y. 1983). For example, a taxpayer who failed to file and pay for 50 months could be subject to a 25 percent penalty for failure to pay (0.5 percent x 50 months) and 22.5 percent penalty for failure to file (25 percent (5 percent x 5 months) minus 2.5 percent (0.5 x 5 months - the period during which both penalties applied)). However, if the return is filed over 60 days past the due date this coordination rule will not cause the failure to file penalty to be reduced below \$100 or, if lower, the tax required to be shown on the return. IRC § 6651(a).

¹⁰⁵ IRC § 6651(d).

¹⁰⁶ IRC § 6651(h).

¹⁰⁷ IRC § 6651(a)(1); Treas. Reg. § 301.6651-1(c). IRM 20.1.1.3.1.2 (Feb. 22, 2008).

¹⁰⁸ IRM 20.1.2.1.3(2)(B) (Apr. 25, 2008).

¹⁰⁹ According to the IRM:

It is not in the taxpayer's interest for the Service to consider or effect FTP penalty abatements on accounts with outstanding tax due, as the penalty continues to accrue and often leads to the taxpayer having to make a second request for abatement. As a further example, if the Service were to consider and allow an abatement of FTP on a return filed five months late with unpaid tax, and the ½% FTP is abated for the first five months, the FTF rate goes from 4½% to 5%, effectively transferring the decreased FTP amount over to an increased FTF amount, creating a wash, while the maximum applicable FTP rate that had gone down to 22½% is re-started once again.... These type scenarios do not provide quality taxpayer relations and only serve to multiply confusions. IRM 20.1.2.1.3(2)(B) (Apr. 25, 2008).

¹¹⁰ For additional discussion of challenges facing automated programs which may assess penalties, see, e.g., National Taxpayer Advocate 2007 Annual Report to Congress 259 (Most Serious Problem, *Automated Underreporter*); National Taxpayer Advocate 2007 Annual Report to Congress 275 (Most Serious Problem, *The Accuracy-Related Penalty in the Automated Underreporter Units*); National Taxpayer Advocate 2006 Annual Report to Congress 311 (Most Serious Problem, *IRS Implementation of Math Error Authority Impairs Taxpayer Rights*). For a discussion of other problems with the failure to pay penalty, see Most Serious Problem, *The IRS Miscalculates Interest and Penalties but Fails To Correct These Errors Due To Restrictive Abatement Policies*, *supra*.

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rates: 0.5 percent and 1 percent. The penalty for late filing also applies during different periods at two different rates: 4.5 percent and 5 percent. Although he is eligible for abatement, the IRS will not consider abating any portion of the failure to pay penalty until he fully pays the tax.

Recommendations¹¹¹

- A. Separate the failure to pay penalty and the failure to file penalty so that the failure to pay penalty does not reduce the failure to file penalty. Establish independent rates and caps for each penalty. This change would reduce the complexity of the failure to pay computation.
- B. Eliminate the increased failure to pay penalty rate that applies after the IRS issues a notice of intent to levy.

Because only the IRS knows when it will issue a notice of intent to levy, the increased penalty that applies after the IRS issues the notice operates primarily to reimburse the government for the cost of enforcement activity rather than to enhance voluntary compliance. Pursuant to the principles articulated by the IRS Task Force Reports, discussed above, penalties should not be used to reimburse the government for the cost of compliance programs because this purpose may conflict with the goal of maximizing voluntary compliance. Especially if a taxpayer is not paying because he or she cannot afford to do so, such a penalty may seem unfair, potentially discouraging some taxpayers from working with the IRS to pay the liability. The increased charge may also violate principles of horizontal equity because it applies to taxpayers who receive a notice of intent to levy before reaching the rate cap, but does not apply to similarly situated taxpayers who have already reached the rate cap when they receive the notice (*e.g.*, because of IRS delay in issuing it).

7. Simplify the prior year estimated tax payment safe harbor and encourage taxpayers to use it.**Problem**

The rules for computing estimated tax payments are complicated, especially for taxpayers trying to minimize payments in years when their income is falling. A telephone survey found approximately two-thirds of taxpayers with a balance due did not plan to owe a balance upon filing.¹¹² Many of these taxpayers likely inadvertently triggered an estimated tax

¹¹¹ The National Taxpayer Advocate previously recommended substituting a higher underpayment interest rate for the failure to pay penalty. See National Taxpayer Advocate 2001 Annual Report to Congress 179. The Joint Committee on Taxation (JCT) also recommended replacing the failure to pay penalty with a five-percent per year late fee applicable to taxpayers who had not entered into an IA by the fourth month after the assessment. JCT Study at 3. The Treasury Department recommended increasing the penalty percentage from 0.5 percent to one percent per month after six months, but would cut the rate in half for any month in which an installment agreement is in effect. Treasury Study at 74.

¹¹² See Wage and Investment Division (W&I), Research Group 5, Project No. 5-03-06-2-028N, *Experimental Tests of Remedial Actions to Reduce Insufficient Prepayments: Effectiveness of 2002 Letters 7* (Jan. 16, 2004), citing W&I Customer Research Group 5, *Causes and Potential Treatments for Underwithholding and Insufficient Estimated Payments* (2000).

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penalty as a result of the complexity of the computation, as well as difficulties in predicting future income.

This complexity probably stems from attempts to balance competing considerations. On one hand, the estimated tax payment system is very important in fostering voluntary tax compliance. According to IRS research, taxpayers who owe a balance upon filing their returns are more likely than others to understate their tax liabilities.¹¹³ Moreover, according to the same study, more than 20 percent of such taxpayers with a balance due fail to pay it in full.¹¹⁴ On the other hand, individual taxpayers have a right to minimize overpayments. Given these competing considerations, under current law individual taxpayers may compute the required quarterly estimated tax payments in three different ways.

One alternative is for taxpayers to make four equal estimated tax payments totaling 90 percent of the tax that will be shown on the return for the current year (the “90 percent rule”).¹¹⁵ For many taxpayers, it is very hard to predict the full year’s income or tax in advance.¹¹⁶ Fortunately, there are two other methods of computing the required payments.

A second alternative for computing estimated tax payments allows taxpayers to make smaller estimated tax payments earlier in the year if the taxpayer’s “annualized income installment” – a complicated calculation that involves creating a *pro forma* return for a portion of the year preceding the quarterly due date – is less than the amount that would otherwise be payable.¹¹⁷ This alternative is most helpful for taxpayers whose income is concentrated late in the year.

A third alternative for computing the payments, which results in lower payments for taxpayers whose taxable income is rapidly increasing, is to make four equal estimated tax payments totaling 100 percent of the tax shown on the individual’s return for the preceding taxable year (the “prior year safe harbor”).¹¹⁸ For taxpayers who reported more than \$150,000 in adjusted gross income (\$75,000 if married and filing separately) on their return for the preceding year, the prior year safe harbor is based on 110 percent (rather than 100 percent) of the tax shown on the prior return (the “110 percent rule”).¹¹⁹ Notwithstanding the 110 percent rule, the prior year safe harbor is much simpler than the other two

¹¹³ See *id.*; Charles Christian, Phoenix District Office of Research and Analysis, *The Association Between Underwithholding and Noncompliance* 1-2 (July 14, 1995) (finding that “[o]n average, understated tax on balance due returns is ten times as large as understated tax on other returns.”).

¹¹⁴ See W&I, Research Group 5, Project No. 5-03-06-2-028N, *Experimental Tests of Remedial Actions to Reduce Insufficient Prepayments: Effectiveness of 2002 Letters* 7 (Jan. 16, 2004). For the 2006 tax year, 15 percent of all taxpayers who owed a balance upon filing their return failed to pay it in full. Compliance Data Warehouse, Individual Returns Transaction File (IRTF) (Oct. 2008).

¹¹⁵ IRC § 6654(d).

¹¹⁶ Farmers and fishermen, taxpayers whose income may depend on forces of nature, are permitted to make only one installment late in the year. IRC § 6654(i).

¹¹⁷ Any such reduction must be recaptured in subsequent estimated tax installments. IRC § 6654(d)(2).

¹¹⁸ IRC § 6654(d).

¹¹⁹ IRC § 6654(d)(1)(C)(i).

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alternatives for computing estimated payments. More importantly, it does not require taxpayers to predict the future.

Taxpayers may be more likely to inadvertently trigger an estimated tax penalty if the rules discourage taxpayers from using the prior year safe harbor. However, taxpayers whose prior-year income exceeds the \$150,000 threshold are required to make higher payments to meet it – 110 percent (rather than 100 percent) of the prior year’s tax. An analysis of Schedule C filers with prior year income in excess of the \$150,000 threshold confirmed that they were significantly more likely to trigger an estimated tax penalty when compared to those who had prior year income at or below the threshold (29.7 percent vs. 11.9 percent, respectively).¹²⁰

Similarly, when economic activity and taxable income are declining and taxpayers have the greatest need to conserve cash, they have an incentive to use methods other than the prior year safe harbor to compute the required estimated tax payments. In such cases, taxpayers may not want to use the prior year safe harbor, especially if they would be subject to the 110 percent rule, because it could lead to significant estimated tax overpayments that do not bear interest and cannot be recovered by individuals later in the year.¹²¹ Not surprisingly, Schedule C taxpayers whose incomes went down between tax year 2005 and 2006 were slightly more likely to trigger estimated tax penalties than those whose incomes went up.¹²² These rules encourage individual taxpayers, especially those subject to the 110 percent rule, to resort to more complicated alternatives. Thus, we could likely reduce complexity and estimated tax penalties by encouraging taxpayers to use the prior year safe harbor to estimated tax payments, rather than more error-prone methods.

Example

A self-employed small business taxpayer reported tax of \$25,000 on her 2006 return. Because she was married filing separately and her adjusted gross income for the prior year exceeded \$75,000, she needed to make four estimated tax payments of \$6,875 ($\$25,000 \times 110 \text{ percent} \times 25 \text{ percent}$) during the year to qualify for the prior year safe harbor. She made her first quarterly payment of \$6,875 during the 2007 tax year. However, because business revenues have been declining, she would like to minimize the remaining three

¹²⁰ IRS Compliance Data Warehouse Individual Returns Transaction File and Individual Master File (Tax Years 2005 and 2006) (analysis of data from tax years 2005 and 2006 regarding filers subject to the \$150,000 threshold, *i.e.*, those who were not married filing separately).

¹²¹ Rev. Rul. 54-149, 1954-1 C.B. 159 (explaining taxpayers cannot recover estimated tax overpayments); Treas. Reg. § 1.6425-1 (providing a procedure for corporations, but not individuals, to recover estimated tax overpayments). For purposes of computing interest on an overpayment, estimated tax payments are deemed to have been paid on the due date of the income tax return. See IRC 6611(d); IRC § 6513(b)(2); *Baral v. United States*, 528 U.S. 431 (2000). Thus, estimated tax payments do not bear interest before the due date of the return.

¹²² IRS Compliance Data Warehouse, Individual Returns Transaction File (Oct. 6, 2008) (TY 2005 and 2006) (13.5 percent vs. 13.2 percent) IRS Compliance Data Warehouse, Individual Returns Transaction File (Oct. 6, 2008) (analysis of data from tax years 2005 and 2006 regarding filers subject to the \$150,000 threshold, *i.e.*, those who were not married filing separately). In 2005, individual taxpayers with incomes above the threshold were only slightly more likely to have a greater tax liability in the following year than those whose incomes were at or below the threshold. According to IRS data, 47.6 percent of taxpayers with income greater than the \$150,000 threshold in 2005 had higher taxes in 2006 than in 2005, while 45.8 percent of the taxpayers at or below the threshold had higher taxes in 2006 – a difference of less than two percentage points. *Id.* Most individual taxpayers did not have a higher tax liability in the following year (2006), regardless of whether their income was above or below the threshold. *Id.*

estimated tax payments, especially since the IRS does not pay any interest on estimated tax overpayments.

Because her revenues were down by about 20 percent, the taxpayer estimated that she would owe 20 percent less tax in the 2007 tax year ($\$25,000 \times 80 \text{ percent} = \$20,000$), which would allow her to reduce her quarterly tax payments by about 35 percent (from $\$6,875$ to $\$4,500$) under the 90 percent rule ($\$20,000 \times 90 \text{ percent} = \$18,000$; $\$18,000 \times 25 \text{ percent} = \$4,500$). Since she believed she had overpaid on the first quarterly payment, she thought she could reduce the next two quarterly payments even further. Due to unexpectedly robust holiday sales at the end of the year and application of the AMT, her full-year taxable income increased from the prior year. The taxpayer increased the final estimated tax payment, but because she did not compute her 2007 tax liability before April of 2008 she could not be sure it was sufficient. She was subject to an estimated tax penalty for 2007.

Recommendation

Allow all individuals, regardless of income, to avoid an estimated tax penalty if they base their estimated tax payments on 100 percent of the prior year's tax shown on the return for the preceding year (rather than 110 percent for certain taxpayers).¹²³ This change would reduce complexity as well as the incentive for these taxpayers to use more complicated methods to compute estimated tax payments.¹²⁴

8. Simplify the estimated tax penalty computation and provide an automatic waiver of *de minimis* estimated tax penalties.

Problem¹²⁵

The estimated tax penalty is not easy to calculate. The penalty is computed by applying the underpayment interest rate to the underpayment from the date the quarterly payment was due until the earlier of the date the tax is satisfied or due (*e.g.*, April 15).¹²⁶ Because the underpayment interest rate changes quarterly and “quarterly” estimated tax payments are due on four oddly spaced dates (April 15, June 15, September 15, and January 15), each delinquent payment is subject to more than one penalty rate (*i.e.*, the rate applicable in two calendar quarters), even if satisfied by the next quarterly payment.¹²⁷

Because penalty computations are so complicated, the IRS allows a taxpayer to either compute his or her own estimated tax penalty and report it on his or her return or have

¹²³ The JCT recommended establishing a 100 percent prior year safe harbor for all taxpayers regardless of income (*i.e.*, eliminating the special 110 percent rule for certain taxpayers). JCT Study at 116.

¹²⁴ The next recommendation further addresses the complexity of the estimated tax penalty.

¹²⁵ The National Taxpayer Advocate identified this problem in her 2001 report. See National Taxpayer Advocate 2001 Annual Report to Congress 30-33 (Most Serious Problem, *Understanding Estimated Tax Payments*).

¹²⁶ IRC § 6654(a). Underpayments continuing after the tax is due are subject to interest charges and failure to pay penalties, but not estimated tax penalties.

¹²⁷ IRC § 6621(b)(2). However, the estimated tax penalty rate that applies to the third month following the close of the taxable year (typically March) also applies to the first 15 days of the fourth month (typically April 15). IRC § 6621(b)(2)(B). The JCT recommended applying only one rate per tax installment period. JCT Study at 118.

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the IRS compute it and send the taxpayer a separate bill.¹²⁸ The IRS does not bill taxpayers for estimated tax penalty amounts below a certain threshold.¹²⁹ According to TIGTA's most recent report on the subject, about 4.3 million (or 84 percent) of the taxpayers subject to the penalty computed it themselves in 1998 and 2.9 million (67.2 percent) of those taxpayers paid almost \$116 million, which they would not have been required to pay if they had allowed the IRS to compute the penalty.¹³⁰ The result – charging penalties to taxpayers who self-assess but not charging similarly situated taxpayers who do not – violates horizontal equity principles.

Example

Taxpayer W completes her return, calculates that she owes an \$X estimated tax penalty, and reports it on her return. She has to use two different rates to compute the penalty for a single quarter. Taxpayer Y also owes an \$X estimated tax penalty, but opts to have the IRS compute it. W must pay the penalty, but because the IRS does not bill taxpayers for penalties of less than \$Z (an amount greater than \$X), the IRS does not assesses the penalty against Y.

Recommendations¹³¹

- A. Apply only one estimated tax payment penalty rate for each estimated tax payment period.
- B. Automatically waive small estimated tax penalties of less than a set amount.¹³²

9. Allow the IRS to abate estimated tax penalties for first-time estimated tax payers who have reasonable cause.

Problem

The IRS is generally not authorized to waive the estimated tax penalty even if a taxpayer has a reasonable cause for the failure to pay and was never before required to make estimated tax payments.¹³³ As a result, the penalty sometimes applies to taxpayers who had a reasonable cause for failing to make estimated tax payments.

¹²⁸ See, e.g., Instructions for Form 2210, *Underpayment of Estimated Tax by Individuals, Estates, and Trusts* (2007) (explaining: “Because Form 2210 is complicated, we strongly encourage you to let the IRS figure the penalty. If you owe it, we will send you a bill.... If you want us to figure the penalty for you, complete your return as usual. Leave the penalty line on your return blank; do not file Form 2210.”)

¹²⁹ LEM 20.1.3.2.7 (Oct. 12, 2006). These small dollar thresholds are called “tolerances.”

¹³⁰ TIGTA, Ref. No. 2000-30-112, *Estimated Tax Penalty Assessment Processes Create Significant Taxpayer Inequity* (Aug. 2000). The same tolerance levels exist today. LEM 20.1.3.2.7 (Oct. 12, 2006); LEM 3.6.7 (Sept. 25, 1998).

¹³¹ In connection with this reform, Congress should also consider certain technical changes previously recommended by JCT and General Accounting Office (now called the Governmental Accountability Office, or GAO) to simplify the estimated tax penalty computations. See JCT Study 116-22 (recommending: applying the same 100 percent preceding-year safe harbor to all individuals, regardless of income, applying only one rate per estimated tax payment period, providing that underpayment balances are cumulative, and using a 365-day year for penalty calculations); GAO, GAO/GGD-98-96, *Ways to Simplify the Estimated Tax Penalty* (May 1998) (making similar recommendations).

¹³² The Treasury Department recommended expanding penalty waivers for taxpayers with penalties in the \$10-\$20 range. Treasury Study at 88.

¹³³ While the IRS is authorized to waive the penalty if due to certain “unusual circumstances” it would be against “equity and good conscience,” this authority is very narrow and is not equivalent to “reasonable cause.” See IRC § 6654(e)(3); IRM 20.1.3.4.1.2 (Sept. 12, 2006).

Taxpayers are not required to make estimated tax payments in the first year they earn income. They do not have to make estimated tax payments if they did not owe any tax in the prior 12-month taxable year, provided they were U.S. citizens or residents during that period.¹³⁴

Taxpayers who earn income solely from wages generally do not need to worry about the estimated tax payment system. If they owe less than \$1,000 in the current year after applying the credit for wage withholding (but not estimated tax payments), they are not required to make estimated tax payments.¹³⁵

Similarly, individuals who retire or become disabled during the year are not subject to the penalty if an estimated tax underpayment is due to reasonable cause and not willful neglect.¹³⁶ These rules implicitly recognize that taxpayers may inadvertently fail to comply with the estimated tax payment requirements when they are first required to do so and should not be subject to a penalty.

However, no similar reasonable cause exception applies to other taxpayers who are subject to the estimated tax payment regime for the first time for other reasons. For example, no reasonable cause exception applies when an employee first becomes an independent contractor or first receives a sudden increase in investment income, and fails to make sufficient estimated tax payments. Nor does a reasonable cause exception apply when a taxpayer simply receives an unexpectedly large amount of income late in the year.

Example

Taxpayer X retires after age 62 and opens a lawn service business. As a result of bad advice from a tax advisor, she fails to make a sufficient estimated tax payment and is subject to a penalty. Because she reasonably relied on her advisor in her first year of retirement, she has a reasonable cause for the error. The IRS abates the penalty.

Taxpayer Y does similar work as an employee of a lawn services company. Y's employer reclassifies her as an independent contractor and stops withholding on her earnings. Y consults the same tax advisor and fails to make sufficient estimated tax payment in the first quarter after she becomes an independent contractor. Y has reasonable cause for the failure, but the IRS is not authorized to abate the penalty on the basis of Y's reasonable cause.

¹³⁴ IRC § 6654(e)(2).

¹³⁵ IRC § 6654(e). Both the JCT and Treasury Department have recommended expanding this safe-harbor by considering estimated tax payments in computing the \$1,000 threshold, but each would require additional complex rules to prevent taxpayers from back-loading estimated tax payments. See Treasury Study at 82-88; JCT Study at 115.

¹³⁶ IRC § 6654(e)(3).

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Recommendation¹³⁷

Expand the reasonable cause waiver that applies to taxpayers who are retired and disabled during the year to all first-time estimated tax payers.¹³⁸

10. Make the Trust Fund Recovery Penalty more effective by clarifying that it covers third party payers.**Problem**

The Trust Fund Recovery Penalty (TFRP) helps to ensure that trust fund taxes reach the government. However, it may not apply to “third party payers” – persons who contract to assist the taxpayer in paying trust fund taxes to the government and take possession of funds designated for that purpose. The TFRP applies to any person required to collect, truthfully account for, and pay over withheld income and employment (Social Security and railroad retirement) taxes, and collected excise taxes, who willfully fails to do so.¹³⁹ Despite its denomination as a “penalty,” the TFRP serves as a collection device rather than a means of imposing an additional penalty over and above the amount of the unpaid tax.¹⁴⁰ In keeping with this purpose, the business and each of its “responsible persons” are jointly and severally liable for the entire unpaid trust fund tax liability, including interest and penalties; however, the IRS has a policy of collecting the liability only once.¹⁴¹

In FY 2007, third party payers transmitted approximately one third of all electronic federal tax deposits received by the Treasury.¹⁴² In recent years, a number of third party payers have gone out of business or embezzled customer funds.¹⁴³ Because the taxpayer/customer remains liable for the taxes, he or she can experience significant burden if the third party does not make timely payments to the government. Such taxpayers may be required to pay the amount twice – once to the third party payer that absconded with or dissipated the funds and a second time to the IRS – plus interest and penalties. While in some cases a third party payer or one or more of its employees could be deemed a “responsible person,”

¹³⁷ The National Taxpayer Advocate made a similar recommendation in 2001 to allow the IRS to grant one-time abatement of the penalties for failure to file and pay the first time a taxpayer makes an error. See National Taxpayer Advocate 2001 Annual Report to Congress 188.

¹³⁸ The Treasury Department recommended applying reasonable cause waivers to individuals who are first-time estimated tax payers, provided the balance due on the return is below a threshold amount and paid with a timely filed return. Treasury Study at 88. We agree with this recommendation, except that we do not believe that first-time estimated tax payers who have a reasonable cause for the failure should be denied access to the abatement process solely because their income is too high or they were unable to pay the tax in full with their return. Such limitations also introduce additional complexity.

¹³⁹ IRC § 6672. In certain cases, if a third party payer pays employee wages, it may be liable pursuant to IRC § 3504. See, e.g., *Pediatric Affiliates, P.A. v. United States*, 2006-1 USTC ¶ 50,201 (D.N.J. 2006); *Morin v. Frontier Bus. Tech.*, 288 B.R. 663, 671-72 (W.D.N.Y. 2003) (holding that agent was not liable for payroll taxes because it never had actual control over the funds used to pay employee wages).

¹⁴⁰ See, e.g., *Kelly v. Lethert*, 362 F.2d 629 (8th Cir.1966) (stating that “[a]lthough 26 U.S.C. § 6672 denominates this liability as a penalty it is well settled that it is, in substance, a tax”).

¹⁴¹ IRS Policy Statement 5-14, IRM 1.2.14.1.3 (June 9, 2003); IRM 5.7.3.1(8) (Oct. 30, 2007); IRM 5.17.7.1.9 (Nov. 2, 2007). See also *Botta v. Scanlon*, 314 F.2d 392, 393 (2d Cir. 1963) (noting “that section 6672 is simply a means for ensuring that the tax is paid...”).

¹⁴² See IRS, *EFTPS Deposits Received and Processed, Volumes and Dollars Collected FY 2007 Year End* (Sept. 28, 2007). See also Brady Bennett, Director, Filing and Payment Compliance, W&I, *Talking Points, Important Contributions of Reporting Agents, SB/SE Focus and Updates*, National Reporting Agents Forum (Feb. 21, 2007).

¹⁴³ SB/SE Fraud Digest (Aug. 2007). For a full discussion, see National Taxpayer Advocate 2007 Annual Report to Congress 337 (Most Serious Problem, *Third Party Payers*).

potentially subject to the TFRP with respect to its customer's tax payments, this result is far from certain.¹⁴⁴

Example

A taxpayer hires a payroll service provider (PSP) to administer its payroll, collect payroll taxes, and file applicable IRS forms. The PSP collects payroll tax deposits from the taxpayer but does not pay them over to the IRS. The PSP also changes the taxpayer's mailing address on file with the IRS to the PSP's business address without the taxpayer's knowledge. When the IRS sends delinquent payroll tax notices to the taxpayer, the PSP receives them, but does not disclose the delinquency to the taxpayer. The taxpayer remains liable for delinquent payroll taxes, interest, and penalties. The IRS does not assert that the PSP or any of its owners or employees is liable for the TFRP because of the uncertainty regarding its applicability.

Recommendation

Clarify the definition of a "responsible person" who may be subject to the TFRP. The definition should expressly include a third party payer – a person that has agreed to fulfill the taxpayer's tax payment obligations – and the third party payer's agents and employees to the extent they exercise authority or control over the taxpayer's tax payments.¹⁴⁵

11. Reduce the penalty for failure to make tax deposits in the prescribed manner.

Problem¹⁴⁶

Taxpayers who inadvertently fail to make timely tax deposits because they made a deposit using the wrong method (*e.g.*, paid the IRS rather than the proper authorized depository) may be subject to a disproportionate penalty.

Taxpayers must pay certain taxes by making deposits with an authorized depository or through electronic payments on dates that vary from taxpayer to taxpayer. Taxpayers must make tax deposits of payroll taxes, such as income, Social Security, and Medicare (Forms

¹⁴⁴ Compare *Bowlen v. U.S.*, 956 F.2d 723, 728 (7th Cir.1992) (noting that "responsibility under section 6672 encompasses all those connected closely enough with the business to prevent the default from occurring.") and *Quattrone Accountants, Inc. v. IRS*, 895 F.2d 921 (3d Cir. 1990) (holding that the accounting firm that managed financial affairs of a farmers' cooperative on a daily basis was a responsible person) with *Jorgenson v. U.S.*, 92-2 USTC ¶ 50,558 (N.D. Ind. 1992) (holding that the accountant who prepared monthly financial statements, assisted in the payroll process, and had check-writing authority was not a responsible person, since he did not have authority to determine whether employer would pay taxes) and *In re Professional Sec. Services, Inc.*, 162 B.R. 901 (Bankr. M.D. Fla. 1993) (stating that "[u]nder the statute, an entity, *i.e.* a corporation, does not qualify as a person."). IRC § 6671(b) explains that the term "person" for purposes of the TFRP "includes an officer or employee of a corporation, or a member or employee of a partnership, who as such officer, employee, or member is under a duty to perform the act in respect of which the violation occurs." As used in the IRC, however, the term "includes" means "includes without limitation," and the term "person" broadly includes individuals, corporations, and various other entities. See IRC §§ 7701(a)(1) and (c). Thus, the definition does not expressly include or exclude third party payers or their employees.

¹⁴⁵ The National Taxpayer Advocate made a very similar proposal last year. See National Taxpayer Advocate 2007 Annual Report to Congress 538-59 (Key Legislative Recommendation, *Taxpayer Protection from Third Party Payer Failures*). She also proposed to make this liability non-dischargeable in a bankruptcy. *Id.*

¹⁴⁶ For a discussion of the problem that taxpayers may be penalized for inadvertent failures to use the correct deposit method or for being late when their due date changed, see National Taxpayer Advocate 2001 Annual Report to Congress 41-42 (Most Serious Problem, *Awareness and Understanding of Federal Tax Deposit Requirements*).

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941 and 943), Federal Unemployment (FUTA) taxes (Form 940), nonpayroll withholding (Form 945), withholding on payments to non-U.S. persons (Form 1042), railroad employer's retirement and unemployment taxes (Form CT-1), federal excise taxes (Form 720), and corporate and nonprofit income and unrelated business tax deposits (Forms 1120, 990-C, and 990-T).¹⁴⁷ To avoid penalties, taxpayers must make their deposits in full, on time, and in the right manner. Taxpayers that fail to do so are subject to a four-tier failure to deposit (FTD) penalty:

- Two percent if the correct deposit is one to five days late;
- Five percent if the correct deposit is six to 15 days late;
- Ten percent if the correct deposit is more than 15 days late; and
- Fifteen percent if the correct deposit is not paid within ten days after the IRS issues a delinquency notice or immediate payment demand in jeopardy cases.¹⁴⁸

The FTD penalty is disproportionately high for those taxpayers who make timely deposits using the wrong method because the same (ten percent) penalty applies to a failure to deposit in the correct manner that applies to a failure to make the deposit at all.¹⁴⁹

The IRS may abate the FTD penalty if the taxpayer establishes the failure was due to reasonable cause and not willful neglect.¹⁵⁰ The IRS will also generally waive an FTD penalty the first time a taxpayer uses an unauthorized deposit method.¹⁵¹ In addition, it will generally abate first-time FTD penalties for taxpayers with an otherwise clean compliance history under its first-time abatement program.¹⁵² However, because it is costly for taxpayers to seek and obtain an abatement, which may require a significant amount of fact-finding, taxpayers are more likely to pay small penalties than to request an abatement.¹⁵³ Table 2, *Top Ten Civil Penalties Assessed During FY 2003-2005 and Abated as of March 2008*, shows that for FY 2005 the IRS abated 15 percent of the FTD penalties, representing 63 percent of the FTD penalty dollars assessed, suggesting the IRS abated larger-than-average assessments more frequently than smaller ones. Thus, the perceived fairness of the penalty might be improved, and the administrative burdens associated with submitting and processing abatement requests might be reduced, if a smaller penalty applied to minor errors, such as the error of making a timely deposit using the wrong method.

¹⁴⁷ IRC § 6302.

¹⁴⁸ IRC § 6656(b).

¹⁴⁹ IRM 20.1.4.2.1 (Oct. 1, 2007).

¹⁵⁰ IRC § 6656(a).

¹⁵¹ IRM 20.1.4.14.1.4 (Oct. 1, 2007). IRM 20.1.4.16.3 (Oct. 1, 2007). The IRS is authorized to waive FTD penalties with respect to employment tax deposits for taxpayers who inadvertently trigger the penalty and meet certain net worth requirements (*i.e.*, net worth of \$2 million or less for individuals, estates and trusts, or \$7 million or less for corporations or other business entities which must also have no more than 500 employees) if the taxpayer timely filed the related return and the failure occurred during the first quarter that a person was required to deposit any employment tax or with respect to the first deposit after a taxpayer was required to change employment tax deposit methods. IRC § 6656(c).

¹⁵² See IRM 20.1.1.3.5.1 (Feb. 22, 2008) (first time abatement (FTA) guidance).

¹⁵³ The taxpayer must request the abatement, even if it would be granted automatically. See IRM 20.1.4.16 (Oct. 26, 2007).

Example

An employer ran out of federal tax deposit coupons, was unable to make a \$2,000 deposit at his bank, and instead took it to a local IRS office. The IRS assessed a ten percent FTD penalty of \$200 against him because he did not make the deposit through his bank, the authorized depository.¹⁵⁴ Because the employer had been delinquent once before and his deposit method had not changed, the IRS would not automatically abate the penalty. The employer would have to apply for an abatement of the penalty and an IRS employee would need to process the request.

Recommendation

Reduce the penalty rate for failure to make a deposit in the manner prescribed from ten percent to two percent.¹⁵⁵ Because making a deposit in the wrong manner is much less damaging to the tax system than failing to make a deposit at all, the penalty would be more proportionate if it were lower than the penalty for failing to make a deposit at all.¹⁵⁶

¹⁵⁴ See generally Treas. Reg. § 1.6302-1; IRM 20.1.4 (Oct. 1, 2007).

¹⁵⁵ According to the Treasury Study, “the penalty for failure to use the correct deposit method should be reduced from 10 percent to 2 percent. The current-law 10-percent penalty is too severe for this type of error.” Treasury Study at 5. See *also id.* at 96. The National Taxpayer Advocate made the same recommendation in her 2001 report. See National Taxpayer Advocate 2001 Annual Report to Congress 222 (Additional Legislative Recommendation, *Federal Tax Deposit (FTD) Avoidance Penalty*).

¹⁵⁶ In addition, the IRS is apparently authorized to stack concurrent estimated tax and failure to deposit penalties for the same lapse. See GCM 36137 (Jan. 15, 1975). Although the IRS does not currently stack such penalties, Congress may wish to eliminate the potential for stacking these penalties in connection with any broad reform. See, e.g., Arthur H. Boelter, 1 Tax Pen. & Int. § 2:107 (Nov. 2007) (noting, with respect to concurrent estimated tax and FTD penalties, that “[t]he author is aware of no instance in which this has occurred.”).

Appendix A

Table 4, *The Number of FY 2007 Assessments for Selected Civil Tax Penalties by Internal Revenue Code Section*, below, lists about 130 civil tax penalties by code section and the number of assessments reflected in the IRS's penalty database for each one. Determining how to aggregate or disaggregate individual penalties required the exercise of subjective judgment. For example, someone could reasonably compile a similar list that would disaggregate the failure of individuals to pay estimated taxes under IRC § 6654, which we listed as a single penalty, into penalties applicable to different types of taxpayers, such as farmers and fishermen, who are subject to special rules and requirements. Others might list all of the failure to pay penalties under IRC § 6651, which we listed separately, as a single penalty. As the table shows, the IRS has no data or only aggregate data for many of the penalties listed below.

Table 4, The Number of FY 2007 Assessments for Selected Civil Tax Penalties by Internal Revenue Code Section

IRC §	Description	Number of Assessments ¹⁵⁷
6038(b)(1)	Failure of certain controlling persons to furnish information with respect to controlled foreign corporations and partnerships	83
6038(b)(2)	Failure of certain controlling persons to furnish information with respect to controlled foreign corporations and partnerships after IRS notice	
6038A(d)	Failure of certain foreign-owned corporations to furnish information or maintain records	41
6038B(c)	Failure to furnish information with respect to certain transfers to foreign persons (on Form 926 or Form 8865, Schedule O)	8
6038C(c)	Failure of certain foreign corporations to furnish information or maintain records	-
6039F(c)	Failure to timely report receipt of large gifts from foreign persons	<5
6039G(c)	Failure to file expatriate/residency report (Form 8854)	
6651(a)(1)	Failure to file a return	5,686,080
6651(a)(2)	Failure to pay tax shown on return when due	18,289,071
6651(a)(3)	Failure to pay amounts greater than \$100,000 within 10 days of notice of additional tax due	194,783
6651(a)(3)	Failure to pay amounts of \$100,000 or less within 21 days of notice of additional tax due	
6651(d)	Failure to pay within 10 days of notice of intent to levy	
6651(f)	Fraudulent failure to file	2,070
6652(a)	Failure to file information returns for dividends aggregating less than \$10	-
6652(b)	Failure to report tips	12,850

¹⁵⁷ A dash (“-”) indicates that either the IRS either has not assessed the penalty during the year or does not track the penalty assessment data. Where the number of assessments is greater than zero but less than five (“<5”), we do not list the actual figures.

Appendix A

IRC §	Description	Number of Assessments
6652(c)(1)(A)	Failure to file an annual return by exempt or political organization	86,382
6652(c)(1)(B)	Failure of manager to file annual return of exempt or political organization after IRS demand	
6652(c)(1)(C)	Failure of exempt or political organization to make annual returns and reports available for public inspection	
6652(c)(1)(D)	Failure of exempt or political organization to make application for exemption and notice of status available for public inspection	
6652(c)(2)(A)	Failure of certain trusts and terminating or reorganizing exempt organizations to file certain returns	
6652(c)(2)(B)	Failure of managers of certain trusts and terminating or reorganizing exempt organizations to file certain returns after IRS demand	
6652(c)(2)(C)	Failure of split-interest trust to file a return	
6652(c)(2)(C)	Knowing failure of required person to file trust return	
6652(c)(3)(A)	Failure of certain exempt organizations to report participation in certain "reportable" transactions	
6652(c)(3)(B)	Failure of certain exempt organizations to report participation in certain "reportable" transactions after IRS demand	
6652(d)(1)	Failure by certain pension plans to file an annual registration statement under IRC § 6057(a)	
6652(d)(2)	Failure by certain pension plans to file a notification of change in status under IRC § 6057(b)	
6652(e)	Failure to file a return or statement (Form 5500) required in connection with certain plans of deferred compensation	
6652(f)	Failure by foreign persons holding U.S. real property to file a return required under IRC § 6039C	
6652(g)	Failure by a plan administrator to file a return under IRC § 219(f)(4)	
6652(h)	Failure to give notice under IRC § 3405(e)(10)(B) to recipients of certain pension, etc., distributions	
6652(i)	Failure to give written explanation under IRC § 402(f) to recipients of certain qualifying rollover distributions	
6652(j)	Failure to file certification under IRC § 142(d)(7) with respect to certain residential rental projects	
6652(k)	Failure to make reports under IRC § 1202(d)(1)(C) with respect to qualified small business stock	-
6652(l)	Failure to file a return under IRC § 6043(c) with respect to certain corporate recapitalizations	-
6654	Failure by individuals to pay estimated tax	2,836,822
6655	Failure by corporations to pay estimated tax	96,280
6656(a)	Failure to deposit	1,967,698
6657	Bad check	255,605
6662(b)(1)	Negligence or disregard of rules or regulations	402,681
6662(b)(2)	Substantial understatement of income tax	
6662(b)(3)	Substantial valuation misstatement	
6662(b)(4)	Substantial overstatement of pension liabilities	
6662(b)(5), (g)	Substantial estate or gift tax valuation understatement	
6662(h)	Gross valuation misstatements	
6662A(a)	Disclosed reportable transaction understatement	
6662A(c)	Undisclosed reportable transaction understatement	47
6663	Underpayment due to fraud	4,024
6672	Failure to collect and pay over trust fund taxes - the "trust fund recovery penalty"	140,984
6673(a)(1)(A)	Instituting tax court proceedings primarily for delay	12
6673(a)(1)(B)	Instituting frivolous tax court proceedings	
6673(a)(1)(C)	Instituting tax court proceedings without pursuing administrative remedies	
6673(a)(2)	Instituting unreasonable and vexatious tax court litigation	

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IRC §	Description	Number of Assessments
6673(b)	Instituting frivolous court proceedings under IRC § 7433 for unauthorized collection actions	5
6674	Willful failure to furnish an employee Form W-2, Wage and Tax Statement	-
6674	Willfully furnishing a false or fraudulent employee Form W-2, Wage and Tax Statement	-
6674	Willfully failing to furnish an employee Form W-2, Wage and Tax Statement, in the manner, at the time and showing all information required	-
6676	Erroneous income tax claim for refund or credit	-
6677(a)	Failure to file information (on Form 3520) with respect to creation of or transfers to certain foreign trusts under IRC § 6048(a)	7
6677(b)	Failure to file annual information return (on Form 3520A) with respect to certain foreign trusts under IRC § 6048(b)	126
6679(a)(1)	Failure to file timely and complete returns etc. with respect to certain foreign entities under IRC § 6046 or IRC § 6046A	-
6679(a)(2)	Failure to file timely and complete returns etc. with respect to certain foreign entities under IRC § 6046 or IRC § 6046A after IRS notice ¹⁵⁸	43
6682	Providing false information with respect to withholding that results in underwithholding	-
6684	Willful and flagrant failure with respect to certain tax exempt entities' liability for tax under chapter 42	-
6685	Willful failure to comply with public inspection requirements applicable to certain tax-exempt organizations	-
6686	Failure to file returns or supply information by DISC or former FSC	-
6688	Failure to report information (on Form 8898) regarding change residency in a U.S. Possession	-
6689	Failure to timely notify the IRS of a foreign tax redetermination	-
6690	Fraudulent statement or willful failure to furnish a statement to a plan participant	-
6692	Failure of a plan administrator to file an actuarial report in the time and manner required	-
6693(a)(1)	Failure to provide reports on certain tax-favored accounts or annuities in the time and manner required	<5
6693(b)(1)	Overstatement of designated nondeductible contributions	
6693(c)(1)	Failure of employer to provide one or more simple retirement account notices required by IRC § 408(l)(2)(C)	
6693(c)(2)(A)	Failure of trustee or issuer to provide one or more statements required by the last sentence of IRC § 408(i)	
6693(c)(2)(B)	Failure of trustee or issuer to provide one or more summary descriptions required by IRC § 408(l)(2)(B)	
6694(a)(2)(A)-(C)(i)	Understatement of taxpayer's liability by tax return preparer due to undisclosed positions without "substantial authority"	365
6694(a)(2)(C)(ii)	Understatement of taxpayer's liability by tax return preparer due to disclosed positions without a "reasonable basis"	
6694(b)	Willful or reckless understatement of taxpayer's liability by a tax return preparer	278
6695(a)	Failure of preparer to furnish a copy to the taxpayer	60
6695(b)	Failure of preparer to sign return	
6695(c)	Failure of preparer to furnish identifying number	
6695(d)	Failure of preparer to retain copy or list	
6695(e)	Failure of preparer to file correct information returns	
6695(f)	Negotiation by preparer of check issued to taxpayer	-
6695(g)	Failure of preparer to be diligent in determining eligibility for earned income tax credit	277
6695A	Substantial and gross valuation misstatements attributable to incorrect appraisals	-

¹⁵⁸ The data showing the number of assessments under IRC § 6679(a)(2) may also include assessments under IRC § 6677(a).

Appendix A

IRC §	Description	Number of Assessments
6698	Failure to file a timely and complete partnership return	5,101
6699	Failure to file a timely and complete S corporation return	
6700	Promoting abusive tax shelters	96
6701	Penalties for aiding and abetting understatement of tax liability	134
6702(a)	Filing frivolous tax returns	5,939
6702(b)	Submitting specified frivolous positions	
6704	Failure to keep records necessary to meet reporting requirements under IRC § 6047(d)	-
6705	Failure by broker to provide notice to payers	<5
6706(a)	Failure by issuer to set forth original issue discount information on certain debt instruments	-
6706(b)	Failure by issuer to furnish certain debt instrument information to the IRS (on Form 8281)	
6707(b)(1)	Failure to furnish information regarding "reportable" transactions that are not "listed"	<5
6707(b)(2)	Failure to furnish information regarding "listed" transactions	
6707A(b)(1)(A)	Failure to include information with a natural person's return regarding "reportable" transactions that are not "listed"	<5
6707A(b)(1)(B)	Failure to include information with an entity's return regarding "reportable" transactions that are not "listed"	
6707A(b)(2)(A)	Failure to include information with a natural person's return regarding "listed" transactions	
6707A(b)(2)(B)	Failure to include information with an entity's return regarding "listed" transactions	
6708	Failure to provide lists of advisees to the IRS upon request with respect to "reportable" transactions	<5
6709(a)	Negligent material misstatement with respect to a mortgage credit certificate	-
6709(b)	Fraudulent material misstatement with respect to a mortgage credit certificate	-
6709(c)	Failure to file a required report with respect to a mortgage credit certificate	-
6710(a)	Failure to disclose that contributions are nondeductible without reasonable cause	-
6710(c)	Intentional failure to disclose that contributions are nondeductible	-
6711	Failure by a tax-exempt organization to disclose that certain information or services are available from the federal government	-
6712	Failure to disclose treaty-based return positions (i.e., the position that a treaty overrules or otherwise modifies the IRC)	<5
6713	Improper disclosure or use of return information by preparers	-
6714	Failure to meet disclosure requirements applicable to quid pro quo contributions	<5
6716(a)-(b)	Failure to file information with respect to certain transfers at death and gifts without reasonable cause	-
6716(c)	Intentional failure to file information with respect to certain transfers at death and gifts	-
6717(a)	Refusal to permit entry or examination allowed by IRC § 4083(d)(1)	-
6720	Fraudulent acknowledgments with respect to donations of motor vehicles, boats, and airplanes or failure to provide acknowledgement required under IRC § 170(f)(12)	6
6720B	Fraudulent identification of exempt use property	-

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Appendix A

IRC §	Description	Number of Assessments
6721(a)	Failure to file timely and correct information returns	24,497
6721(b)(1)	Untimely or incorrect information returns corrected within 30 days of due date	
6721(b)(2)	Untimely or incorrect information returns not corrected/filed within 30 days of due date, but corrected on or before August 1	
6721(d)(1)(A)	Failure to file timely and correct information returns by persons with gross receipts of not more than \$5,000,000	
6721(d)(1)(B)	Untimely or incorrect information returns corrected/filed within 30 days of due date by persons with gross receipts of not more than \$5,000,000	
6721(d)(1)(C)	Untimely or incorrect information returns not corrected/filed within 30 days of due date, but corrected/filed on or before August 1 by persons with gross receipts of not more than \$5,000,000	
6721(e)	Failure to file timely and correct information returns as a result of intentional disregard	144,120
6722(b)	Failure to furnish correct and timely payee statements	1,051
6722(c)	Failure to furnish correct and timely payee statements as a result of intentional disregard	19
6723	Failure to comply with other information reporting requirements	42
7269	Failure to produce estate tax information upon request in connection with an examination	-
7482(c)(4)	Frivolous or groundless appeal from the Tax Court instituted or maintained primarily for delay	-
7519(f)(4)	Failure to make required payment by entities electing an alternate taxable year under IRC § 444	11

**BUILDING A BETTER FILTER:
PROTECTING LOWER INCOME
SOCIAL SECURITY RECIPIENTS
FROM THE FEDERAL PAYMENT
LEVY PROGRAM**

Building a Better Filter: Protecting Lower Income Social Security Recipients from the Federal Payment Levy Program

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Executive Summary

Established by Congress in 1997, the Federal Payment Levy Program (FPLP) enables the IRS to continuously levy up to 15 percent of certain federal payments made to delinquent taxpayers.¹ By far, these levies most commonly attach to Social Security Administration (SSA) payments. In 2008, the IRS received more than two million FPLP levy payments from taxpayers, with more than 83 percent of those payments coming from Social Security benefits.² FPLP levies on SSA benefits are not one-time attachments, but remain in effect until the liability is resolved or the taxpayer contacts the IRS with payment arrangements or proof of his or her current inability to pay the liability. Until 2005, the IRS used a filter to prevent low income taxpayers from being subjected to FPLP levies on their Social Security payments. However, a 2003 report by what was then the General Accounting Office (GAO)³ questioned the effectiveness of the low income filter, which relied on a taxpayer's Total Positive Income (TPI) as its sole measure of the taxpayer's financial situation.⁴ GAO's report cited similar installment agreement (IA) rates from taxpayers with incomes above and below the filter income threshold. The report also noted the filter fails to recognize that taxpayers might have other assets that could satisfy the tax liability; however, the report did not explore the effect of the FPLP levies on taxpayers truly unable to afford the levy.⁵ Since the removal of the low income filter, TAS FPLP cases have sharply increased.⁶

This report documents TAS Research's design, development, and preliminary testing of an improved filtering or screening model to determine whether the FPLP levy will cause a taxpayer economic hardship. Specifically, the new TAS model uses taxpayers' income information from filed individual income tax returns and payor documents supplied to the IRS to estimate the taxpayers' incomes.⁷ Next, the TAS model uses other tax return data to estimate expenses routinely allowed by the IRS, known as Allowable Living Expenses (ALE), when determining a taxpayer's ability to pay.⁸ The TAS model then compares these two amounts to determine a taxpayer's true ability to afford to pay the FPLP levy on SSA benefits without experiencing economic hardship. In additional testing of the model, TAS Research compares the effects of differences between application of the IRS 2006 and 2008 ALE standards. Finally, TAS Research explores differences that emerge when

¹ Taxpayer Relief Act of 1997 (*TRA 97*), Pub. L. No. 105-34, § 1024 (111 Stat. 788, 923) (Aug. 5, 1997).

² IRS, Wage and Investment Division (W&I) spreadsheet, *FPLP Monthly Counts FY 2008*. [1,797,530 (total number of FPLP SSA levy payments received in fiscal year 2008) / 2,161,974 (total number of FPLP levy payments received in FY 2008) = 83 percent].

³ The General Accounting Office was renamed the Government Accountability Office in July 2004.

⁴ TPI is calculated by summing the positive values from the following income fields from a taxpayer's most recently filed individual tax return: wages; interest; dividends; distribution from partnerships, small business corporations, estates, or trusts; Schedule C net profits; Schedule F net profits; and other income such as Schedule D profits and capital gains distributions. Losses reported for any of these values are treated as zero. For a more detailed discussion of this filter, see National Taxpayer Advocate 2001 Annual Report to Congress 202-09; National Taxpayer Advocate 2003 Annual Report to Congress 206-12; National Taxpayer Advocate 2004 Annual Report to Congress 246-63; and National Taxpayer Advocate 2005 Annual Report to Congress 123-35.

⁵ GAO, GAO 03-356, *Tax Administration, Federal Payment Levy Payment Program Measures, Performance and Equity Can Be Improved* 13-15 (Mar. 6, 2003).

⁶ TAS FPLP cases grew from 1,707 in FY 2005 to 2,890 in FY 2008. TAS, *Business Performance Management System (BPMS)* (Sept. 2008).

⁷ Income data from tax year 2005.

⁸ The IRS publishes allowable expense guidelines which are based on average, actual taxpayer expenditures. These guidelines are used by the IRS to determine a taxpayer's ability to pay delinquent tax liabilities.

the filter based on the 2008 ALE standards is applied, and then compares the results to the 2008 poverty level. TAS Research's initial findings show that the use of data already in the possession of the IRS is sufficient to accurately determine whether FPLP levies will cause economic hardship to Social Security recipients. TAS Research uses FPLP cases with known IRS Collection dispositions to evaluate the effectiveness of the model, to explore discrepancies, and to project the effect of updated IRS allowable expense standards.⁹

This report also examines the availability of other assets to satisfy the tax liability. In addition to looking for the presence of real property, as suggested by GAO¹⁰ TAS Research also reviewed cases for the presence of more liquid assets, by estimating underlying principal amounts from reported interest, dividends, and capital gains.

The most significant conclusions from this report follow:

- Overall, the TAS model demonstrates sufficient reliability to be considered for use by the IRS.
- An analysis of taxpayer incomes supports the model's classification results and shows that in many cases where the taxpayer agreed to pay the liability, the taxpayer may have experienced hardship.
- Although about eleven percent of taxpayers classified as "can pay" by the model have incomes exceeding the allowable expenses, further analysis finds that their incomes are still insufficient for them to afford the 15 percent FPLP attachment.
- Over one-third of all FPLP cases subject to an ongoing FPLP levy would likely be classified as unable to pay based on current IRS allowable expense guidelines.
- More than one-quarter of FPLP taxpayers who paid their tax liability, entered into an installment agreement with the IRS or were subject to an ongoing FPLP levy had incomes at or below the poverty level.
- Most taxpayers with small liabilities endured the FPLP Social Security levy, even though their incomes showed an inability to pay, thus suggesting that they may have forgone some basic living expenses.
- Although the 2008 allowable expense standards are typically more generous than the 2006 standards and classified more taxpayers who paid or established IAs as being unable to pay, most of these taxpayers still had incomes at or below the poverty level.
- An analysis of taxpayer assets located by a third party data source shows that the IRS has sufficient tax data to determine if many of these taxpayers have assets which may be used to satisfy a tax delinquency.

⁹ The objective of the analysis is to explore whether the filter would inappropriately exclude from levy a significant number of taxpayers who actually paid or entered into an agreement to pay, resulting in an unjustified potential revenue loss to the government. Hardship cases are excluded from the analysis, because the revenue loss is justified due to the financial hardship the taxpayer would experience if subjected to levy.

¹⁰ GAO, GAO 03-356, *Tax Administration, Federal Payment Levy Payment Program Measures, Performance and Equity Can Be Improved* 15 (Mar. 6, 2003).

Building a Better Filter: Protecting Lower Income Social Security Recipients from the Federal Payment Levy Program

Introduction

Congress enacted the FPLP in 1997 to allow the IRS to systematically issue levies to federal payment recipients with delinquent tax liabilities.¹¹ While the IRS can levy upon a variety of federal payments, the overwhelming majority of these levies have involved payments from the SSA to taxpayers who are elderly or disabled. Most FPLP funds are received from Social Security payments.¹² FPLP levies on SSA benefits are not one-time attachments, but remain in effect until the liability is either resolved or the taxpayer contacts the IRS with payment arrangements or proof of his or her current inability to pay the liability.

The IRS is authorized to issue continuous levies of up to 15 percent of a taxpayer's payments received from the federal government via an electronic process.¹³ This authorization forms the basis for the FPLP, which systemically matches IRS delinquent accounts to the records of the Financial Management Service.¹⁴ Such matches allow the IRS to locate federal payment recipients who have delinquent tax liabilities. Once the IRS identifies the federal payment recipients, it sends a notice to the taxpayer explaining the outstanding liability, including the taxpayer's right to appeal the collection of the liability. The IRS then sends an additional notice to taxpayers before levying SSA benefits.¹⁵

As noted above, the vast majority of FPLP levy payments are received from SSA benefits.¹⁶ In January 2002, the IRS developed a filter to prevent low income taxpayers from being subjected to a levy of their SSA benefits. This filter was based on the total positive income reported on the taxpayer's last filed income tax return.¹⁷ In March 2003, the GAO issued a report on the IRS' FPLP program. Among other findings, the GAO determined that the TPI filter was often based on outdated information and resulted in a disparate treatment of taxpayers. Moreover, the report suggested that even taxpayers with low incomes might have other assets that could satisfy their tax obligations.¹⁸ The IRS agreed to phase out the TPI filter, and in January 2005, the filter was completely eliminated. Its elimination coincided with a dramatic increase in TAS FPLP cases, which rose by more than 200 percent from FY 2004 to 2005, from about 500 cases to over 1,700. TAS FPLP cases grew another 143 percent the following year, with the total case count swelling to over 4,000 in FY 2006. While FY 2007 and FY 2008 saw a drop in TAS FPLP cases, the FY 2008 level is still nearly 500 percent higher than in FY 2004.¹⁹

¹¹ Taxpayer Relief Act of 1997 (TRA 97), Pub. L. No. 105-34, § 1024 (111 Stat. 788, 923) (Aug. 5, 1997).

¹² IRS, W&I spreadsheet, *FPLP Monthly Counts* FY 2008. See note 2, *supra*.

¹³ Internal Revenue Code (IRC) §§ 6331(h) and 6343(a)(1)(D).

¹⁴ The FMS is the Department of the Treasury agency that processes payments for various federal agencies.

¹⁵ Internal Revenue Manual 5.11.7.2.3.2 (Aug. 24, 2007).

¹⁶ IRS, W&I spreadsheet, *FPLP Monthly Counts* FY 2008. See note 2, *supra*.

¹⁷ GAO, GAO 03-356, *Tax Administration, Federal Payment Levy Payment Program Measures, Performance and Equity Can Be Improved* 11 (Mar. 6, 2003). See note 4, *supra*.

¹⁸ GAO, GAO 03-356, *Tax Administration, Federal Payment Levy Payment Program Measures, Performance and Equity Can Be Improved* 13-15 (Mar. 6, 2003).

¹⁹ TAS, *BPMS* (Sept. 2004, 2005, 2006, 2007, 2008).

Concerned by the growing TAS FPLP case inventory and the significant hardship FPLP levies may cause SSA recipients, the National Taxpayer Advocate urged the IRS to develop a new FPLP filter which better protects low income taxpayers from undue hardship, without exempting taxpayers who have the wherewithal to satisfy their tax obligations.²⁰ During FY 2007, the IRS W&I Division Compliance function agreed to begin a joint study with TAS Research to explore the development of a more effective filter that would protect certain SSA recipients from being unduly burdened by the FPLP levy, but not exempt taxpayers who can afford the levy payment. Initial analysis by the IRS showed that, as indicated by the GAO report, most FPLP taxpayers had not filed a recent income tax return, suggesting the last filed return may not be appropriate to determine which taxpayers can and cannot endure the FPLP levy without hardship.²¹

In the initial phase of the project, the IRS and TAS independently developed preliminary models to predict whether FPLP levies would cause hardship. These models had different results: the IRS model more accurately identified non-hardship cases while the TAS model more accurately identified hardship cases. However, it should be noted that evaluation of the IRS model was based on an assumption that all continuous FPLP cases were non-hardship. Specifically, the IRS presumed that a taxpayer could pay, just because the levy remained in effect, even though financial information was never obtained. On the other hand, the TAS model only evaluated disposed cases where financial information was obtained by the IRS. Both models proved inadequate; a subsequent analysis of the sample data showed that more than half of the cases considered “hardship” by the IRS had previously been in a continuous FPLP levy status.²² Likewise, the initial analysis also suggested the TAS method of including only dispositions where the financial information secured by the IRS resulted in a biased filter because too many cases were excluded from the analysis. For these reasons, the IRS and TAS agreed to begin a second phase of research during spring 2008.

The second phase of research incorporated payor data reported to the IRS in addition to information included on tax returns, allowing for a reasonable estimate of taxpayers’ incomes even if a recent tax return had not been filed.²³ The IRS chose to use this additional taxpayer income information to see if a better mathematical model could be developed, but continued to classify all FPLP continuous levy cases as non-hardship cases. TAS, on the other hand, chose to use the additional taxpayer information to inquire whether IRS ALE standards could accurately determine whether a taxpayer can afford the FPLP levy without experiencing significant hardship. While the National Taxpayer Advocate has noted the shortcomings of the ALE standards, she has also suggested that they could constitute a reasonable “floor” and that the IRS should be flexible in accepting documentation of basic

²⁰ National Taxpayer Advocate 2006 Annual Report to Congress 155, 156.

²¹ Only 27 percent of the taxpayers receiving FPLP levies during the first six months of FY 2007 had filed 2005 individual income tax returns (most recent tax year available on IRS Compliance Data Warehouse at beginning of study).

²² E-mail from W&I Research analyst dated May 22, 2007.

²³ For example, payor data included income reported to IRS from the SSA or interest income reported to the IRS from financial institutions.

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living expenses that exceed that “floor.”²⁴ The methodology, findings, and conclusions outlined in this report focus on the viability of using IRS ALE standards along with other taxpayer information to filter Social Security recipients from being subjected to the FPLP levy, when the levy would likely create a financial hardship. The analyses will also explore taxpayer incomes, balances due, and the poverty level, where appropriate.

Background

In FY 2008, more than two million FPLP payments were received from levies issued by the IRS. These FPLP levies garnered an estimated \$405 million of federal payments to taxpayers. By far, the most common federal source of payments from the FPLP program is SSA benefits. In fact, more than 83 percent of the FPLP payments received in FY 2008 were from Social Security benefits.²⁵ FPLP levies are issued by the IRS systemically, without review of the individual facts of the cases. These levies on Social Security payments may result in significant harm to taxpayers, since their Social Security benefits are often their sole or majority source of income.

Social Security Facts:

- Social Security provides at least half of the total income for 65 percent of beneficiaries aged 65 or over, and comprises 90 percent or more of total income for more than 34 percent of this population.²⁶
- As of August 2007, Social Security recipients received an average benefit of \$962.70 per month.²⁷
- The FPLP levy would reduce this amount to \$818.29.
- *These facts illustrate how devastating the FPLP levy may be for many Social Security recipients.*

Because of concerns about the effect of the FPLP on low income taxpayers, the National Taxpayer Advocate persuaded the IRS to institute a filter to protect low income Social Security recipients from FPLP levies. In 2002, the IRS implemented such a filter based on taxpayers' TPI, representing their entire actual income reported on their most recently filed income tax return.²⁸ A report issued by the GAO in 2003 raised questions about the effectiveness and fairness of this filter. The GAO report cited equal payment rates for taxpayers at or below the TPI threshold and for taxpayers above the TPI threshold. The GAO report also noted that some taxpayers filtered out of the FPLP had other assets such as real

²⁴ National Taxpayer Advocate 2006 Annual Report to Congress 155.

²⁵ IRS, Wage and Investment Division spreadsheet, *FPLP Monthly Counts FY 2008*. [1,797,530 (total number of FPLP SSA levy payments received in FY 2008) / 2,161,974 (total number of FPLP levy payments received in FY 2008) = 83 percent].

²⁶ SSA, *Fast Facts & Figures About Social Security* (Sept. 2007).

²⁷ SSA, Office of Policy, Research, Evaluation and Statistics, *Monthly Statistical Snapshot, Table 2, Social Security Benefits* (Aug. 2007). [$\$962.70 \times 0.15 = \144.41 and $\$962.70 - \$144.41 = \$818.29$].

²⁸ See note 4, *supra*..

estate which might be used to pay the tax obligation. Furthermore, the GAO report noted that many taxpayers filtered out of the FPLP had not filed recent income tax returns and that payor documents submitted to the IRS showed incomes higher than those reported on their last filed returns.²⁹

In response to the GAO report, the IRS began to phase out the TPI filter and ultimately eliminated it in 2005. TAS saw a significant increase in its FPLP caseload corresponding to the phase-out and elimination of the filter. From FY 2004 to FY 2006, TAS cases involving the FPLP rose from about 500 to more than 4,000.³⁰ Accordingly, the National Taxpayer Advocate continued to draw attention to the problems of the FPLP in her Annual Reports to Congress. The IRS agreed to reexamine the possibility of developing a new FPLP filter for SSA recipients. The IRS and TAS began to work on the development of a new filter in 2007.

Beginning in 2007, the IRS and TAS worked together to compile FPLP data to design and test new FPLP filters for SSA recipients. These data included FPLP data, tax return data, and other data regarding taxpayer income reported to the IRS from third parties. The IRS pursued the use of data mining techniques to develop a filter to classify FPLP SSA recipients into “can pay” and “cannot pay” categories. In contrast, TAS pursued the application of IRS ALE standards to classify SSA recipients subject to FPLP levies into “can pay” and “cannot pay” categories. TAS then compared the results of its classification of taxpayers into the two categories to the IRS case disposition. This allowed us to examine the effectiveness of using allowable expenses to classify potential SSA FPLP levy recipients into “can pay” and “cannot pay” categories.

The objective of the analysis is to explore whether the filter would inappropriately exclude from levy a significant number of taxpayers who actually paid or entered into an agreement to pay, resulting in an *unjustified* potential revenue loss to the government. Hardship cases are excluded from the analysis because the revenue loss is *justified*, given the financial hardship the taxpayer would experience if subjected to levy. This report outlines the results of TAS’s effort to use IRS allowable expense standards to determine the ability of a recipient of SSA benefits to afford the FPLP levy without enduring financial hardship.

Methodology

W&I Filing and Payment Compliance provided data for all taxpayer delinquent account cases subjected to an FPLP levy during the first six months of FY 2007. This included information on type of tax, taxable period, delinquency balance, and type of IRS disposition of any resolved case. Tax return line item information for this sample of FPLP taxpayers was also extracted from the Individual Returns Transaction File (IRTF) while third-party income information was extracted from the Individual Returns Master File (IRMF).

²⁹ GAO, GAO 03-356, *Tax Administration, Federal Payment Levy Payment Program Measures, Performance and Equity Can Be Improved* 13-15 (Mar. 6, 2003).

³⁰ TAS, *BPMS* (Sept. 2004, 2005, 2006).

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TAS Research then used IRTF and IRMF data to construct an estimate of taxpayer income, and developed an estimate of the amount of expenses that should be allowed by the IRS based on its allowable expense standards. To construct its model, TAS Research used third party data to include the full amount of taxpayer income and made conservative assumptions to estimate taxpayer expenses.³¹ Although the sample FPLP data were from FY 2007, the IRS 2006 allowable expense standards were in effect throughout this time, and were thus used for the preliminary analysis. However, because the 2006 allowable expense standards have now been updated by the IRS, we have also compared the FPLP data to the 2008 IRS allowable expense standards. While the application of the 2006 standards forms a better basis of comparison to the case disposition (because the cases were disposed in accordance with the 2006 standards), the use of the 2008 standards provides an estimate of their effect, if implemented, on current IRS FPLP cases.

The 2008 ALE standards not only update the 2006 standards, but they also broaden the scope of expenses to include health care. The 2006 IRS allowable expense standards contained guidelines for what the IRS terms its “National Standards” for such items as food and clothing by gross monthly income, transportation costs, and housing and utility expenses. The 2008 IRS ALE standards do not break the National Standard expenses down by gross monthly income but they contain generally larger allowances for these same items, in addition to an allowance for health care. The tables describing the 2006 and 2008 standards are located in the Appendix of this paper.

As described hereafter, the TAS model is designed to be a conservative estimate of taxpayer expenses, while also using multiple sources to ascertain all taxpayer income, even if unreported. For the purposes of TAS’s model, we used data from two sources to determine the taxpayers’ income to which the allowable expense standards would be compared. We considered:

- The TPI from the tax year 2005 individual federal income tax return.³²
- The taxpayer’s and spouse’s income from the IRMF wage and Form 1099 income (SSA, miscellaneous, interest, dividend, and Individual Retirement Account (IRA) and pension income).³³

Next we developed income estimates based on the previously discussed sources and following the guidelines listed below.

³¹ For example, TAS Research used the larger amount between third party payor data and the corresponding line item on the taxpayers federal income tax return to estimate taxpayer income. If the most recent year’s tax return was not filed, allowable expenses were based on a household size of one, since the number of dependents could not be determined. Transportation expenses were only allowed for operating one car with no expense allocation for operating additional vehicles or for vehicle ownership. The housing and utility allowance was the *lower* of 20 percent of the taxpayer’s total positive income (*lowest* housing expense amount from the Census American Community Survey) or the IRS maximum allowable housing and utility expense amount. The National Standard expense tables are included in the Appendix.

³² To ensure a conservative analysis, tax year 2004 TPI was used if no tax year 2005 return was filed and if the tax year 2004 TPI exceeded the IRMF data available for analysis.

³³ Form 1099, *U.S. Information Return*, is an income information document supplied to the taxpayer and the IRS from third party payors. See IRC § 6041(a).

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- If a taxpayer filed a tax year 2005 return, we compared the IRMF data and the corresponding tax return line item to determine the largest value (*e.g.*, if a taxpayer reported \$500 interest income on the 2005 tax return, but the IRMF data showed the taxpayer received \$700 of interest income, the \$700 amount was used for the taxpayer's interest income).
- For tax year 2005, we computed taxpayers' incomes as the sum of the maximum of the tax return line item or the corresponding IRMF amount and the amount of other income reported on the return for which no IRMF data were available.
- For taxpayers where the most recently filed return was older than 2005, we considered the taxpayers' incomes to be the sum of the IRMF income.

After determining the taxpayers' incomes, we computed the IRS allowable expense amounts as follows:

Annual Allowable Expenses = (National Standard + Transportation + Housing & Utility) X 12³⁴

1. The National Standard allowable expense amount was based on the size of household as determined by exemptions claimed on the tax year 2005 return. Absent a 2005 return, we based the National Standard allowable expense amount on a household size of one. See Table A-1 for National Standard expense figures.
2. The Transportation allowable expense amount is based on the lowest regional IRS allowable operating expense for one car. While this amount is provided to everyone for the allowable expense proxy, we provided no allowance for ownership expense, public transportation, or for operating more than one car. See Tables A-3 and A-4 for transportation expense figures.
3. The Housing and Utility allowable expense amount is the smaller of 20 percent of total positive income (from return) or the IRS allowable expense amount.³⁵ The 20 percent of total income is the lowest Census American Community Survey allowance for housing expenses.³⁶ If a tax return was not filed, or if the most recently filed return was older than tax year 2005, we used the income amounts from Forms 1099 and Forms W-2, *Wage and Tax Statement*, to create a proxy for total positive income. For those records where the smaller amount is the IRS Housing and Utility allowable expense amount, the expense is based on the number of persons in the household, which is taken from exemptions claimed on the tax year 2005 return. If a tax year 2005 return was not filed, the household size was set at one. See Tables A-5 and A-6 for examples of housing and utility expense figures.

³⁴ The 2008 allowable expense standards also included an allowance for health care. See Table A-2, *infra*, for health care expense allowances.

³⁵ The taxpayer's ZIP Code was determined from the SSA address and mapped to the corresponding state and county using a commercial database. For the 185,513 SSA FPLP records, 1,368 did not have a reported ZIP Code from the SSA. An additional 6,988 cases could not be mapped to the IRS allowable expense listing of states and counties, mostly due to differences in the layout of the county name (*e.g.*, presence or absence of a hyphen). In these instances, the national average for each county (by household size) was used.

³⁶ This figure comes from the Census Bureau's American Fact Finder, a web-based research tool on www.census.gov, the U.S. Census website.

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We then performed additional analyses to explore the availability of other taxpayer assets to satisfy the liability. The GAO report examined IRMF data to look for the presence of real estate which could be leveraged to satisfy the delinquent liability. A similar analysis, conducted for this report, looked for tax return data on mortgage interest or real estate taxes paid and IRMF data on mortgage interest paid. This information on potential assets was cross-referenced with the allowable expense classification of a taxpayer's ability to pay. This report further includes an additional asset analysis that examines interest, dividend, and positive income amounts from Form 1040 Schedule D, *Capital Gains and Losses*, and extrapolates an underlying asset value by assuming a five percent return on investment. Again, these results are cross-referenced with the allowable expense classification of a taxpayer's ability to pay.

Finally, to determine if IRS data sources are sufficient to determine the presence of assets which could be used to satisfy the tax liability, we conducted a test on a sample of the cases classified as unable to pay. We pulled a stratified sample of 700 cases classified as unable to pay by either the 2006 or 2008 allowable expense analysis and then compared it with a third party data source of individuals' property.³⁷ Next, we compared the presence of property from this sample to internal IRS sources suggesting the availability of property in order to examine the IRS's ability to detect property that could possibly be used to satisfy a delinquency if data indicate that income is insufficient for payment to the IRS.

Limitations

In addition to the limitations described in the prior methods section, the following limitations were also present:

Although for FY 2007 FPLP cases, the most recent tax return due was tax year 2006, the most recent data available for analysis was tax year 2005.

The following cases were removed from analysis because of special circumstances:

- 3,305 cases were removed because the case had multiple delinquencies with different disposition types.
- 2,243 cases were removed from analysis because the cases were in a collection status other than continuous levy, full pay, or IA (*e.g.*, bankruptcy, offer in compromise, etc).³⁸

Some significant differences exist between the comparison of the 2006 and 2008 allowable expense proxies to the case dispositions. This is not unexpected because of generally larger 2008 allowable expense amounts, particularly for lower income taxpayers. Accordingly, the comparison of the 2008 allowable expense proxy and the case dispositions should not be

³⁷ The LexisNexis Accurint database for IRS was used for this property search. Accurint for IRS is a web-based research tool for public records/asset locator research. Additional databases have been added to the tool for specific IRS needs.

³⁸ Ultimately, 185,513 cases remained for analysis.

viewed as a measure of accuracy of the 2008 proxy, but rather as an estimate of the effect of using the 2008 allowable expense proxy as a filter for the FPLP.³⁹

Findings

As previously described, the models compare a proxy for IRS allowable expenses to a taxpayer's income to determine whether an ability to pay existed. TAS attempted to estimate expenses conservatively to ensure that taxpayers with an ability to pay were not inappropriately removed from the FPLP. TAS Research placed taxpayers with incomes greater than their allowable expenses in the "can pay" group, while placing taxpayers with incomes less than or equal to their allowable expenses in the "cannot pay" group.⁴⁰ The models then compared these two groups to the status of the taxpayer's account (at the time of sample extraction) as depicted in Table 1.⁴¹

Evaluating Taxpayer's Ability to Pay

Table 1 shows that the largest category of sample cases is those subject to an ongoing FPLP levy. The IRS has generally not received financial information for these taxpayers and has not closed their collection cases. Accordingly, the TAS allowable expense model results cannot be compared to the IRS disposition. Nevertheless, these findings suggest that a significant number of taxpayers are subject to a levy on their SSA income, even though they cannot afford the levy. The fact that over half of the FPLP sample cases disposed by the IRS as hardship were once in an ongoing FPLP levy status further supports this finding.⁴² Based on current IRS expense standards, over one-third of taxpayers subject to an ongoing FPLP levy cannot afford this loss of income.⁴³

³⁹ Taxpayer incomes may have increased from 2005 to 2007 (the most recent year available for implementation of a filter). This use of the older income data may result in an overstatement of the number of taxpayers screened by such a filter; however this should have no impact on the filter's accuracy.

⁴⁰ Forty-five taxpayers classified as unable to pay by the allowable expense analysis were claimed as a dependent on another tax return; however, even if no housing expenses were allowed to these individuals, their allowable expenses still exceed their income.

⁴¹ The objective of the analysis is to explore whether the filter would inappropriately exclude from levy a significant number of taxpayers who actually paid or entered into an agreement to pay, resulting in an unjustified potential revenue loss to the government. Hardship cases are excluded from the analysis, because the revenue loss is justified due to the financial hardship the taxpayer would experience if subjected to levy.

⁴² E-mail from W&I Research analyst (May 22, 2007).

⁴³ See Table 1 (53,102 / (53,102 + 103,953)).

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Table 1, Taxpayer Ability to Pay (Using 2006 and 2008 Standards)

Case Status/Ability to Pay	2006			2008		
	Cannot Pay ⁴⁴	Can Pay	Total	Cannot Pay	Can Pay	Total
<i>Levy</i>	28,420	128,635	157,055	53,102	103,953	157,055
<i>Paid</i>	785	14,435	15,220	2,333	12,887	15,220
<i>Installment Agreements</i>	935	12,303	13,238	2,695	10,543	13,238
Totals	30,140	155,373	185,513	58,130	127,383	185,513

In Table 1 above, italicized cells indicate those instances where the allowable expense proxy classified the cases differently from the IRS disposition. The 2006 allowable expense proxy classified six percent of sample cases as being unable to pay, even though the taxpayer either paid the balance due or entered into an arrangement with the IRS to pay the liability.⁴⁵ The 2008 allowable expense proxy classified nearly 18 percent of the sample cases as being unable to pay, even though these cases had full payment or installment agreement dispositions. This level of inconsistency is to be expected, however, since the dispositions were made according to the 2006 ALE. Many of these inconsistencies may have a reasonable explanation, and will be explored in some detail hereafter.

Analysis - Inconsistencies

The following sections compare the Collection case dispositions with both the 2006 and 2008 allowable expense proxies. The disposition cross-tabulations to the 2006 and 2008 allowable expense proxies are shown side-by-side for ease of comparison.

Full Pay Cases where Allowable Expense Proxy Shows an Inability to Pay

As indicated in Table 1, slightly more than 2,300 taxpayers full paid their liabilities, even though the 2008 allowable expense proxy showed these taxpayers to be unable to pay.⁴⁶ Although this represents nearly a 200 percent increase from the application of the 2006 allowable expense proxy, the actual increase in number of cases is relatively small at only 1,548. The increase is reasonable given the generally larger expense allowances for 2008. As indicated in Table 2 below, 80 percent of these taxpayers had total liabilities of at most \$870 with 70 percent having liabilities of \$451 or less, regardless of which year's allowable expense standards were used.

⁴⁴ Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*, is used to report income from both pensions and IRA distributions. For this analysis, Form 1099-R was compared to IRA distributions reported on the tax return. Data were not available to determine whether the 1099-R was for pension income or IRA distributions. As a result, nine cases classified as "cannot pay" cases could potentially be classified as "can pay" cases, if the Form 1099R were compared to pension income instead of IRA distributions.

⁴⁵ See Table 1. Six percent = $(785 + 935) / (785 + 935 + 14,435 + 12,303)$.
Eighteen percent = $(2,333 + 2,695) / (2,333 + 2,695 + 12,887 + 10,453)$.

⁴⁶ The exact number is 2,333. See Table 1.

Table 2, Tax Liability Amounts of Full Pay Taxpayers Classified as Unable to Pay Using 2006 and 2008 Allowable Living Expense Standards

2006 Standards		2008 Standards	
Percentiles	Balance Due	Percentiles	Balance Due
10	\$ 0	10	\$ 0
20	\$ 41	20	\$ 43
30	\$ 82	30	\$ 89
40	\$ 114	40	\$ 127
50	\$ 184	50	\$ 186
60	\$ 264	60	\$ 282
70	\$ 434	70	\$ 451
80	\$ 870	80	\$ 837
90	\$ 2,366	90	\$ 2,433
Mean	\$ 2,638	Mean	\$ 2,219

It seems likely that based on IRS guidelines, these taxpayers did not have an ability to pay but were able to compensate for missing income for the relatively short period of time required to pay off their balance due. Most likely, these taxpayers either went without necessary expenses or borrowed from family or friends to pay their tax liability.

Table 3 shows that taxpayers in this group did not generally have high incomes. Although the more generous 2008 allowable expenses show that significantly more taxpayers who paid their liability would now be classified as unable to pay, more than two-thirds of these taxpayers had incomes at or below the 2008 poverty level. The poverty level varies by household size. For 2008, the poverty level for a household size of two is \$14,000, with an extra allowance of \$3,600 for each additional person in the household. About 64 percent of these 2,333 taxpayers had a household size of two or more.

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Table 3, Income Levels of Full Pay Taxpayers Classified as Unable to Pay Using 2006 and 2008 Allowable Expenses

Percentiles	Best Income	
	2006 standards	2008 standards
10	\$ 2,401	\$ 5,013
20	\$ 3,968	\$ 7,376
30	\$ 5,056	\$ 8,742
40	\$ 6,090	\$ 9,919
50	\$ 6,823	\$ 10,913
60	\$ 7,422	\$ 13,271
70	\$ 7,955	\$ 15,169
80	\$ 8,443	\$ 17,290
90	\$ 10,606	\$ 19,886
Mean	\$ 6,600	\$ 12,175

Installment Agreement Cases where Allowable Expense Proxy Shows an Inability to Pay

Table 1 showed that nearly 2,700 FPLP taxpayers entered into installment agreements, even though the 2008 allowable expense proxy showed them to be unable to pay.⁴⁷ While the number filtered out by application of the 2008 ALE standards is almost three times the number filtered out by the 2006 ALE, this increase is reasonable given the generally higher allowances associated with the 2008 standards. Moreover, only 119 (4.4 percent) of these IAs required taxpayers to submit financial information (non-streamlined IAs). Since the IRS did not collect financial information from these taxpayers, it is possible that they experienced financial hardship by entering into an agreement to pay their liabilities. While the 2008 allowable expense proxy classified 14.7 percent of non-streamlined installment agreement cases as *not* having an ability to pay, the 2006 allowable expense standards, under which the IA was established, classified only 6.6 percent as not having an ability to pay. As shown in Table 4, taxpayers with IAs classified as unable to pay by the 2008 allowable expense proxy also had significantly higher incomes than those classified as unable to pay by the 2006 allowable expense proxy. Nevertheless, more than 70 percent of the IA cases classified as unable to pay by the 2008 allowable expense proxy had incomes at or below the 2008 poverty level.⁴⁸

⁴⁷ The exact number is 2,695. See Table 1.

⁴⁸ The poverty level varies by household size. For 2008, the poverty level for a household size of one is \$10,400, with an extra allowance of \$3,600 for each additional person in the household. About 55 percent of these 2,695 taxpayers had a household size of two or more.

Table 4, Income Levels of Installment Agreement Taxpayers Classified as Unable to Pay Using 2006 and 2008 Standards

Percentiles	Best Income	
	2006 standards	2008 standards
10	\$ 2,467	\$ 5,114
20	\$ 4,131	\$ 7,090
30	\$ 5,219	\$ 8,380
40	\$ 6,072	\$ 9,381
50	\$ 6,732	\$ 10,294
60	\$ 7,214	\$ 11,160
70	\$ 7,728	\$ 13,719
80	\$ 8,153	\$ 16,224
90	\$ 9,539	\$ 18,792
Mean	\$ 6,438	\$ 11,355

In contrast to those taxpayers who paid their liability in full, these taxpayers generally have larger outstanding liabilities.

Table 5, Tax Liability Amounts of Installment Agreement Taxpayers Classified as Unable to Pay Using 2006 and 2008 Standards

Percentiles	Balance Due	
	2006 Standards	2008 Standards
10	\$ 86	\$ 139
20	\$ 261	\$ 318
30	\$ 434	\$ 514
40	\$ 690	\$ 767
50	\$ 1,036	\$ 1,062
60	\$ 1,425	\$ 1,479
70	\$ 1,975	\$ 2,137
80	\$ 3,284	\$ 3,242
90	\$ 5,952	\$ 5,690
Mean	\$ 3,373	\$ 3,223

Additional Analyses

Assets to Satisfy Delinquent Tax Liability

We performed additional analyses to estimate if the taxpayer had other assets to satisfy the tax obligation. For one analysis, the sum of a taxpayer's interest, dividend, and Schedule D profit (liquid assets) was computed to estimate the underlying principal asset, presuming

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an annual rate of return of five percent per year.⁴⁹ The results of this analysis are displayed in the following table:

Table 6, Taxpayers with Liquid Assets Available

Case Status/Ability to Pay	2008 Allowable Expense Classification		
	Cannot Pay	Can Pay	Total
Ongoing FPLP Levy	24	196	220
Paid	897	7,139	8,036
Installment Agreement	397	2,430	2,827
Total	1,318	9,765	11,083

Table 6 shows that over 85 percent of individuals with interest, dividend or capital gain-producing assets sufficient to satisfy the liability were already classified as able to pay (“can pay” column) according to the 2008 allowable expense proxy, although a small additional number of taxpayers show that they *may* have sufficient assets to satisfy the liability.⁵⁰ The number of taxpayers with sufficient assets to potentially satisfy the liability, but classified as unable to pay, is even smaller when compared to the 2006 allowable expense proxy.

We also reviewed the presence of real estate as indicated by mortgage interest or taxes deducted on Form 1040 Schedule A, or from mortgage interest reported to the IRS by third party lenders on Form 1098, *Mortgage Interest Statement*. Table 7 depicts the distribution of taxpayers by ability to pay, with an underlying principal asset greater than the tax liability (*i.e.*, those taxpayers depicted in the prior table) *or* with real estate.⁵¹

Table 7, Taxpayers with Liquid or Real Estate Assets Available

Case Status/Ability to Pay	2008 Allowable Expense Classification		
	Cannot pay	Can Pay	Total
Ongoing FPLP Levy	1,296	19,470	20,766
Paid	1,009	8,945	9,954
Installment Agreement	533	4,702	5,235
Total	2,838	33,117	35,955

Again, this table also shows that about 90 percent of taxpayers who *may* have sufficient liquid or real estate assets to satisfy the liability would be already classified as able to pay

⁴⁹ Interest and dividend amounts reported on the tax return were compared to their corresponding IRMF amounts and the higher value was used.

⁵⁰ Calculation for over 85 percent = 9,765 / 11,083.

⁵¹ No attempt was made to value the real estate or determine if it contains equity.

based on the 2008 allowable expense proxy.⁵² Nevertheless, a small additional number of taxpayers show that they *may* have sufficient assets to satisfy the liability.

Test of Third Party Data Source to Locate Taxpayer Assets

A significant concern raised by GAO in its report on the previous FPLP filter used by the IRS was that many of the taxpayers had other assets which might have been used to satisfy the tax liability. To further explore this issue, TAS Research randomly selected 700 taxpayers from the FPLP taxpayer data provided for this project by W&I Compliance, where the 2008 allowable expense proxy showed the taxpayer as being unable to pay. We ran these taxpayers against the Accurint database to search for property which could possibly be used to satisfy the delinquent tax obligations.⁵³ Overall, 31.5 percent of the sample showed the presence of some type of real property.⁵⁴ Those taxpayers where Accurint showed the presence of real estate were cross-referenced with IRS tax return and Form 1098 data. The IRS data showed the presence of real estate in about 40 percent of these cases.⁵⁵ It is unknown whether the remaining 60 percent of the cases had real property not detectable by tax data sources, or whether the Accurint data is incorrect. Nevertheless, even if these taxpayers had real estate which could not be detected from IRS data, the population is relatively small at only about 19 percent of the taxpayers shown by the allowable expense proxy to be unable to pay. Accordingly, this analysis indicates that internal IRS data is mostly sufficient to determine whether a taxpayer has other assets, besides income, which could be leveraged by the IRS to obtain payment of the tax liability.

Comparison of 2008 Allowable Expense Proxy to the 2008 Poverty Level

We further examined whether use of the federal poverty level⁵⁶ would prove a simpler method to filter out and protect Social Security recipients from economic hardship due to FPLP levies. Table 8 depicts the federal poverty level for 2008, which was used in the analyses shown below.

Table 8, Poverty Levels For 2008

Poverty Level	2008 Poverty Level Income		
	1 person	2 persons	Additional person (over 1)
100 percent	\$10,400	\$14,000	\$3,600
125 percent	\$13,000	\$17,500	\$4,500
150 percent	\$15,600	\$21,000	\$5,400

⁵² Calculation for 90 percent = 33,117 / 35,955 = 92.1 percent.

⁵³ The LexisNexis Accurint database for IRS was used for this property search. Accurint for IRS is a web-based research tool for public records/asset locator research. Additional databases have been added to the tool for specific IRS needs.

⁵⁴ The sample results were 31.5 percent plus or minus 3.9 percent at the 95 percent confidence interval.

⁵⁵ The sample results were 40.0 percent plus or minus 4.0 percent at the 95 percent confidence interval.

⁵⁶ The federal poverty guidelines are issued each year in the *Federal Register* by the Department of Health and Human Services (HHS).

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The following table compares the differences in results between the allowable expense and poverty level methods.

Table 9, Comparison of 2008 Poverty Level Filter to 2008 Allowable Expense Proxy⁵⁷

	2008 Poverty Level	
	Cannot Pay	Can Pay
Allowable Expense Classification Cannot Pay	49,289	9,841
Allowable Expense Classification Can Pay	75	127,308
Total	48,364	137,149
Percent of Total	26.1%	73.9%

Table 9 shows that nearly 10,000 taxpayers would be classified as able to pay according to a 2008 poverty level filter, even though the 2008 allowable expense proxy shows these same taxpayers as being unable to pay.⁵⁸ This is not surprising given that the 2008 allowable expense standards often provide an expense allowance somewhat above the poverty level.⁵⁹ Even more importantly, Table 9 shows that more than one-quarter of taxpayers who paid their tax liability, had an IA, or who were experiencing an ongoing levy had incomes below the poverty level.

If the filter were 125 percent of the poverty level, then 87 percent of the taxpayers with incomes above the poverty level but showing no ability to pay according to the 2008 allowable expense proxy would then be classified as unable to pay. Table 10 depicts this result.

Table 10, Comparison of 125 Percent of 2008 Poverty Level Filter to 2008 Allowable Expense Proxy⁶⁰

	2008 - 125 Percent of Poverty Level	
	Cannot Pay	Can Pay
Allowable Expense Classification Cannot Pay	56,806	1,324
Allowable Expense Classification Can Pay	10,073	117,310

While moving the filter to 125 percent of the poverty level would also filter out most taxpayers shown as unable to pay according to the 2008 ALE proxy, the number of taxpayers

⁵⁷ For 2008, the poverty level for a household size of one is \$10,400, with an extra allowance of \$3,600 for each additional person in the household. About 83 percent of those identified as 'Cannot Pay' by the Allowable Expense analysis were also identified as 'Cannot Pay' by the Poverty Level analysis. $(48,289 / (48,289 + 9,841)) = 83.1$ percent.

⁵⁸ 84.8 percent of these cases remained subject to an FPLP levy.

⁵⁹ Small Business/Self-Employed Division Collection, *ALE Comparisons Application of Allowable Living Expenses to Various Family Sizes and Expense Categories* (June 25, 2008).

⁶⁰ For 2008, the poverty level for a household size of one is \$10,400, with an extra allowance of \$3,600 for each additional person in the household. More than 97 percent of those identified as "Cannot Pay" by the allowable expense analysis were also identified as 'Cannot Pay' by the 125 percent of poverty level analysis. $(56,806 / (56,806 + 1,324)) = 97.7$ percent.

excluded by the 125 percent poverty level filter, but with an ability to pay according to the 2008 ALE proxy also increases significantly. As indicated by Table 11, moving the filter to 150 percent of the poverty level would protect all taxpayers filtered out by the 2008 ALE proxy from an FPLP levy. However, the number of taxpayers also filtered out, but showing an ability to pay according to the 2008 ALE proxy, increases even more.

Table 11, Comparison of 150 Percent of 2008 Poverty Level Filter to 2008 Allowable Expense Proxy⁶¹

	2008 - 150 Percent of Poverty Level	
	Cannot Pay	Can Pay
Allowable Expense Classification Cannot Pay	58,130	0
Allowable Expense Classification Can Pay	25,045	102,338

Ability to Make More than a Nominal Payment

We further conducted separate analyses to review the taxpayer’s ability to pay based on the minimum IRS installment agreement payment amount and the FPLP levy 15 percent attachment amount. As presented in the following tables, if a taxpayer’s income were required to show an ability to pay at least equal to the IRS minimum IA payment, a similar number of cases would be moved from the “can pay” category to the “cannot pay” category with either the application of the 2006 or 2008 allowable expense standard proxies. Table 12 shows the number of taxpayers who show a minimal ability to pay on their tax liability, but whose incomes exceed their estimated allowable expense by less than the amount necessary for the minimum IA payment.

Table 12, Classified as “Can Pay”: Unable to Make Minimum Installment Agreement

Case Status	Unable to Make Minimum Installment Agreement Payment	
	2006 Standard	2008 Standard
Ongoing FPLP Levy	2,515	2,298
Paid	75	113
IA	103	126

Table 13 depicts taxpayers with some ability to pay on their tax liability, but who cannot afford the 15 percent FPLP attachment to their Social Security Income. This table shows that a significant percentage of taxpayers cannot afford the FPLP attachment amount, even though they have *some* ability to pay.

⁶¹ For 2008, the poverty level for a household size of one is \$10,400, with an extra allowance of \$3,600 for each additional person in the household. One hundred percent of those identified as “Cannot Pay” by the Allowable Expense analysis were also identified as ‘Cannot Pay’ by the 150 percent of poverty level analysis. $(58,130 / (58,130 + 0)) = 100$ percent.

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Table 13, Classified as “Can Pay”: Unable to Afford FPLP Levy

Case Status	Cannot Afford FPLP Attachment			
	2006 Standard	Percent	2008 Standard	Percent
Ongoing FPLP Levy	15,979	12.4%	12,952	12.5%
Paid	534	3.7%	643	5.0%
IA	737	6.0%	745	7.1%
Total	17,250	11.1%	14,340	11.3%

The scenarios for both allowable expense proxies show that comparing the taxpayers’ income and allowable expenses to either the ability to afford the IRS minimum IA amount or the FPLP attachment amount moves a significant number of taxpayers from the “can pay” to the “cannot pay” group. Most of the affected taxpayer delinquencies were in continuous levy status and had not been disposed of by the IRS.

Conclusions

Overall, the TAS model demonstrates sufficient reliability to be considered for use by the IRS.

- An analysis of taxpayer incomes supports the model’s classification results and shows that in many cases where the taxpayer agreed to pay the liability, the taxpayer may have experienced hardship.
- Although about 11 percent of taxpayers classified as “can pay” by the model have incomes exceeding the allowable expenses, further analysis finds that their incomes are still insufficient for them to afford the 15 percent FPLP attachment.
- Over one-third of all FPLP cases subject to an ongoing FPLP levy would likely be classified as unable to pay based on current IRS allowable expense guidelines.
- More than one-quarter of FPLP taxpayers who paid their tax liability, entered into an installment agreement with the IRS, or who were subject to an ongoing FPLP level had incomes at or below the poverty level.
- Most taxpayers with small liabilities endured the FPLP Social Security levy, even though their incomes showed an inability to pay, thus suggesting that they may have forgone some basic living expenses.
- Although the 2008 allowable expense standards are typically more generous than the 2006 standards and classified more taxpayers who paid or established IAs as being unable to pay, most of these taxpayers still had incomes at or below the poverty level.
- An analysis of taxpayer assets located by a third-party data source shows that the IRS has sufficient tax data to determine if many of these taxpayers have assets which may be used to satisfy a tax delinquency.

Recommendation

Conduct a field test of the allowable expense proxy to determine its accuracy in protecting low income Social Security recipients from economic hardship without unfairly filtering out taxpayers who have the wherewithal to satisfy their tax liabilities. During the test, financial information would be collected from taxpayers selected to participate. The results of this analysis could then be compared to results of the simulated financial analysis performed by the filter to determine its accuracy. If the field test verifies the accuracy of the allowable expense model, the IRS should proceed to implement this filter to protect taxpayers from FPLP levies which would cause economic hardship.

Appendix: National Allowable Living Expense Standards

Table A-1, National Standards By Gross Monthly Income⁶²

Total Amount for:	Gross Monthly Income								
	2006								2008
	less than \$833	\$833 to \$1,249	\$1,250 to \$1,666	\$1,667 to \$2,499	\$2,500 to \$3,333	\$3,334 to \$4,166	\$4,167 to \$5,833	\$5,834 and over	All income levels
One Person	\$367	\$409	\$461	\$498	\$556	\$621	\$703	\$916	\$507
Two Persons	\$578	\$595	\$627	\$679	\$744	\$825	\$904	\$1,306	\$961
Three Persons	\$802	\$808	\$812	\$819	\$924	\$937	\$1,017	\$1,368	\$1,151
Four Persons	\$856	\$890	\$936	\$941	\$1,042	\$1,063	\$1,203	\$1,546	\$1,370
More than Four Persons (For each additional person, add to four person total allowance:)	\$138	\$149	\$160	\$171	\$182	\$193	\$204	\$216	\$262

Data Source: IRS Collection Financial Standards, 2006, 2008

Table A-2, 2008 National Standards for Health Care (Monthly)

Age	Out of Pocket Costs
Under 65	\$57
65 and Older	\$144

⁶² The IRS did not break down the 2008 national standards by gross monthly income, hence the table reflects only one standard for each family size.

Appendix: National Allowable Living Expense Standards

Table A-3, 2006 Transportation Standards

Ownership Costs			
		One Car	Two Cars
National		\$471	\$803
Operating Costs & Public Transportation Costs			
	No Car	One Car	Two Cars
Northeast Region	\$238	\$311	\$393
Boston	\$267	\$300	\$382
New York	\$313	\$402	\$484
Philadelphia	\$245	\$304	\$386
Pittsburgh	\$167	\$274	\$357
Midwest Region	\$199	\$275	\$358
Chicago	\$264	\$327	\$410
Cincinnati	\$227	\$260	\$343
Cleveland	\$204	\$280	\$362
Detroit	\$320	\$390	\$473
Kansas City	\$252	\$296	\$379
Milwaukee	\$214	\$254	\$336
Minneapolis-St. Paul	\$284	\$333	\$416
St. Louis	\$207	\$264	\$346
South Region	\$203	\$260	\$343
Atlanta	\$291	\$238	\$320
Baltimore	\$233	\$271	\$353
Dallas-Ft. Worth	\$317	\$348	\$430
Houston	\$287	\$338	\$420
Miami	\$292	\$348	\$431
Tampa	\$264	\$253	\$336
Washington, D.C.	\$299	\$350	\$433
West Region	\$252	\$338	\$420
Anchorage	\$319	\$341	\$423
Denver	\$312	\$338	\$420
Honolulu	\$300	\$328	\$410
Los Angeles	\$284	\$426	\$508
Phoenix	\$275	\$351	\$433
Portland	\$194	\$297	\$379
San Diego	\$322	\$382	\$464
San Francisco	\$325	\$401	\$484
Seattle	\$267	\$329	\$412

Appendix: National Allowable Living Expense Standards

Table A-4, 2008 Transportation Standards

Public Transportation		
National	\$163	
Ownership Costs		
	One Car	Two Cars
National	\$489	\$978
Operating Costs		
	One Car	Two Cars
Northeast Region	\$235	\$470
Boston	\$225	\$450
New York	\$280	\$560
Philadelphia	\$235	\$470
Midwest Region	\$183	\$366
Chicago	\$217	\$434
Cleveland	\$186	\$372
Detroit	\$267	\$534
Minneapolis-St. Paul	\$187	\$374
South Region	\$201	\$402
Atlanta	\$226	\$452
Baltimore	\$217	\$434
Dallas-Ft. Worth	\$228	\$456
Houston	\$263	\$526
Miami	\$275	\$550
Washington, D.C.	\$230	\$460
West Region	\$211	\$422
Los Angeles	\$261	\$522
Phoenix	\$232	\$464
San Diego	\$244	\$488
San Francisco	\$261	\$522
Seattle	\$192	\$384

Appendix: National Allowable Living Expense Standards

The IRS computes housing and utility expense standards on a county by county basis and the tables are therefore too voluminous to display; however, the following tables contain an excerpt from the 2006 and 2008 standards:

Table A-5, 2006 Maine Housing and Utility Standards

Maine Housing & Utilities Standards by County			
County	Family of 2 or less	Family of 3	Family of 4 or more
Androscoggin County	1,021	1,201	1,381
Aroostook County	748	880	1,012
Cumberland County	1,207	1,420	1,633
Franklin County	845	994	1,144
Hancock County	986	1,160	1,334
Kennebec County	944	1,111	1,278
Knox County	963	1,133	1,303
Lincoln County	965	1,135	1,306
Oxford County	871	1,025	1,178
Penobscot County	930	1,095	1,259
Piscataquis County	735	865	995
Sagadahoc County	1,066	1,254	1,443
Somerset County	793	933	1,072
Waldo County	907	1,067	1,227
Washington County	735	865	995
York County	1,142	1,344	1,545

Appendix: National Allowable Living Expense Standards

Table A-6, 2008 Maine Housing and Utility Standards

2008 Maine Housing and Utility Standards by County					
County	Housing and Utilities for a Family of 1	Housing and Utilities for a Family of 2	Housing and Utilities for a Family of 3	Housing and Utilities for a Family of 4	Housing and Utilities for a Family of 5 or more
Androscoggin County	1,090	1,281	1,349	1,505	1,529
Aroostook County	808	949	1,000	1,115	1,133
Cumberland County	1,283	1,507	1,588	1,771	1,800
Franklin County	908	1,067	1,124	1,254	1,274
Hancock County	1,054	1,238	1,305	1,455	1,478
Kennebec County	1,011	1,188	1,251	1,395	1,418
Knox County	1,031	1,211	1,276	1,422	1,445
Lincoln County	1,033	1,213	1,278	1,425	1,448
Oxford County	935	1,098	1,157	1,290	1,311
Penobscot County	997	1,171	1,234	1,375	1,398
Piscataquis County	794	933	983	1,096	1,114
Sagadahoc County	1,138	1,336	1,408	1,570	1,595
Somerset County	854	1,003	1,057	1,178	1,197
Waldo County	972	1,142	1,203	1,341	1,363
Washington County	794	933	983	1,096	1,114
York County	1,205	1,415	1,491	1,662	1,689

National Taxpayer Advocate

2008 Annual Report to Congress

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**THE NEED TO INCREASE
PREPARER RESPONSIBILITY,
VISIBILITY, AND COMPETENCE**

Annual Report to Congress

2008

Annual Report to Congress

The Need to Increase Preparer Responsibility, Visibility, and Competence

*Leslie Book**

Introduction

Time to Change the Dynamics

My previous report submitted in connection with the National Taxpayer Advocate's 2007 Annual Report to Congress concerned the role of practitioners in taxpayer decisions to comply with the tax laws, with a focus on the Earned Income Tax Credit (EITC) and sole proprietor reporting of income.¹ My report described the significant usage of paid preparers and the high incidence of errors among those returns, summarized a significant amount of the research relating to the role of preparers in tax compliance decisions, and offered a preliminary typology identifying the various categories of preparers and how the various types of preparers may prepare erroneous returns.² As the Government Accountability Office (GAO) has reported, inaccuracies on preparers' returns are not necessarily the fault of the preparer.³ Yet, limited quantitative data associates a significant amount of

* I wish to thank the dedicated research assistance of John Brian Hudson, Villanova Law School 2010, and the efforts and insights of the research team at the Taxpayer Advocate Service. All errors and omissions are mine alone.

¹ See generally Leslie Book, *Study of the Role of Preparers in Relation to Taxpayer Compliance with Internal Revenue Laws* [hereinafter Book, *Role of Preparers*] in National Taxpayer Advocate, 2007 Annual Report to Congress vol. 2, 44-74 [hereinafter 2007 NTA Report vol. 2].

² See generally *id.* As in my initial report, this report focuses on ways that preparers can assist in reducing the underreporting portion of the tax gap, particularly with respect to issues not associated with legal ambiguity (like the potential classification of transactions as corporate tax shelters) or significant factual uncertainty (like valuation cases in transfer pricing cases). Those issues implicate different legislative and administrative responses, and, in particular, the ways that government can temper practitioners from improperly exploiting ambiguity. Current research suggests that preparers have tended to exploit ambiguity on behalf of their clients, but this report does not address that. In part, my decision to focus on these unambiguous issues is attributable to a prior lack of emphasis on the preparers' role in issues not involving significant legal or factual ambiguity, despite quantitative evidence showing heavy taxpayer reliance on preparers for issues like the reporting of income attributable to sole proprietors. See Government Accountability Office, *Tax Gap: A Strategy for Reducing the Gap Should Include Options for Addressing Sole Proprietor Noncompliance* (GAO-07-1014, July 2007) [hereinafter GAO, *Tax Gap*] (discussing a broad approach to reducing the underreporting gap among sole proprietors but failing to integrate preparer strategies in that approach).

³ GAO, *Tax Preparers: Oregon's Regulatory Regime May Lead to Improved Federal Tax Return Accuracy and Provides a Possible Model for National Regulation* 7 (GAO-08-781, Aug. 2008) [hereinafter GAO, *Oregon/California Preparer Registration Study*] (noting, for example, that taxpayers providing incorrect information to preparers may trigger errors in such returns).

tax-reporting error to returns that are prepared by paid practitioners.⁴ A growing amount of qualitative research — including some limited use of mystery shopper scenarios — identifies significant preparer misconduct, including misconduct that would potentially trigger the IRS imposing civil or criminal penalties.⁵

In my initial report, I called for additional qualitative research to better understand the dynamics of the taxpayer-practitioner relationship.⁶ I likewise urged the IRS to better capture data as a prerequisite to further efforts relating to preparers’ ability to reduce systemic underreporting with respect to different areas of the tax law.⁷

This report discusses a number of prescriptive actions Congress and the IRS can take to change the posture of preparers with respect to compliance with unambiguous issues like claiming the EITC and reporting sole proprietor income. The common themes of the proposals are increasing the visibility of preparer and taxpayer conduct, and emphasizing the responsibility and accountability of preparers to the tax system, as well as to their clients. Because the relationship between the practitioner and the taxpayer is dynamic, some of the proposals look to the taxpayer and others to the preparer. As part of any meaningful strategy to reduce the tax gap, the IRS must more actively strive to understand the preparer community. As part of a preparer strategy, it must demonstrate engagement with issues

⁴ The GAO has determined that a statistically significant difference in error rates exists between those returns prepared by the taxpayers themselves and those prepared by paid practitioners. GAO, *Paid Tax Return Preparers: In a Limited Study, Chain Preparers Made Serious Errors* 29 (GAO-06-563T, Apr. 4, 2006) [hereinafter GAO, *Limited Study*]. The following is a table of comparative error rates among Form 1040 filings by paid practitioners and by the taxpayers themselves, based on 2001 National Research Program (NRP) data.

Type of Return	Estimate (percent)
Prepared by a paid preparer	56%
Prepared by the taxpayer	47%
All returns	52%

Id. My initial report also quantified the limited data relating to relative error rates among types of return preparers. Book, *Role of Preparers*, *supra* note 1, at 68. That the IRS should readily capture data tying taxpayer error to preparer usage is an important first step in any systematic approach to focusing on the role of preparers in taxpayer compliance decisions. My suggestion that the IRS monitor preparers, and require a uniform preparer identification number, may help facilitate this. See *infra*, section III.A.

The following is a table of error rates among specific line items in Form 1040, relating to 2001.

Form 1040 Line Item	Self-prepared returns (percent)	Returns done by paid preparer (percent)
Deductions	23%	31%
Foreign tax credit	16%	6%
Earned Income Credit	45%	53%
Refund	43%	57%

GAO, *Limited Study*, *supra* at 29.

⁵ See generally *id.*; Treasury Inspector General for Tax Administration (TIGTA), *Most Tax Returns Prepared by a Limited Sample of Unenrolled Preparers Contained Significant Errors* (2008-40-171, Sept. 3, 2008) [hereinafter TIGTA, *Limited Sample*]; see also Chi Chi Wu et al., *Tax Preparers Take a Bite out of Refunds: Mystery Shopper Test Exposes Refund Anticipation Loan Abuses in Durham and Philadelphia* (Apr. 2008) (finding a wide range of preparer errors and abuses despite the fact that quality of return preparation was not the focus of study).

⁶ Book, *Role of Preparers*, *supra* note 1, at 51. See also Robert Kidder & Craig McEwen, *Taxpaying Behavior in Social Context: A Tentative Typology of Tax Compliance and Noncompliance*, in *2 Taxpayer Compliance* 47 (Jeffrey Roth et al. eds., 1989) (postulating that preparers can broker and facilitate both compliance and noncompliance).

⁷ Book, *Role of Preparers*, *supra* note 1, at 74.

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that are systemic compliance problems through identifying preparers, communicating with preparers, and educating preparers and taxpayers,⁸ all as part of a broad-based effort to achieve acceptable compliance levels.⁹ In this report, I offer several steps that tie into my themes of responsibility, visibility, and competence. The steps include reforming due diligence rules by anchoring obligations to data reflective of systemic noncompliance, requiring the use of a common preparer identification number to facilitate the creation of a reliable database that will enhance the IRS's ability to tie specific preparers to returns that are likely erroneous, and registering and testing preparers to ensure a minimum competence level and inject a more uniform sense of professionalism into the industry. In addition, to emphasize accountability, visibility, and responsibility for taxpayers as well as preparers, Congress and the IRS should require more robust taxpayer self-reporting for items connected to systemic noncompliance. Examples of this include separately scheduling out items of gross receipts on Schedule C (such as credit card versus cash receipts) so taxpayers and practitioners bring areas of noncompliance to the surface.

While the increased expectations with respect to preparers should not fundamentally change the role they play in the tax system, it does assume that preparers have an affirmative obligation to enhance the tax system's integrity, especially in areas associated with unacceptable error rates and high preparer usage. Efforts to increase visibility and accountability can contribute to preparers taking responsibility for returns they submit, educating new entrants into the tax system, (or new entrants with respect to specific issues where data suggests areas of high noncompliance, as when there are new Schedule C filers visiting a preparer) and make bad actors fear IRS exposure and possible sanction through enhanced monitoring and data-tracking.

Others have written about the importance of education to tax compliance, with the need to tie in as part of any serious effort to increase compliance with a more robust effort at educating taxpayers.¹⁰ The IRS can leverage the educational role that preparers can (and do) play in the system, through communicating with preparers — in person or in writing — who have a threshold of new Schedule C returns, for example, or other relatively new entrants to the tax system. With respect to targeting preparers who have prepared returns suggestive of high rates of noncompliance,¹¹ or some other benchmark significantly higher

⁸ Marjorie Kornhauser, *Tax Compliance and the Education of John (and Jane) Q. Taxpayer*, *Tax Notes*, Nov. 10, 2008, 737, 740 [hereinafter Kornhauser, *Compliance and Education*] (discussing how any serious attempt at tax compliance must seek to educate taxpayers to increase tax morale, including linking taxes to the positive benefits of government to strengthen people's attitudes to the government). See also, Marjorie Kornhauser, *Normative and Cognitive Aspects of Tax Compliance: Literature Review and Recommendations for the IRS Regarding Individual Taxpayers*, in 2007 NTA Report Vol. 2, *supra* note 1, at 138-71.

⁹ I take no direct position in this paper as to what an acceptable compliance rate is. Recent tax gap data, however, shows significant systemic areas of non-compliance associated with certain issues or taxpayers, including that associated with EITC claimants and sole proprietors. See Book, *Role of Preparers*, *supra* note 1, at 65-68.

¹⁰ See generally, Kornhauser, *Compliance and Education*, *supra* note 8.

¹¹ For example, the Discriminant Function (DIF) scores—a metric of the likelihood of gaining additional tax payments in the case of an audit—for 1040-SS and 1040-PR (Self-Employment Tax Returns) are significantly lower than the DIF scores for Schedule C and F filings where the EITC is present and gross receipts are less than \$25,000, regardless of the type of preparer. (Unpublished IRS data on Average DIF Scores by Activity Code and Preparer Classification for Tax Year 2006 (2008)).

than industry or preparer averages, like information on client return Discriminant Function (DIF) scores that are outside the norm, math error activity on client returns, or examination results that are suggestive of higher adjustments than an appropriate benchmark, IRS efforts to communicate with preparers can demonstrate that preparer actions are visible, and allow the IRS to position itself as a service provider and educator to both the preparer and the taxpayer. The agency use of information to influence compliance through a tiered approach reflective of educating and progressing toward a more sanction-based approach to preparers is not my idea alone, but the need to tie in this approach to the IRS's more systematic capturing of preparer data is not a part of the IRS's implemented strategy.¹² In the near background, the IRS must have the tools to remind the potential bad actors that sanctions are always a possibility for egregious misconduct.

My proposals recognize that while enforcement at the back-end requires significant agency resources, an emphasis on front-end compliance efforts—like identifying preparers and testing competence, and communicating both in person and in writing—does not necessarily put the agency in the typical command-and-control regulatory posture, with the resource-intensive demands of preparer audits and the continued use of civil injunction powers to shut down bad preparers. First steps can be tied to educating, serving and informing preparers of best practices, so long as the IRS is willing to continue monitoring and to impose more intrusive sanctions on bad actors. The old audit-first approach cannot work, given agency resource issues and the backlash that would likely accompany a meaningful increase in IRS audits of preparers and small business taxpayers.¹³ This approach, which borrows from the insights of scholars and regulators who have adopted a responsive regulation framework, is further discussed below in Section V.

The Current Landscape

A common theme among those skeptical of additional government regulation of preparers is that adding new measures directed at preparers makes little sense given the limited information about the role that preparers play (namely whether errors are tied to poor scruples, or incompetence, or whether the errors are more properly attributable to some characteristic of the taxpayer), and the lack of meaningful or sustained governmental effort within the existing regulatory framework.¹⁴ Despite the need for additional information and the admittedly inadequate attention given to preparers, the importance of preparers to tax compliance and the need for at a minimum a more robust understanding of the preparer community seems compelling. Consider the following:

¹² See Michael Albert, Kim Bloomquist & Ron Edgerton, *Evaluating Preparation Accuracy of Tax Practitioners: A Bootstrap Approach*, 2007 IRS Research Conference 77, 89 (2007) (“[W]e believe that a substantial reduction in the number of AUR [a noncompliance metric] discrepancies could be achieved by annually monitoring tax practitioners using data-driven techniques ... in combination with a program of outreach and education to the selected preparers”).

¹³ This point is especially germane in times of economic difficulty, as materially increasing compliance efforts directed at small businesses, at times when small businesses are facing significant short-term economic pressures, would likely generate intense political pressure on the IRS.

¹⁴ See H&R Block, *H&R Block Voices Concerns with Proposed Rules That Would Limit Solicitation of Refund Anticipation Loans*, Tax Notes, May 1, 2008, Lexis, 2008 TNT 85-21 [hereinafter *Block Comments*] at nn.100-03 and surrounding text; Christine C. Bauman & Katrina L. Mantzke, *An Education and Enforcement Approach to Dealing with Unscrupulous Tax Preparers*, 2 Am. Tax'n Ass'n J. Legal Tax Res. (June 11, 2004).

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- The use of paid preparers has been increasing significantly over the past several years;¹⁵
- The IRS does not know how many paid preparers there are;¹⁶
- Preparers often overlook current rules about preparer identification and due diligence (despite how limited they are), and the IRS often overlooks these violations;¹⁷
- The IRS does not meaningfully capture data to allow for monitoring or tracking preparer performance;
- Limited quantitative data suggest high error rates associated with returns that paid practitioners prepare and file on behalf of taxpayers;¹⁸
- In most of the country there is no requirement that preparers demonstrate any level of competence before they can begin to prepare tax returns, nor are there meaningful continuing education requirements despite the constant legislative changes to the tax law and a general sense that preparers' lack of understanding of some areas of the tax law contributes to both underreporting and missed opportunities for taxpayers;¹⁹
- Many preparers are engaged in return preparation as an ancillary business to the selling of other products or services, with (i) the increased profit potential from these ancillary sales raising questions about preparer incentives and motivation to professionalize their tax return preparation functions; and (ii) consumer demand for these products in close proximity to the return preparation process providing potential fuel for improper taxpayer or preparer conduct;²⁰
- Among issues not characterized by legal ambiguity, preparers may limit personal responsibility by hiding behind a “don't ask, don't tell” approach to facts that may be germane to computing a correct tax return, which makes it difficult—if not impossible—for the government to assign responsibility for errors;²¹

¹⁵ In 1996, approximately 63 million (53 percent) of individual income tax returns were prepared by paid practitioners. By 2005, that number had risen to over 80 million (62 percent). IRS, SOI Taxpayer Usage Study 1998 & 2006.

¹⁶ “The IRS acknowledges that it does not know how many paid preparers exist and cannot determine the full extent of noncompliance and incompetence among practitioners.” TIGTA, *Most Returns Prepared by a Limited Sample of Unenrolled Preparers Contained Significant Errors* 2-3 (Ref. No. 2008-40-171, Sept. 3, 2008) [hereinafter TIGTA, *Unenrolled Preparers*]. Cf. GAO, *Limited Study*, *supra* note 4, at 5 (noting that not all paid preparers provide preparer information on returns they prepare).

¹⁷ See TIGTA, *Unenrolled Preparers*, *supra* note 5, at 5 (noting 61 percent of returns prepared in mystery shopper study were prepared incorrectly); cf. *Regulation of Federal Tax Return Preparers, Hearing Before the S. Comm. on Finance*, 109th Cong. 6 (July 20, 2005) (written statement of Nina E. Olson, National Taxpayer Advocate) [hereinafter *Olson Hearing Testimony*], available at http://www.irs.gov/pub/irs-utl/testimony_wm_oversight_returnpreparers.pdf.

¹⁸ GAO, *Limited Study*, *supra* note 4, at 23, 25, 28-29 (laying out tables comparing error rates between returns prepared by paid practitioners and returns prepared by taxpayers).

¹⁹ “Most paid preparers are not subject to any education, testing, or registration requirements. Two states, California and Oregon, are exceptions in that... they have had their own requirements that apply to paid preparers working in their states.” GAO, *Oregon/California Preparer Registration Study*, *supra* note 3, at 1. Maryland has also recently imposed a registration requirement for return preparers, See below, at Part IV.

²⁰ National Taxpayer Advocate, 2007 Annual Report to Congress, 83, 86 [hereinafter 2007 NTA Report].

²¹ Susan Cleary Morse, Stewart Karlinsky & Joseph Bankman, *Cash Businesses and Tax Evasion*, Stan. L. & Pol'y Rev. (forthcoming 2009) (manuscript at 24-25) (discussing practices of “don't ask, don't tell” preparers); Susan Cleary Morse, *Using Salience and Influence to Narrow the Tax Gap*, 39 Loy. U. Chi. L.J. (forthcoming 2009) (manuscript at n.76 and applicable text) (discussing interviews that suggest at least some practitioners fall into a “don't ask, don't tell” norm).

- When Congress and the IRS have changed the rules of the “don’t ask, don’t tell” approach, the changes have been insufficient and there has been a demonstrated lack of sustained governmental interest in enforcing the limited rules or making these changes visible to both taxpayers and the IRS itself;²²
- The limited qualitative research suggests that preparers make errors characterized by both incompetence and lack of meaningful diligence;²³
- Noncompliance among preparers and taxpayers may become habitual, which suggests that IRS monitoring and educating new taxpayers or preparers is important as a means of stemming years of possible problems;²⁴ and
- The possible concentration of incompetent or unscrupulous preparers and noncompliant taxpayers suggests that if the IRS meaningfully captures preparer data and correlates preparers with possible benchmarks of taxpayer noncompliance, and (DIF scores, industry averages, etc.), the IRS can efficiently touch significant levels of noncompliance.²⁵

Emphasizing Responsibility

The Types of Taxpayers and Preparers—General Classification

Given the above, in this section I discuss specific proposals that build on the information that we know, and I highlight areas where immediate attention is required. As context for these proposals, I return to the challenges associated with identifying types of preparers and types of taxpayers. Mapping taxpayers and preparers is essential to assist the IRS and Congress in understanding the causes of noncompliance. The underlying reasons for errors will likely assist in formulating administrative or legislative solutions, and serves as an important backdrop to this and my prior report.

Many studies have been done about taxpayer compliance and the reasons behind decisions not to comply. Some economic deterrence models have studied the interaction between the taxpayer and the government as more of a “strategic game – where each party makes the best response to the other’s strategy in light of available information – rather than a static gamble.”²⁶ Although more advanced than the models that considered decisions between

²² Olson Hearing Testimony, *supra* note 17, at 6-7.

²³ TIGTA, *Unenrolled Preparers*, *supra* note 5, at 5 (noting that some mistakes and omissions were the results of mistakes or misinterpretation of the tax law); GAO, *Limited Study*, *supra* note 4, at 17-25 (identifying sources of filing mistakes in mystery shopper scenario).

²⁴ See Kidder & McEwen, *supra* note 6.

²⁵ Albert et al., *supra* note 12 (looking at data within one state, and finding that a small number of preparers were likely responsible for a significant amount of errors in the Automated Underreporter Program, and also concluding that a program of monitoring and educating tax preparers may substantially reduce noncompliance); Stuart Karlinsky & Joseph Bankman, *Developing a Theory of Cash Business Tax Evasion Behavior and the Role of their Tax Preparers*, in 5th International Conference on Tax Administration 164 (2002).

²⁶ Sagit Leviner, *A New Era of Tax Enforcement: From ‘Big Stick’ to Responsive Regulation* 18 (Univ. Mich. Law Sch. Pub. Law & Legal Theory Working Paper Series, Paper No. 68, 2006).

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taxpayers and the administration to be independent of each other, this still fails to consider the role tax practitioners play in the mix.

In my initial study, I discussed research that examined the relationship between preparers and taxpayers, and how that relationship contributes to compliance decisions:

Some studies support the view that practitioners view taxpayers as instigators of aggressive advice, but also recognize that the search for a single model to explain the complex dynamics of practitioner/taxpayer interaction is likely to be futile. Sakurai and Braithwaite, for example, classify practitioners into three distinct types: 1) honest and risk averse, 2) cautious minimizers of tax, and 3) the creative and aggressive planner. Sakurai and Braithwaite concluded that the latter is the least popular in terms of taxpayer preference, but that this aggressive practitioner type is of particular concern. They suggested that taxpayers are inclined to seek out preparers who share their values. This insight is consistent with Karlinsky and Bankman's study of sole proprietor noncompliance, where sole proprietors intent on minimizing income sought preparers they knew who would be comfortable with their approach. It is also consistent with Albert, Bloomquist, and Edgerton's study of underreporting, which suggests that a relatively small number of practitioners are responsible for a disproportionate share of underreporting of certain types of income. Likewise, Kidder and McEwen, adapting a sociological approach, postulated that there are different types of practitioners, those that broker or facilitate compliant behavior, and those that facilitate noncompliant behavior.²⁷

As my prior research suggests, there is a general understanding that taxpayers present themselves to practitioners in one of three ways:

1. They are intent on understating their liabilities or overclaiming refunds (Type 1 taxpayers);
2. They are indifferent about understating their liabilities or overclaiming their refunds (Type 2 taxpayers)—these taxpayers will likely defer to the practitioner's advice; or
3. They seek assistance in preparing their returns correctly (Type 3 taxpayers).²⁸

Preparers, on the other hand, drawing on the Sakurai and Braithwaite, Bankman and Karlinsky model (and supported in part by my focus group research) generally fall into one of three categories:

1. They are intent on helping clients understate their liabilities or overclaim refunds (Type 1 preparers);

²⁷ Book, *Role of Preparers*, *supra* note 1, at 59-60. See also Albert et al., *supra* note 12; Yuka Sakurai, and Valerie Braithwaite, *Taxpayer's Perceptions of the Ideal Tax Adviser: Playing Safe or Saving Dollars?* (Centre for Tax System Integrity, Working Paper No. 5, 2001), available at <http://ctsi.anu.edu.au/publications/WP/5.pdf>; Karlinsky & Bankman, *supra* note 25; Kidder & McEwen, *supra* note 6.

²⁸ See Book, *Role of Preparers*, *supra* note 1, at 61.

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2. They are indifferent about whether their clients comply with their tax reporting or refund claiming (Type 2 preparers); or
3. They are intent on ensuring that clients properly report their liabilities or claim their refunds (Type 3 preparers).²⁹

In my first report, I emphasized that the IRS would learn a great deal about possible solutions to the tax gap by exploring the relationship between taxpayers and preparers, focusing on the way that certain types of preparers interact with taxpayers who present different characteristics. Others have likewise emphasized that given the important role that preparers play, researchers and tax administrators should pay more attention to actual interactions between taxpayers and practitioners.³⁰ I will return to this classification scheme in Part III B when considering the ways the IRS can use mystery shopper scenarios to help gauge preparer motivations and reasons behind potentially erroneous returns.

This desire to appreciate the dynamic relationship should animate future research that the IRS conducts into the preparer's role in the decision to comply or not to comply with the tax law. Despite the current lack of information, there are specific steps that Congress and the IRS can take that build on what we know about the relationship between preparers and taxpayers. These steps will likely contribute to fewer errors associated with preparer-generated individual income tax returns.

It is Time to Tie Preparer Due Diligence to Areas of Systemic Noncompliance.

Current Due Diligence Rules Are Not Adequately Designed to Ensure that Preparers Emphasize their Responsibility to the Integrity of the Tax System.

As I and others have stated,³¹ relying on due diligence rules to either temper practitioners' willingness to become type 1 or type 2 preparers, or check the appetites of type 1 taxpayers, is limited by the difficulty of attributing knowledge — for example, knowledge of a sole proprietor's unreported income — to the preparer.³² Current rules provide that preparers may not ignore the implications of what they know and must make reasonable inquiries if

²⁹ See *id.* at 59 (citing Sakurai & Braithwaite, *supra* note 27, at iv). Sakurai and Braithwaite characterize preparers as “honest and risk averse,” “cautious minimizers of tax,” and “creative and aggressive planner[s].” Sakurai & Braithwaite, *supra* note 27, at iv.

³⁰ Margaret Mc Kerchar, *Why Do Taxpayers Comply? Past Lessons and Future Directions in Developing a Model of Compliance Behaviour*, in *Tax Administration in the 21st Century* 225, 241 (Michael Walpole & Chris Evand eds., 2001) (emphasizing the importance of identifying various typologies of noncompliance and urging that additional studies be made relating to actual taxpayer and preparer behavior). Professor Tan, for example, notes that several areas are in need of research, including: (1) to what extent practitioners are willing to give in to client demands and to what extent clients are willing to adopt practitioners' advice; (2) whether the client or the practitioner has greater influence over tax decisions; (3) what (if any) effect the length of the working relationship between client and preparer has on tax decision making; (4) what factors steer the working relationship between client and preparer; (5) whether practitioner advice is affected by firm size; (6) whether practitioners are “client driven”; and (7) how the practitioner balances the requirements of the tax law, their clients' interest, their professional responsibilities, and the demands of the organization they work in. Lin Mei Tan, *Research on the Role of Tax Practitioners in Taxpayer Compliance: Identifying Some of the Gaps*, in *Taxation Issues in the Twenty-First Century* (ed. Sawyer) (2006).

³¹ See Book, *Role of Preparers*, *supra* note 1, at 69-70 (laying out typology showing how different levels of preparer awareness of tax law and client motives affects compliance); Morse et al., *supra* note 21, at 23-24 (discussing how particular practitioners' compliance decisions are driven by amount of knowledge they have).

³² Morse et al., *supra* note 21, at 18.

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information appears to be incorrect.³³ Yet, there is no sense of additional preparer obligations with respect to issues that are characterized by systemic noncompliance. Moreover, standards meant to inform preparers concerning when they are supposed to make further inquiry are tied to generally vague and adaptable common-law negligence standards, providing less than clear guidance and likely inconsistent application of the existing standards.³⁴

One approach that I and others have emphasized as a general matter is that the IRS needs to move away from a one-size-fits-all approach to noncompliance.³⁵ If research suggests high areas of noncompliance associated with specific types of issues, our tax system should more affirmatively impose upon preparers an obligation to ask questions that relate to ferreting out facts that will at a minimum (i) place the responsibility for taxpayer actions squarely on the taxpayer's shoulders and (ii) discourage preparers from becoming facilitators of noncompliance by limiting their ability to hide behind clients and avoid any existing affirmative obligations by choosing not to ask relevant questions.

Consider the touchy subject of inquiring about a taxpayer's lifestyle if the preparer knows that the lifestyle is inconsistent with the information the taxpayer gives to the preparer.³⁶ It is difficult to calibrate preparer responsibilities because return preparers wishing to attract and retain clients properly do not view themselves as having to cross-examine them on subjects that have a potential to alienate them or bring into question the preparer's loyalty to those clients. Interviews with preparers who have ties to the cash economy illustrate

³³ See Morse et al., *supra* note 21, at 19-25. Penalties against noncompliant preparers are structured in a way to penalize more heavily those preparers who are more active in the filing of noncompliant returns. Those preparers who understate a taxpayer's liability due to an unrealistic position are fined either \$1,000 or 50 percent of the income derived, whichever is greater. Preparers who understate a taxpayer's liability through willful or reckless conduct are fined \$5,000 or 50 percent of the income derived, whichever is greater. Failure to exercise due diligence in determining EITC eligibility brings a \$100 fine per failure. See I.R.C. §§ 6694(a)-(b), 6695(g) (2006).

³⁴ A recent article considered the lawyer's ability to rely on a taxpayer's recitation of facts. See Jasper Cummings, *When Can a Tax Attorney Rely on Taxpayer's Representation of Facts*, Fed. Taxes Wkly. Alert, Aug. 21, 2008 (noting that preparers may generally rely on a taxpayer's representation of facts, subject to reason). Cummings notes, for example, that Treasury Circular 230 warns against "false statements," which have been interpreted as including "failure to ask an obvious question in a commonplace situation" and that "the absence of a fact or the untrustworthiness of the client may require the lawyer to go farther." Yet, Cummings notes that while there are myriad factors which may put the lawyer on notice that more inquiry is needed, the standard is tied to the reasonable standards associated with common law negligence, "with all of its nuance and adaptability." Cummings points to examples where the IRS has held that preparers had an obligation to ask additional questions of their clients, relating to (i) a client who claimed that he used his car in his work and the preparer failed to ask whether that involved nondeductible commuting, or (ii) a preparer who failed to inquire about the purpose of trips that a client claimed to be business-related. *Id.* (referring to Scenario of Disciplinary Action, 1997-13 IRB 32).

³⁵ See, e.g., Leslie Book, *Preventing the Hybrid from Backfiring: Delivery of Benefits to the Working Poor Through the Tax System*, 2006 Wis. L. Rev. 1103, 1146-49 (2006) [hereinafter Book, *Hybrid*] (proposing more stringent set of due diligence requirements for paid preparers); Alex Raskolnikov, *Beyond Deterrence: Targeting Tax Enforcement with a Penalty Default* 19-20 (Columbia Law & Econ. Working Paper No. 337, 2008). Cf. GAO, *Tax Gap*, *supra* note 2, at 26 ("Treasury's tax gap strategy does not discuss specific options to address the tax gap overall or sole proprietor income in particular").

³⁶ My focus group participants, for example, were asked the following:

Assume a potential new client comes to you and is interested in retaining you. You have seen this client around town, and know that he has recently spent hundreds of thousands of dollars on a major home renovation, that his kids go to the same private school as your children, and that he belongs to the poshest country club in town. Prior to the meeting, to be more productive, you ask to review the prior year's income tax returns. On the returns you review, you notice that the income claimed on the return seems low based upon the lifestyle that you have observed. What, if anything, should you do in terms of due diligence (i) prior to agreeing to be this individual's return preparer, or (ii) as part of your services in preparing his tax return if he only provides information that is consistent with the prior year's reported income?

See Leslie Book, *Focus Group: 2007 IRS Nationwide Tax Forum* (focus group data on file with author) [hereinafter Book, *Focus Group*].

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that some preparers engage in actively signaling to the taxpayer their lack of interest in knowing harmful facts.³⁷ My focus group research suggested that while some preparers indicated they would make inquiries to tie the taxpayer's circumstances to the information on the return, and turn away business if they were uncomfortable with an inconsistency with the taxpayer's general economic circumstances and the tax return information, that was by no means the norm. There was significant disagreement about what kinds of questions preparers should ask as part of the return preparation process and the preparers' role in asking questions, given that there may be legitimate reasons for the discrepancies (*e.g.*, inheritances and prior receipt of reported taxable income). This discomfort was exacerbated especially if there was only general awareness highlighting inconsistencies between the taxpayer's lifestyle and the information the taxpayer presented in the return.³⁸

In addition, with the exception of the EITC, there is little connection between what preparers are required to ask taxpayers and the research that has identified systemic areas of high noncompliance. The current tax compliance regime does not tie due diligence to the underlying issues, but rather to the preparer's underlying knowledge of individual circumstances that would trigger a duty of further inquiry under general negligence principles. I believe it is time to tie preparer inquiry levels into research about systemic noncompliance problems within the tax system. This research should inform a preparer's specific due diligence obligations, at least to some degree, and facilitate specific guidance from the IRS as to what is important and perhaps what preparers should be required to ask. While Congress has legislated specific due diligence rules for the EITC, even when Congress or the IRS has instituted something beyond the normal posture that highlights the preparers' role in the system (and implicitly connects the due diligence obligation to systemic areas of noncompliance), the requirements do not emphasize the preparer's role in preventing errors nor do they require the preparer to ask sufficient questions to isolate responsibility for potential errors.

Some researchers have begun to identify the inadequacy of the current due diligence regime. As Morse indicates, Internal Revenue Code (IRC) § 6694 (even before the recent legislative change essentially restoring preparer standards to those of taxpayers for undisclosed return positions) and Circular 230 do not change preparer obligations to inquire into taxpayer circumstances,³⁹ and generally allow preparers to rely on taxpayer-provided information without any inquiry into its accuracy.⁴⁰ While the preparers cannot turn a blind

³⁷ See Morse et al., *supra* note 21, at 24-25 (discussing the "don't ask, don't tell" approach some paid practitioners use).

³⁸ See Book, *Focus Group*, *supra* note 36.

³⁹ Morse et al., *supra* note 21, at 24-25. See also Book, *Focus Group*, *supra* note 36. In focus group research I conducted for the IRS, I asked preparers about the due diligence they would engage in or the inquiry they would conduct with a client who reported income inconsistent with their lifestyle. See *id.* There was wide disagreement about the appropriate role that preparers should play when they have general information which is inconsistent with information on a tax return. A significant number of preparers cautioned against jumping to conclusions based on lifestyle, given the possibility that many people had sources of funds that were not inconsistent with the information presented to return preparers (*e.g.*, gifts, prior inheritances). *Id.*

⁴⁰ See *id.* Note that Congress has specifically legislated substantiation requirements with respect to some individual itemized deductions susceptible to abuse, thus triggering levels of inquiry and preparer due diligence to the substantive entitlement to the deduction. See, *e.g.*, I.R.C. § 274(d) (2006) (requiring strict substantiation for all travel expenses).

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eye to the implications of information given to them, or information actually known by the preparers, there is little in terms of practical advice given to preparers about the need to inquire further in light of information on general lifestyle, for example, or in the face of facts relating to tax issues reflective of systemic taxpayer underreporting of income.⁴¹

Prior congressional and administrative action directed at EITC claimants heightened due diligence requirements and attempted to address these general concerns. However, as the National Taxpayer Advocate has previously identified, the IRS's implementation of the rules has been inadequate, and there is ample opportunity for legislative changes to make the provisions more meaningful.⁴² For example, implementing a tiered penalty structure, as well as requiring the preparer to sign under penalties of perjury and submit the due diligence attestation to both the IRS and the claimants, would increase the visibility and significance of the preparer action.⁴³ The IRS, apparently accepting the possibility that its due diligence rules in this area may play a more meaningful role, is investigating the possibility of refining the EITC due diligence requirements to require practitioners to ask claimants questions that correlate to higher error rates and perhaps identify documentary sources of evidence that, for example, tie qualifying children to the residence of the taxpayer.⁴⁴

Changes to this effect would be significant and could likely influence taxpayer and practitioner conduct at minimal cost. Consider the residency requirement under the EITC rules, in which the taxpayer and the child must live together for more than six months.⁴⁵ The specific statutory EITC due diligence requirements for preparers have not pushed preparers to gather information that would flag likely errors relating to the residency requirement. Despite the fact that failing to meet the residency requirement is one of the largest sources of EITC errors,⁴⁶ in Form 8867, the EITC due diligence checklist, question 11 is the only question that addresses the residence of children. It reads as follows:

“Did the child live with the taxpayer in the United States for over half of the year?”⁴⁷

⁴¹ Morse et al., for example, discuss three different spending strategies cash business owners use to keep from reporting cash revenues as income: “spend it,” “hoard it,” and “invest it in the business.” Often, these actions are an attempt to hide the income from the accountant or the tax preparer. Some practitioners seek out correct information in order to foster compliance with the tax law, while others employ a “don’t ask, don’t tell” approach. See Morse et al., *supra* note 21, at 19-25. See generally Cummings, *supra* note 34. Widespread disagreement among my focus group participants, who were mostly enrolled preparers, reflects at a minimum the need to address what expectations the IRS should place on preparers in this context. See Book, *Focus Group*, *supra* note 36.

⁴² Olson Hearing Testimony, *supra* note 17, at 6-8.

⁴³ Book, *Hybrid*, *supra* note 35, at 1146-49 (suggesting more stringent due diligence requirements on paid preparers); Olson Hearing Testimony, *supra* note 17, at 7 (proposing tiered penalty structure for violations of EITC due diligence requirements).

⁴⁴ Nicole Duarte, *Tighter Knowledge, Documentation Requirements Expected for EITC Claims*, Tax Notes, Sept. 9, 2008, Lexis, 2008 TNT 176-4.

⁴⁵ A qualifying child is a child “who has the same principal place of abode as the taxpayer for more than one-half of such taxable year.” I.R.C. § 152(c)(1)(B) (2006). Though a limited EITC is available for low wage workers between the ages of 25-64 who do not live with children, the presence of a qualifying child is a meaningful variable affecting both eligibility and amount of the EITC. I.R.C. § 32(c)(1).

⁴⁶ It is unclear, however, whether EITC errors are the result of actual failure to meet the residency requirement or an inability to provide adequate records to satisfy the requirement. Regardless, the size of the problem warrants more of the preparer’s attention. Janet Holtzblatt & Janet McCubbin, *Whose Child is it Anyway? Simplifying the Definition of a Child*, 61 Nat’l Tax J. 701, 712.

⁴⁷ IRS Form 8867.

This question is inadequate on a number of levels. While it does tie into connecting the child to living in the United States, that is a separate requirement apart from the residency requirement tying the taxpayer to living with the child,⁴⁸ and it diverts attention from the main issue at hand. Given the importance of residence to program error, the applicable form could specifically require the preparer to list the address (or addresses) of the children that the taxpayer has claimed throughout the year, with a specific notation in the form highlighting that this is an issue resulting in significant taxpayer error. It could additionally ask if the preparer has viewed documentary evidence that lists the child or children's address as an address that is consistent with information that the preparer has or knows about the taxpayer's address. This will likely result in some additional time to complete the return, and it could potentially increase the preparation cost. However, listing addresses and tying those addresses to time periods should take no more than five minutes for most claimants and would further highlight the issue's importance for both preparers and taxpayers.

When it comes to other relatively unambiguous issues, like sole proprietor compliance, the tax system defaults to a “don't ask, don't tell” possibility, meaning that preparers can largely hide behind a veil of ignorance, avoid responsibility for any errors on returns that they prepare, and direct responsibility for misconduct to the taxpayers themselves.⁴⁹ To avoid that default, Congress could consider expanding specific due diligence rules to other areas of systemic noncompliance, and the IRS should provide meaningful questions in tailored due diligence worksheets tied to a select few specific issues characteristic of both high preparer usage and high error rates. For example, for sole proprietors, a due diligence worksheet could specifically address questions regarding the different components of gross receipts, with the goal of ensuring that preparers ask sufficient questions so they can no longer safely hide behind the “don't ask, don't tell” wall that Morse identifies.⁵⁰

In sum, the current rules emphasize that preparers have duties of further inquiry only in relation to specific information about a particular taxpayer. If, for example, the preparer has reason to believe the information is false, the preparer must ask further questions. I propose that Congress and the IRS heighten the preparer's responsibilities in response to research that suggests there is systemic noncompliance with specific issues. Their doing so will reflect a more nimble approach to tax compliance, allow for tailored responsibilities

⁴⁸ See I.R.C. § 32(c)(1)(D) (2006).

⁴⁹ Morse et al., *supra* note 21, at 24-25.

⁵⁰ See Morse et al., *supra* note 21, at 38 (putting additional disclosure obligations on preparers and sole proprietors themselves; for example, requiring sole proprietors and preparers to sign a statement that all reported income includes “all revenue, cash and otherwise, and that deductions are accurately reported”). See also *The Cash Economy*, in National Taxpayer Advocate 2007 Annual Report, *supra* note 20, at 35-65, at 40 (proposing amending Schedule C to enable IRS to more easily match income reported on Schedule C with income reported on Form 1099). Note that recent legislation heightens the possibility that the IRS and preparers can monitor sole proprietors who appear to be reporting low levels of cash receipts. Section 6050W provides new information reporting rules for third parties making reimbursements in settlement of reportable payment card transactions. Under the new provision, banks and other entities obligated to reimburse merchants using electronic payment card mechanisms will need to provide information returns to the IRS as well as the merchants. See I.R.C. § 6050W, Emergency Economic Stabilization Act of 2008, P.L. 110-343 (2008). This will allow a relatively easy determination of the percentage of gross receipts that reflect these reportable payments. See *The Cash Economy*, *supra*, at 40.

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that tie to specific systemic issues, and increase taxpayer and practitioner visibility and responsibility for presenting correct factual information on tax returns.

The IRS Needs to Change the Norm of Ignoring the Due Diligence Rules.

In addition to the due diligence rules failing to meaningfully connect the preparer's overall role in ensuring the integrity of our tax system, current research shows those preparers often ignore the existing due diligence rules.⁵¹ The IRS must undertake a meaningful education and outreach program to clearly identify what its expectations are of preparers, to ensure that an increased use of due diligence is not met by a collective sigh or just the shuffling of additional pieces of paper.

Consider the EITC due diligence requirements.⁵² The recent TIGTA mystery shopper scenario highlights the inconsistency and lack of compliance with respect to the information gathering process, even when there are fairly specific requirements associated with generating facts from clients.⁵³ In that study, while preparing the tax returns, many of the preparers did solicit probing questions prior to and in the midst of the preparation process. To establish eligibility determinations in cases when the preparers did not ask probing questions, the preparers usually took one of two avenues: formulating assumptions or relying on tax return preparation software. The preparers utilized numerous methodologies to obtain information from the mystery shoppers. In just over half of the visits (16 of 28) the tax return preparers had the TIGTA auditors complete an information worksheet. This information worksheet is used to collect data such as information regarding children that can be claimed as dependents or data concerning various sources of income. Of the preparers that had the auditors complete an information worksheet, only five of 16 properly completed the tax returns. The preparers in the remaining 11 visits merely asked for identification cards. With respect to the EITC, there was consistent noncompliance with the due diligence requirements. Although the seven EITC-return preparers did complete the required *Paid Preparer's Earned Income Credit Checklist*,⁵⁴ none of them asked all of the probing questions on the form.

This ignoring of responsibilities likely occurs because there is no requirement for the preparer to sign the appropriate due diligence checklist and submit that checklist to either the IRS or the taxpayer,⁵⁵ and the IRS has not meaningfully backstopped its requirements with enforcement.⁵⁶ While the mystery shopper scenario described above is limited, my

⁵¹ The National Taxpayer Advocate has noted the inadequacies of IRS efforts in collecting on penalties that have been assessed. In calendar years 2001 and 2002, the IRS assessed \$2.4 million in preparer penalties, but collected only \$291,000 (12 percent) of those assessed penalties. National Taxpayer Advocate, 2003 Annual Report to Congress 270.

⁵² IRC § 6695(g) (2006) (imposing \$100 fine for each failure to meet EITC due diligence requirements).

⁵³ See generally TIGTA, *Unenrolled Preparers*, *supra* note 5.

⁵⁴ IRS Form 8867.

⁵⁵ EITC preparers must complete an EITC checklist (Form 8867 or equivalent form), and complete the EITC worksheets in Forms 1040, 1040A, or 1040 EZ. The preparers must also not have any knowledge of any of the information being incorrect, and must retain this information for three years after the filing date. Reg. § 1.6695-2; Olson Hearing Testimony, *supra* note 17, at 6 nn.14-15; Book, *Hybrid*, *supra* note 35, at 1146.

⁵⁶ "[T]he IRS is virtually a nonexistent presence in the unenrolled preparer community." Olson Hearing Testimony, *supra* note 17, at 6.

sense is that it is reflective of many unenrolled preparers, and that there is a norm of non-compliance with the current due-diligence regime. If I am right, this suggests that the IRS will have significant (though not insurmountable) obstacles in getting preparers to comply with whatever additional requirements Congress and the IRS impose. Getting the IRS to ensure compliance with specific requirements imposed on preparers has as a prerequisite the agency's ability to track and monitor preparers, so that the agency can properly educate preparers about their specific responsibilities and also meaningfully backstop education with enforcement in the face of continued noncompliance. The importance of tracking and monitoring preparers is addressed in Section III.A.

The Next Steps with Due Diligence.

The premise behind the heightened approach to due diligence that I suggest derives from the principle that additional preparer obligations into inquiring about client facts should follow from IRS data that suggest there is systemic noncompliance with respect to a particular area or issue. The EITC rules reflect a nascent but ineffective effort in that direction.

The government expects that preparers have a responsibility to the integrity of the tax system overall, in addition to serving their clients. The IRS and Congress should use the research which suggests that there is a significant usage of preparers in areas like the EITC and the reporting of sole proprietor income. This seems especially helpful for areas where there is relative legal clarity, and where taxpayers (or preparers) should not have varying risk tolerance or a strong appetite for challenging uncertain legal positions. After all, there is no uncertainty about the need to report gross income, and the presence of qualifying children does not generally involve issues subject to legal ambiguity.⁵⁷ It does not implicate, for example, the situation under IRC § 6694 (prior to its 2008 amendment that repealed a heightened level of disclosure for undisclosed positions), when the fear was that preparers and taxpayers had varying standards of certainty to avoid penalties.⁵⁸ When it comes to reporting gross income, or whether children lived with the claimant, there is not much in the way of legal wiggle room that potentially puts preparers and taxpayers at odds, and differing views of likelihood of success or risk tolerance should not create uncomfortable conflicts between the preparer and the taxpayer.

While a heightened due diligence regime might make some preparers uncomfortable, that discomfort should serve as a reminder that there are three parties at the table—the preparer, the taxpayer, and the IRS—and might serve to create or tip noncompliance norms that have settled in areas where taxpayers are used to misstating information to

⁵⁷ Cf. *Rowe v. Commissioner*, 128 T.C. No. 3 (2007). In a deeply divided Tax Court opinion, the Court held that a taxpayer's incarceration should be treated as a "temporary" absence from the home and thus allowed her to satisfy the six-month residency requirement rule for purposes of treating the child as a qualifying child. While Rowe does illustrate that legal ambiguity does exist in these areas, that is not the norm, nor does it typify the relationship between preparer and taxpayer in this context. In contrast, with respect to many other areas of the tax law, there is a significant interaction between preparers and taxpayers revolving around acceptable reporting positions in light of the possibility of IRS challenge, for example, to the amount or existence of a deduction or loss.

⁵⁸ Richard Lipton, *What Hath Congress Wrought? Amended Section 6694 Will Cause Problems for Everyone*, 107 J. Tax'n 68, 69-71 (2007). See P.L. 110-343, retroactively eliminated toughened standards and replaced it with an eased standard for returns prepared after May 25, 2007.

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their preparers.⁵⁹ To the extent there are conflicts between preparers and taxpayers, they should revolve around different views regarding the need to comply with the tax law. This proposal emphasizes the preparers' obligation to inquire about relevant facts, and inform taxpayers about why those facts are relevant to complying with the laws, areas that should not legitimately heighten or create preparer tensions with clients.

To be sure, any additional obligations the government imposes upon preparers create the possibility that taxpayers inclined to overstate credits or underreport income will turn away from preparers, and self-prepare returns, relying on increasingly user-friendly software to enable or facilitate the misreporting, especially with respect to Schedule C income. This is admittedly a possibility, but, at a minimum, enhanced due diligence will limit the finger pointing and reduce the difficult problems of proof that the government faces when the taxpayer blames the preparer, and the preparer in turn blames the taxpayer for not telling the truth or for giving incomplete facts. In addition, if the IRS is tracking preparers (as I suggest below in section III.A), the IRS should be able to monitor trends and focus its compliance efforts on those who fail to use reputable return preparers with lower risk of noncompliance.

Visibility: Tracking and Communicating

Tracking and Monitoring Preparer Performance

As my initial report described, exactly what effect paid preparers have on tax compliance is not entirely clear.⁶⁰ Despite the increasing use of preparers and an increased general sense that more research is needed to examine the role that preparers play,⁶¹ both TIGTA and GAO have recently noted that the IRS is limited by the lack of information it captures about preparers, and the limited means of monitoring practitioner performance. The lack of identifying information about preparers is a significant handicap that limits the ability of researchers and policymakers to fully evaluate the types of problems different kinds of preparers are creating, and hampers meaningful consideration of a number of important prescriptive policy proposals.

According to TIGTA, “although paid preparers file the majority of income tax returns, the IRS has limited information on them and insufficient means by which to track or monitor them.”⁶² Likewise, GAO states that:

IRS does little to monitor or track information about individual paid preparers. For example, IRS does not collect information on the type of preparers, such as whether the preparer is an enrolled agent or part of a commercial chain, or the number or types of

⁵⁹ See Leandra Lederman, *The Interplay Between Norms and Enforcement in Tax Compliance*, 64 Ohio St. L.J. 1453, 1503-13 (2004).

⁶⁰ See Book, *Role of Preparers*, *supra* note 1, at 74; 2007 NTA Report, *supra* note 20, at 95.

⁶¹ See Eric Toder, *What is the Tax Gap?*, Tax Notes, October 23, 2007, Lexis, 2007 TNT 130-22 (“[A] key variable of interest would be relative compliance rates among taxpayers who prepare returns by hand, prepare returns with software, and use paid preparers.”).

⁶² TIGTA, *Unenrolled Preparers*, *supra* note 5, at 12.

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returns filed by preparers. Having such information could allow IRS to better identify filing errors and target its outreach to specific preparers or preparer groups.⁶³

TIGTA similarly notes that, in the current environment, preparer identification is a hodgepodge:

Preparers identify themselves on income tax returns they prepare by entering their Social Security number, Employer Identification Number, or Practitioner Tax Identification Number. A Practitioner Tax Identification Number is used by a preparer who does not want to disclose his or her Social Security number on tax returns he or she prepares. It is a nine-character alpha/numeric with the first character being “P” followed by eight numbers. An Employer Identification Number is a unique nine-digit number used to identify a taxpayer’s business account on IRS records.⁶⁴

Given the above, it is not surprising that the IRS has a difficult time in the current environment getting even a general read on the role that preparers play in taxpayer compliance decisions:

The IRS does not have one list or database that collects information on preparers. For example, it does not have a list or database that shows the preparer’s name, associated identifying numbers, or whether the preparer is a practitioner or unenrolled preparer and/or an Electronic Return Originator. Preparers could be self-employed and use their personal Employer Identification Number or employed and preparing tax returns as part of a tax preparation company. In the latter instance, the preparer could use the Employer Identification Number associated with the tax preparation company and his or her personal Social Security number or Practitioner Tax Identification Number.⁶⁵

In addition to these limitations, many practitioners fail to sign returns they prepare. While a preparer failing to sign a return can trigger a civil penalty, it does not trigger meaningful or systemic IRS enforcement; nor does it result in the IRS not processing these unsigned returns. As the GAO indicated, the IRS overlooks this because processing tax returns is a priority even if preparer information is not provided or is inaccurate.⁶⁶

⁶³ GAO, *Tax Administration: 2007 Filing Season Continues Trend of Improvement, but Opportunities to Reduce Costs and Increase Tax Compliance Should Be Evaluated* 18, (GAO-08-38, Nov. 2007) [hereinafter GAO, *2007 Filing Season*]. The IRS is slowly awakening to the importance of tracking data relating to preparers. *Id.*

⁶⁴ TIGTA, *Unenrolled Preparers*, *supra* note 5, at 12.

⁶⁵ *Id.* at 12-13 (internal footnotes omitted). While the IRS does maintain a database of enrolled agents, the database is of limited use because enrolled agents are allowed to use a Practitioner Tax Identification Number, Social Security number, or Centralized Authorization File number. With multiple identifying numbers in the database, the IRS has not been able to determine this population with reasonable certainty. *Id.* at 13-14.

⁶⁶ For example, limited tests showed that more than 9,000 preparers used their Employer Identification Numbers as Social Security numbers to prepare more than 500,000 tax returns filed in calendar year 2008, thus creating additional challenges. TIGTA, *Limited Sample*, at 12-14. These variables make it difficult not only to identify the number of preparers but also to identify all the tax returns they prepared. GAO, *Fiscal Year 2009 Budget Request and Interim Performance Results of IRS’s 2008 Filing Season* 5 (GAO-08-567, Mar. 2008) [hereinafter GAO, *FY2009 Budget*].

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In light of the above, TIGTA has recommended that the IRS develop and require a single identification number that would facilitate controlling and monitoring paid preparers.⁶⁷ GAO has also recommended that the IRS require preparers to use a single identification number to provide the IRS with the means to track preparer performance.⁶⁸ The IRS has indicated that it is studying the issue.⁶⁹ I strongly support such a proposal, which would specifically require preparers to use a single preparer identification number, and I believe it will enable the IRS to educate and enforce in a much more systematic manner as well as make preparers more transparent players in the tax compliance decision.⁷⁰

Keeping Preparers Visible

Research strongly suggests that the presence of information returns has a significant effect on tax compliance. In fact, recent tax gap data show that compliance among items disclosed to the IRS, even if not backstopped by withholding, leads to close to 95 percent compliance.⁷¹ The importance of injecting additional visibility into the areas of systemic noncompliance has recently received significant attention, especially with respect to the possibility of increasing information reporting to service recipients and increasing the obligations with respect to reporting the basis in transactions involving the sale of securities.

At present, preparers are largely invisible from the process, with no systematic means available for the IRS to track preparer-generated returns.⁷² Research has suggested that part of the reason why information reporting is successful for taxpayers is that taxpayers overestimate the possibility that the IRS will detect noncompliance when information is reported to the IRS.⁷³ Precisely the opposite scenario exists for preparers, who operate largely on the basis that their actions are immune and invisible.

⁶⁷ TIGTA, *Unenrolled Preparers*, *supra* note 5, at 14.

⁶⁸ GAO, *FY 2009 Budget*, *supra* note 66, at 6.

⁶⁹ TIGTA, *Unenrolled Preparers*, *supra* note 5, at 15.

⁷⁰ One possibility is that IRS could create a preparer database that allows the IRS to capture compliance related information on each preparer, including, for example, the total number of clients and dollars a preparer has in the cash economy, and information on client return DIF scores that are outside the norm, math error activity on client returns, and examination results. Where a preparer is a member of a firm, that relationship presents the possibility of two different perspectives, one at the preparer level, and the other at the firm level, provided both the preparer and the firm can both be uniquely identified.

⁷¹ Leandra Lederman, *Reducing Information Gaps to Reduce the Tax Gap 6* (2008) (unpublished manuscript, on file with author). See IRS News Release 2006-28, *IRS Updates Tax Gap Estimates* (Feb. 14, 2006) (accompanying charts).

⁷² For instance, working with researchers from TAS, I attempted to determine a breakdown of compliance estimates by types of preparers, considering the number of returns prepared by these preparers. In this report, a significant portion of practitioners were labeled “Unclassifiable.” These unclassifiable preparers constitute just shy of 45 percent of all paid preparers, and prepare over 13 percent of practitioner-prepared returns. (Unpublished IRS data on *Compliance Analysis by Activity Code and Preparer Classification for Tax Year 2006* (2008)). TIGTA has also noted that the IRS does not have one list or database where information on paid preparers can be compiled. TIGTA, *Unenrolled Preparers*, *supra* note 5, at 12.

⁷³ Lederman, *supra* note 71, at 6-7.

Unlike taxpayers, preparers—especially those not governed by Treasury Circular 230—exist in a regime largely outside IRS visibility.⁷⁴ As I suggest below, a necessary condition to any increased reliance on preparers to positively influence taxpayer compliance decisions is changing that equation, and letting preparers know that the IRS is aware of their actions. For example, IRS outreach to preparers should be systematic and reflective of information that relates to the returns those preparers generate. With the increased usage of e-filing, and the possibility that even the IRS can scan or use bar-code data to enter information from paper-filed returns,⁷⁵ the IRS should connect trends in those returns or potential disparities that expand IRS knowledge. As a contrast, tax preparation software can tell taxpayers average amounts of charitable contributions, which can fuel taxpayer compliance decisions, but the IRS too could connect data from specific preparer-generated returns that are different from the norm or suggestive of errors. If, for example, one preparer's EITC returns reflect a significantly higher median refund or a particularly high percentage of Schedule C income rather than wage income, the IRS could contact those preparers quickly with letters alerting them that the IRS has noticed information that differs from the norm. There may be legitimate reasons for that difference. Now, this would only be helpful in the long run if the IRS connected these data to the possibility of audit if the data continue to suggest discrepancies, but it could also provide the possibility for preparer self-correction, without the immediate, heavy-handed, command-and-control approach typically associated with tax compliance. Ultimately, the IRS can ratchet up the pressure if preparers seem to ignore the IRS-generated information.

The prospect of data-driven increased visibility of preparer conduct is discussed further below in Section V concerning responsive regulation, when I consider the theoretical context of a more multi-faceted approach to interacting with preparers. While to some, it may smack of Big Brother, with the IRS capturing data and quickly touching preparers in a “soft” way if the data reflect variations from the norm – like a high percentage of expenses to profits on preparer-generated Schedule C returns, or a low percentage of cash receipts to credit card receipts on a modified Schedule C that would impose additional visibility requirements⁷⁶ – this could also tie in to the increased due diligence requirements (discussed above in section IIB) and allow the IRS to provide useful information to preparers to help them assist taxpayers with complying.

⁷⁴ For example, in my focus group research, a number of practitioners specifically mentioned the IRS's lack of effort to focus on improper preparer conduct as a reason for the continued presence improper return preparer conduct. See Book, *Focus Group*, *supra*, note 36. The National Taxpayer Advocate has noted on several occasions the serious need to understand the role that preparers play in taxpayer compliance decisions and the causes of preparer errors. See, e.g., National Taxpayer Advocate Fiscal Year 2009 Objectives Report to Congress 50-51; National Taxpayer Advocate Fiscal Year 2008 Objectives Report to Congress 57.

⁷⁵ See GAO, *2007 Filing Season*, *supra* note 63, at 3 (“Although IRS has done some research on bar coding and full transcription, it does not know the actions needed to require commercial software vendors to include bar codes on printed returns...”); see also Joab Jackson, *IRS Tests 2-D Bar Codes for Scanning E-Forms*, *Gov't Computer News*, May 3, 2004.

⁷⁶ See 2007 NTA Report, *supra* note 20, at 40 (recommending that a revised Schedule C form be issued to “break out income not reported on information returns”). See also I.R.C. § 6050W (2006).

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The Importance of Targeting New Preparers

The IRS, with the legislative registration and certification initiative facilitating the contact discussed below at Part IV, must affirmatively and promptly reach out to practitioners as they enter the tax profession. Habits start early, and research and intuition suggest that both practitioners and taxpayers themselves can become habitually noncompliant.⁷⁷ This early communication will accomplish a number of important objectives. It will let the practitioners know that the IRS is there as a resource to help practitioners understand the law so that they can apply the proper rules to their clients' situations. It will also help set compliance expectations, and allow the IRS to target information to specific types of returns that the preparer is preparing, and perhaps leverage the role that preparers can (and do) play in educating taxpayers about their rights and responsibilities.

Some recent information suggests that the IRS is striving to identify and target preparers who are new. Promising signs include the government reaching out in writing to first-time EITC preparers, including providing a list of common errors, preparer due diligence requirements and where preparers can turn if they need help.⁷⁸ This targeting acknowledges the significant differences that comprise the tax gap, and ties in to the need to foster acceptable practices at an early stage.

The IRS can take similar steps with new practitioners who prepare returns for sole proprietors, particularly those sole proprietors who have recently started their businesses. Erich Kirchler theorized that sole proprietor noncompliance is largely the result of a perceived loss of freedom in paying taxes.⁷⁹ Entrepreneurs who have taken on the risk of creating their own businesses, by their very nature are likely more independent, and are thus more likely to perceive taxes as an unjustified taking of their hard-earned income.⁸⁰ According to Kirchler, this perceived loss of freedom drives a reactance motive among sole proprietors to evade their taxes.⁸¹

Kirchler's research suggests that this resistance is related in part to the length of time that the proprietor has been in business.⁸² Over time, the entrepreneur's expectations include an awareness of the tax system and the individual's obligations within that system, and they are more likely to take taxes into account in their business operation.⁸³ Newer entrepreneurs also seem to lack the skills, knowledge, and experience with taxes that allow them

⁷⁷ Kidder & McEwen, *supra* note 6.

⁷⁸ *EITC: Due Diligence is More Than a Check Mark on a Form or Clicking Through Tax Preparation Software*, IRS Pub. 4687 (Revised June 2008) (explaining due diligence requirements for paid practitioners); Leslie Book, *Draft Form* (unpublished work, on file with author).

⁷⁹ See Erich Kirchler, *The Economic Psychology of Tax Behaviour* 156 (Cambridge Univ. Press) (2007).

⁸⁰ *Id.*

⁸¹ *Id.* at 157.

⁸² *Id.* ("Length of running a business determines perceived restriction of one's freedom and reactance motives and intention to evade taxes.").

⁸³ See *id.* at 157-58 ("Over time, adaption to the tax system as well as a separation of gross income from net income and taxes into separate accounts are likely to occur." (internal citations omitted)).

to comply even if they do not share or act upon the perceived lack of freedom.⁸⁴ As the business becomes better established, the entrepreneur is less likely to perceive taxes as a loss of their income and freedom and more likely to become more familiar with procedural requirements (including substantiation and recordkeeping), which increases tax compliance among these sole proprietors.⁸⁵

One implication of Kirchler's research is that return preparers, with IRS help, can educate sole proprietors as to the importance of tax compliance and the means to do so.⁸⁶ A sole proprietor may have limited understanding of what his obligations are, and may think (rightly or wrongly) that others in his business are not complying with their tax obligations. To the extent that there is a continued pattern of underreporting in an industry or community, the preparer has an uphill struggle to convince or influence the taxpayer to adopt more positive behavior. This is still a useful avenue for IRS involvement, though, especially if there is a broad-based approach to reducing the systemic noncompliance through other measures.

Persuasive Communication

Effective communication between the IRS and the practitioner is essential to encouraging preparer compliance in areas of systemic noncompliance. While there have been several studies focusing on the effect that persuasive communications have on encouraging tax compliance, two more recent studies—one conducted in Minnesota,⁸⁷ the other in the

⁸⁴ See Erich Kirchler, *The Economic Psychology of Tax Behaviour* 166 (Cambridge Univ. Press) (2007).

⁸⁵ *Id.*

⁸⁶ *Cf. id.* at 189 ("It is important to take into account that the perception of taxpayers and the resulting style of interaction determine the relationship between tax authorities and taxpayers.").

⁸⁷ In the Minnesota study, the Minnesota Department of Revenue decided to look into the impact that "moral persuasion communications" had on compliance. In this experiment, two groups of randomly selected taxpayers each received a certain treatment letter: one group receiving letters appealing to the taxpayer's conscience, and the other group receiving letters discrediting the notion that there is widespread noncompliance. The set of letters appealing to the taxpayer's conscience ("conscience letters") included a reminder that "when taxpayers do not pay what they owe, the entire community suffers." The compliant majority letters sought to drive home the notion that "if one wanted to belong to the majority community of citizens one should comply with the tax laws." The researchers then compared reported income and taxes paid for the recipients of the letters from tax years 1993 and 1994. While income reported and taxes paid by those who received the letter did increase after the letters were sent out, the increases were statistically insignificant when compared to a control group. This led the researchers to conclude that neither of the two approaches affected aggregate compliance, though they did add a caveat that similar appeals delivered in a different way, more frequently, or communications of a different sort might have an effect on compliance. See generally Marsha Blumenthal et al., *Do Normative Appeals Affect Tax Compliance? Evidence from a Controlled Experiment in Minnesota*, 54 Nat'l Tax J. 125 (2001).

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United Kingdom⁸⁸—provide insight into how the IRS can tailor its communications with paid preparers to most effectively encourage their compliance.

These two studies provide some insight into how targeted appeals to taxpayers may affect tax compliance generally. An interesting idea that can be gleaned from these studies, particularly the United Kingdom study, is that compliance may be affected by something as simple as how the tax agency presents itself to the taxpayers. From the United Kingdom study, the letters that showed a greater involvement in the tax collection process, and a greater awareness of the goings-on in return preparation were met with a more substantial response by the taxpayers. As the agency presented itself as more in tune with the facts—or at least more willing to learn the facts—the more compliant the people that were contacted became. In response to the letters where the agency presented itself as a more passive body, simply waiting for the taxpayer to solicit its help, there was no change in taxpayer behavior. As the letters grew “tougher,” and presented a greater involvement and a greater understanding of the collection process, the taxpayers responded by becoming more and more compliant—or at least more cautious in their reporting.

While both of these studies focused on the effect of persuasive communication on the taxpayer, they do provide some insight to how a future study that focuses on preparers can be conducted. It would be interesting to see how similar letters would affect preparer action. If, for instance, the IRS were to send letters to paid preparers, the IRS would be able to track how preparers respond to offers of assistance, appeals to conscience, notification of areas of systemic noncompliance, and threats of guaranteed audits.

This type of study would provide insight into the source of noncompliance. Consider the following: Will the sanction-based letters drive Type 2 preparers to become Type 3 preparers? Can the letters influence Type 1 preparers to change their ways? Insight into these

⁸⁸ In this study, the Inland Revenue (The United Kingdom’s IRS equivalent) sent out five different letters to five different sets of sole proprietors, the contents of which ranged from simply offering assistance in filing an accurate return to notification of a preselected audit. The five letters were characterized as:

1. Enabling—offering advice and support in filing an accurate return;
2. Citizenship—containing both an element of the “conscience” and “compliant majority” letters from the Minnesota study;
3. Increased audit—notifying the taxpayer that there will be an increased number of audits of sole proprietor returns in the upcoming year;
4. Audit/penalties—notifying the taxpayer of an increase in the number of audits in the upcoming year while including a statement on penalties saying, “If we find that a return is incorrect, we may charge financial penalties as well as collect any unpaid tax”; and
5. Preselected audit—notifying the taxpayer of an increase in the number of audits in the upcoming year, and stating that the recipient has been preselected for an audit.

In the United Kingdom, sole proprietors who have annual turnover (sales) of less than £15,000 may file a simplified tax form, while those with annual turnover above £15,000 have much more stringent reporting requirements. This threshold plays a key role in proprietor compliance, as the increased compliance costs may provide an incentive to underreport turnover so they may file the simplified form. The researchers discovered that all of the groups had a higher proportion of sole proprietors claiming turnover above £15,000 than a control group, with the exception of those who had received the most benign letters. This, along with similar results for reported net income, led them to conclude that sanction-based letters could be an effective tool in increasing compliance among those sole proprietors who self-prepare their returns, though effectiveness over the long term would require a significant amount of resources to follow up with increased and targeted audits. Similar results and conclusions were reached among those who used paid preparers, though unlike those who self-prepare, letters that emphasized “being a good citizen” seemed to result in a notable increase in reported net profits.

See generally John Hasseldine et al., *Persuasive Communications: Tax Compliance Enforcement Strategies for Sole Proprietors*, 24 *Contemporary Accounting Research* 171 (2007).

questions will serve to illustrate where the IRS should focus its research and enforcement resources.

To be sure, this information, however, would only get the IRS so far. This information would have to be analyzed in conjunction with qualitative research (for example, through mystery shopper scenarios discussed below) that considers the dynamic relationship between the preparer and the taxpayer. It is unclear to what degree honest and diligent preparers who are intent on reporting their clients' tax information correctly (Type 3 preparers) can influence taxpayer compliance decisions when those taxpayers are intent on underreporting. If the taxpayers are responsive to practitioner efforts at compliance, then this could animate the need to focus our efforts to encourage preparers to change. If the taxpayer is not responsive to practitioners pushing them towards compliance, then that will open up an avenue for further inquiry and research.

Refining the Understanding of the Relationship Between Preparers and Taxpayers

In my initial report, I suggested that the IRS should further study the interaction between preparers and taxpayers, with an eye toward examining the effect (i) that preparers can have on taxpayers' compliance decisions, and (ii) that different types of taxpayers reflecting different factual circumstances or motivations can have on preparer conduct.⁸⁹ Along these same lines, I emphasized that the IRS would learn a great deal about possible solutions to the tax gap by exploring the relationship between taxpayers and preparers, specifically focusing on the way that certain types of preparers interact with taxpayers who present different characteristics. Some qualitative and quantitative research appears to suggest that Type 1 taxpayers seem to seek out Type 1 preparers.⁹⁰ Others have likewise emphasized that given the important role that preparers play, researchers and tax administrations should pay more attention to actual interactions between taxpayers and practitioners.⁹¹

⁸⁹ Book, *Role of Preparers*, *supra* note 1, at 51.

⁹⁰ As mentioned above, taxpayers likely present themselves to preparers in one of three ways:

1. They are intent on understating their liabilities or overclaiming refunds (Type 1 taxpayers);
2. They are indifferent about understating their liabilities or overclaiming their refunds (Type 2 taxpayers)—these taxpayers will likely defer to the practitioner's advice; or
3. They seek assistance in preparing their returns correctly (Type 3 taxpayers).

And the preparers likely act in one of three different ways:

1. They are intent on helping clients understate their liabilities or overclaim refunds (Type 1 preparers);
2. They are indifferent about whether their client complies with their tax reporting or refund claims (Type 2 preparers); or
3. They are intent on ensuring that clients properly report their liabilities or claim their refunds (Type 3 preparers).

See Karlinsky & Bankman, *supra* note 25; Albert et al., *supra* note 12. For the typology of preparer and taxpayer types, see *supra* notes 28-29 and applicable text.

⁹¹ Margaret Mc Kerchar, *Why Do Taxpayers Comply? Past Lessons and Future Directions in Developing a Model of Compliance Behaviour*, in *Tax Administration in the 21st Century* 225, 241 (Michael Walpole & Chris Evans eds., 2001) (emphasizing the importance of identifying various typologies of noncompliance and urging that additional studies be made relating to actual taxpayer and preparer behavior).

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Recent mystery shopper scenarios conducted by both TIGTA⁹² and GAO⁹³ suggest that errors in the EITC and reporting sole proprietor income associated with preparers reflect both willful and negligent conduct.⁹⁴ In my prior report, and in prior research, I have argued that delving deeper into the underlying reasons of why a particular practitioner prepares an erroneous tax return is a helpful tool for policymakers wishing to understand what (if any) administrative or legislative efforts can assist in reducing the error rate among those returns. To that end, I suggest the following nonexclusive reasons for errors among preparer generated returns with respect to the reporting of sole proprietor income and the EITC:

1. Ignorance or misunderstanding of the law – poor training, inadequate attention to changes in the law, or complexity of the law;
2. Misunderstanding or failure to understand or learn the facts – due to language or cultural barriers – can also be related to ignorance or understanding of the law, as the practitioner may not know what information is relevant;
3. Inability or unwillingness to detect false or incorrect information, though the inability or unwillingness or inability is not reflective of failing to exercise due diligence;
4. Facilitate noncompliance by not exercising appropriate due diligence to verify facts or information;
5. Aid and abet in noncompliance by advising taxpayers how to misstate or omit income, or claim inappropriate or excessive deductions or credits;
6. Facilitate continued noncompliance by advising taxpayers how to arrange affairs to minimize chances of detection, including advising taxpayers on practices or positions that are likely to otherwise generate IRS attention; and
7. Directed noncompliance – working in an environment where there is a culture of noncompliance, either through insufficient quality control or active and affirmative exhortations to take affirmative steps which are meant to minimize liabilities or maximize refunds.⁹⁵

I believe this typology to be of use in areas reflective of systemic noncompliance, especially when the errors do not relate to legally ambiguous items—an area prior research has identified as being likely to generate a high degree of preparer-facilitated ambiguity exploiting.⁹⁶ As I indicate in this and my prior report, the high error rates among paid preparer returns

⁹² See generally TIGTA, *Unenrolled Preparers*, *supra* note 5.

⁹³ See generally GAO, *Limited Study*, *supra* note 4.

⁹⁴ For example, a recent TIGTA study examined 28 tax returns prepared by unlicensed and unenrolled preparers at 12 commercial chain and 16 small, independently owned, tax return preparation offices. TIGTA found that “of the 17 tax returns prepared incorrectly, 11 (65 percent) contained mistakes and omissions we considered to have been caused by human error and/or misinterpretation of the tax laws. However, six (35 percent) of the 17 returns contained misstatements and omissions we considered to have been willful or reckless.” TIGTA, *Unenrolled Preparers*, *supra* note 5.

⁹⁵ Book, *Role of Preparers*, *supra* note 1, at 69-70.

⁹⁶ *Id.* at 63.

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for issues like the EITC suggest, at a minimum, the need for a deeper inquiry into the relationship between preparers and the incorrect filing, and the possibility that preparers can steer taxpayers toward compliance,⁹⁷ rather than the taxpayer choosing other more willing preparers or continuing to file erroneously without the use of a preparer.

The mystery shopper methodology is one tool that the IRS should explore expanding and improving to generate information that will provide additional insights into the reasons for the high incidence of errors on preparer-generated returns.⁹⁸ As I mentioned above, recent mystery shopper scenarios suggest that there are both willful errors and other errors based on incompetence. I believe that the IRS should, in a robust manner, inquire into this relationship to explore more deeply the reasons behind the willful or incompetent conduct. The recent mystery shopper tests conducted by TIGTA and GAO provide a framework for the research, but the tests are geographically limited and fail to sufficiently isolate differences among preparer and taxpayer characteristics, making it difficult to take away more than just an anecdotal feel for the problems associated with the returns, and limiting the prescriptive value of the tests.⁹⁹

To make the mystery shopper approach more useful and informative, research that uses the mystery shopper methodology should have the following characteristics:

- Future tests should work backwards from the noncompliance hypothesis that the IRS wishes to consider to specific attributes that may contribute to noncompliance;
- The test design should consider more rigorously the population of preparers that the IRS wishes to assess, with a close consideration of the hypothesis and specific attributes aiding in the selection of the target preparers;
- Future tests should limit the number of different auditors conducting the test to minimize the likelihood that tester differences account for preparer variations;
- Future tests should allow for the actual filing of a tax return to better correlate testing with actual experiences; and
- The tester should have a worksheet following the interaction to allow the tester to identify the likely reasons for the preparer's conduct, with the worksheet (i) mirroring the reasons that may contribute to noncompliance (and allowing for other explana-

⁹⁷ It is possible that, irrespective of efforts to improve the competence or scruples of preparers, taxpayers intent on underreporting income or overclaiming credits will seek out other accommodating preparers or choose to prepare their own incorrect returns. This is discussed above in connection with reforming preparer due diligence requirements. See *supra* section II. To the extent the IRS will be better able to capture data relating to preparers, it is possible that education or audit selection criteria will reflect these possible shifts to other preparers, and allow a more targeted government response directed at those preparers and their clients. To the extent that there is an increase in noncompliance among self-prepared returns, this could likewise drive IRS education efforts and compliance resources. Thus, even if there is not a direct effect on changing taxpayer behavior, these changes should allow the IRS to better target its efforts.

⁹⁸ Other qualitative means to generate information include case studies, personal experience, focus groups, interviews, and participant observation. Kidder and McEwen have actually suggested that researchers spend time as assistants to practitioners or take temporary jobs at a national chain in order to better observe and better understand the role of practitioners. Kidder & McEwen, *supra* note 6, at 69.

⁹⁹ The author is grateful for the advice of Jack Pund, Managing Director of JLP & Associates LLC, whose expertise in fraud investigations and forensic accounting provided valuable insights for this paper.

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tions to provide additional possible insight) and (ii) providing an opportunity for the tester to gauge the relative strength of a reason or reasons to allow for the possibility that multiple explanations animate preparer conduct.

An Illustration

For example, consider that the research sought to explore what circumstances suggest preparer incompetence as a reason for the presence of errors on tax returns claiming the EITC. To start, the research should target the strata of preparers that one wishes to assess. If the focus is on considering the differences between the various preparers, research could reflect the wide universe of the preparers who engage in EITC preparation (including enrolled versus unenrolled preparers), or closely target differences within a subset of preparers, such as franchise versus company-owned national-chain preparers. This selection will depend, in part, on what information the research is trying to generate. For example, it would be interesting and informative to test whether there may be a differing emphasis that corporate-owned stores place on training and quality control as compared with franchise-run outlets. A properly designed mystery shopper scenario can illustrate differences in competence between the two types of national chain offices. It might also consider other variables, including, for example, the length of time a respective franchise store has been in business. The researcher should create a script that injects a degree of legal complexity into the scenario, to allow for the tester to consider varying levels of expertise. For example, as the residency requirement and filing status are two important areas contributing to errors, a scenario should closely mirror legal issues implicated in those issues.¹⁰⁰

Crucially, in light of possible errors that the tester detects in the return that a preparer is generating, the tester should be prepared to ask uniform follow-up questions reflective of a desire to understand why the preparer has offered incorrect return-preparation advice, to allow a greater likelihood for the research to yield tangible and measurable results. For example, some evidence suggests that preparers facilitate taxpayer errors on the EITC out of sympathy for taxpayer circumstances, and a taxpayer who presents information that is close to eligibility might generate a preparer response that elicits that sympathy (e.g., a taxpayer who lives with a child for less than six months but who has demonstrated attachment to that child). Alternatively, the preparer may generate an incorrect return in this circumstance because he feels that the erroneous position is likely not to be detected, and even if it were, would likely not produce any tangible negative consequences for the preparer. Faced with those circumstances, a preparer may generate an incorrect return without even discussing the scenario with the taxpayer. Without appropriate follow-up, it may be difficult to determine what the preparer's motives are, or why the return is not

¹⁰⁰ With residency, for example, the tester could implicate temporary absences as well as the more straightforward test as to whether the child lived with the taxpayer for more than six months.

properly prepared.¹⁰¹ A return reflective of a lack of awareness with the legal rules warrants a different response when compared with a preparer whose error relates to sympathetic concern with the taxpayer's circumstances, and could animate IRS education or more invasive compliance efforts.

Follow-up studies that revolve around the same basic fact pattern and general strata of preparers visited, using a similarly trained tester who understands the scenario and goals of the inquiry could then add to the initial study with the presence of additional variables. For example, injecting the possibility of a refund product like a refund anticipation loan (RAL) would allow researchers to see how this variable might affect preparer interaction, considering, in particular, how preparers interact with taxpayers who begin with the stated objective of seeking a refund product, and alerting the preparer of the presence of additional potential profit from the transaction may motivate preparers to act improperly.¹⁰²

Preparer Reaction to Taxpayers' Express Desire to Underreport Income or Claim Inappropriate or Excess Credits or Deductions

One other interesting avenue for research is to consider preparer response to taxpayers who approach a preparer with the expressed intent of underreporting income or overclaiming deductions or credits. I believe taxpayer conduct falls along a spectrum from most desiring to underreport income and seek active preparer facilitation to enable the deception on one side, to the presenting of information which should engender questions in light of the preparer's due diligence obligations on the other.¹⁰³ Thus, a possibility for the mystery shopper approach is to consider how preparers react in the face of express taxpayer desire to underreport income or overclaim deductions or credits. Limited current qualitative research suggests that with respect to sole proprietor reporting, for example, there frequently is likely a taxpayer driven search for accommodating preparers, with taxpayers inclined to underreport searching out either Type 1 or Type 2 preparers. It would be possible to try to gauge preparer reaction to taxpayers seeking to underreport or overclaim, and to try to determine to what extent preparers are willing to facilitate the noncompliance or turn a blind eye, or attempt to convince taxpayers to comply with their responsibilities. As noted above, awareness of the characteristics of the preparer who is willing to facilitate the misconduct

¹⁰¹ For example, a tester should be prepared to ask the preparer follow-up questions, like "what is the test to claim a child for this credit—I thought it was six months" or if the preparer generates a correct return, allow the tester to push on the preparer's sympathy to determine if the preparer would be willing to bend to taxpayer preferences.

¹⁰² It would be relatively easy to consider preparer reaction to the presence of income that the tester has received in a given year that is not subject to information reporting, to determine how a preparer's attitude to such casual income might affect taxpayer compliance decisions. TIGTA and GAO mystery shopper scenarios accounted for this. TIGTA, *Unenrolled Preparers*, *supra* note 5, at 8; GAO, *Limited Study*, *supra* note 4, at 19-20. This is particularly significant, as the IRS and Treasury have questioned whether the additional profits associated with the offering of products like RALs, refund anticipation checks, or audit insurance. See *Guidance Regarding Marketing of Refund Anticipation Loans*, 73 Fed. Reg. 1131 (Jan. 8, 2008).

¹⁰³ As I discuss above, I believe that preparers should have heightened due diligence obligations when it comes to the reporting of sole proprietor income, given the research reflecting that there is systemic underreporting in this area, evidence that taxpayers are failing to provide sufficient information to preparers to enable the preparers to prepare a correct tax return, and the possibility that asking additional questions or requiring additional documentary proof from the taxpayer will materially limit the taxpayer's possibility to keep his deception undetected. The use of additional qualitative research can enable researchers to determine the compliance with preparers' due diligence obligations. See TIGTA, *Unenrolled Preparers*, *supra* note 5 (showing preparer disregard for the EITC due diligence rules).

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or turn a blind eye to it would assist the IRS in identifying preparers who are not acting in accord with their overall obligations to the tax system's integrity.

To assist the research, I have refined the general three-pronged category of preparer classification and hypothesized that preparers respond to taxpayers who wish to understate their tax liability in one of six ways:

1. Refusing practitioners – these practitioners refuse to engage in a relationship with clients they suspect to be dishonest or overly aggressive;
2. Signaling practitioners – these practitioners will signal their unwillingness to prepare returns for clients they expect to be dishonest by making detailed inquiries or requesting backup documentation;
3. Facilitating practitioners – these preparers facilitate noncompliance by advising the taxpayer how to take improper return positions when they know or reasonably believe that the taxpayer is misstating facts;
4. Indifferent practitioners – these preparers are indifferent to the taxpayer's conduct and are willing to follow taxpayer preference and overlook noncompliance;
5. Incompetent or unsophisticated practitioners – given the due diligence requirements, these preparers should be able to recognize that the taxpayer is taking improper positions, but are unable to detect or suspect taxpayer misconduct because of lack of training, education sophistication, etc.; and
6. Reasonably unknowing practitioners – despite the client's misconduct, the practitioner does not and cannot reasonably know or suspect that the facts the taxpayer alleges are incorrect.¹⁰⁴

One assumption I have made in this report is that the relationship between the preparer and the taxpayer is dynamic, and while the mystery shopper scenarios do not reflect actual taxpayer reaction (after all, the taxpayer in my scenario will be a tester rather than an actual taxpayer), they can gauge the approach that the preparer is willing to take to steer the taxpayer toward compliance or noncompliance. This could provide insight into whether the above reasons are illustrative of preparer conduct in the face of taxpayer desire to under-report income or overclaim deductions or credits.

Given the limitations of the research, it will not demonstrate the effect of preparer conduct determinatively, as it is possible that, in a genuine preparer-taxpayer interaction, a preparer will have no measurable ability to change the behavior of someone intent in underreporting or overclaiming. I believe, however, that at least at the margins, preparers can influence and educate taxpayers about compliance,¹⁰⁵ and steer taxpayers towards complying with

¹⁰⁴ Book, *Role of Preparers*, *supra* note 1, at 71.

¹⁰⁵ See *id.* at 57-63. Admittedly, more research is needed in this field.

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their responsibilities. Accordingly, gauging and evaluating the characteristics of preparers who reflect an awareness of their responsibility to the system's integrity is important.

As I mention above, I do not believe, however, that changing taxpayer behavior when there appears to be a norm of noncompliance will be easy, nor will such behavioral changes be accomplished solely through efforts directed at the preparer. My hope is that the IRS will enhance its understanding and views of preparers in this context as part of its overall strategy to reduce the tax gap and better educate preparers about their obligations and the government's expectations of their conduct in an effort to reduce the tax gap.

Registering and Testing Paid Preparers

As mentioned in my initial report, there are no federal registration, certification, education, or testing (RCET) requirements that apply to all paid preparers. For over 30 years there have been calls for increased regulation of all return preparers, including imposing federal RCET requirements for those currently not governed by Treasury Circular 230.¹⁰⁶ There is renewed interest in such proposals, in part due to the National Taxpayer Advocate's emphasis on the proposal in Reports to Congress,¹⁰⁷ testimony favoring such a regime,¹⁰⁸ proposed legislation that would provide for preparer registration,¹⁰⁹ and the experiences of Oregon and California, two states that have had regulatory regimes applying to paid return preparers since the 1970s.¹¹⁰

One common criticism of the possibility of requiring federal RCET requirements has been the absence of data relating to the Oregon and California programs.¹¹¹ It is likely that this interest will increase given a recent GAO study that looked at the Oregon and California regulatory regimes, and found that Oregon's paid-preparer individual-income tax returns were more accurate than the national average.¹¹² The extent of the difference in Oregon was large. Oregon's 2001 federal returns were on average about \$250 more accurate than the rest of country.¹¹³ According to the GAO, "the odds that a return filed by an Oregon

¹⁰⁶ There have been calls to more closely regulate tax preparers since 1972, when the National Society of Accountants submitted an eight-point plan focusing on registering paid preparers. The issue gained new life in 1989, and again in 1994-95, when the IRS Commissioner's Advisory Group studied the issue and suggested registering and monitoring preparers. Most recently, in 2003, Senator Bingaman of New Mexico introduced the Low Income Taxpayer Protection Act of 2003 calling for registering paid preparers and RAL providers. See Bauman and Matzke, *supra* note 14.

¹⁰⁷ See National Taxpayer Advocate, 2002 Annual Report to Congress, 216 (*Regulation of Federal Tax Return Preparers*); National Taxpayer Advocate, 2003 Annual Report to Congress, 270 (proposing strengthening regulations on paid preparers).

¹⁰⁸ See *Fraud in Income Tax Return Preparation: Hearing Before H. Comm. on Ways and Means*, 109th Cong. 7 (statement of Nina Olson, National Taxpayer Advocate) (recommending professionalizing tax preparation industry); *Fraud in Income Tax Return Preparation: Hearing Before H. Comm. on Ways and Means*, 109th Cong. 7 (statement of Elizabeth Atkinson, President, Board of Trustees, Community Tax Law Project) (urging support for "appropriate regulations and safeguards for taxpayers").

¹⁰⁹ Low Income Taxpayer Protection Act of 2003, S. 685, 108th Cong. (2003) (containing provisions to regulate paid preparers).

¹¹⁰ GAO, *Oregon/California Preparer Registration Study*, *supra* note 3. See also Maryland Individual Tax Preparers Act, 2008 Md. Laws 623 (imposing registration, testing and continuing education requirements for paid preparers).

¹¹¹ Bauman and Matzke, *supra* note 14.

¹¹² See GAO, *Oregon/California Preparer Registration Study*, *supra* note 3, at 3. The study also found that California's paid preparer individual returns were on average less accurate than the rest of the country. *Id.* For a discussion of the differences in the programs, see *infra* sections IV.A.2-3.

¹¹³ *Id.* at 17.

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paid preparer was accurate were approximately 72 percent higher than the odds for a comparable return filed by a paid preparer in the rest of the country.”¹¹⁴ In contrast, the odds that a comparable California return was accurate were approximately 22 percent lower than for other parts of the country.¹¹⁵ With approximately 1.56 million individual income tax filers in Oregon, that state’s increased accuracy translates to about \$390 million more in income taxes paid than if Oregon’s paid preparer returns were prepared at the level of accuracy seen in the rest of the country.¹¹⁶

GAO’s conclusion after studying the regimes was that it was feasible to adopt a national regime that includes preparer education, registration, and, as in Oregon’s case, testing.¹¹⁷ GAO cautioned that Oregon’s results did not “conclusively support or refute the idea that adopting some or all of the California or Oregon program elements at the national level would improve the accuracy of paid preparer returns or reduce the tax gap,”¹¹⁸ but that Oregon’s requirements and GAO’s modeling suggests that “an Oregon-style approach to paid preparer regulation may be beneficial.”¹¹⁹

In this report, I argue that a tax system that values accountability and visibility for return preparers should impose RCET requirements, with one caveat: for a federal RCET program to succeed, the IRS must meaningfully track paid preparer performance so that the agency will be able to efficiently communicate with—and if necessary move up the enforcement pyramid to sanction—preparers who are either incompetent or unscrupulous. One important aspect of a federal RCET program is that such a program could facilitate preparer compliance with identification requirements and enable the IRS to capture data that would allow it to track preparers. I will discuss that below, as well as examine the elements of what I believe are important aspects of a RCET regime, highlighting some of the differences between the Oregon and California models, and suggesting differences that fit into the new paradigm of accountability, visibility and responsibility.¹²⁰ To explore those differences, it is necessary to look at the respective regimes in some detail.

¹¹⁴ GAO, Oregon/California Preparer Registration Study, *supra* note 3, at 3. For example, GAO found that for a return of medium complexity, a return by an Oregon paid preparer had a 74 percent probability of being accurate, compared to only a 55 percent probability of accuracy in California. *Id.* at 16.

¹¹⁵ *Id.* at 15-16.

¹¹⁶ *Id.* at 17.

¹¹⁷ *Id.* at 25.

¹¹⁸ *Id.* at 25. The GAO study acknowledged that other factors may have led to the accuracy. For example, the data did not indicate whether there were higher percentages of CPA’s or other already licensed professionals preparing returns in Oregon. There was also no comparison of accuracy prior to California or Oregon’s regulatory regimes, and some other states without additional regulatory requirements are also above average in paid preparer accuracy, indicating that “regulation over paid preparers alone does not explain the differences that we found.” *Id.* at 17. GAO thus “cannot rule out the possibility that Oregon or California returns were no more or less likely to be accurate than they would have been without the regulation of paid preparers.” *Id.* at 4.

¹¹⁹ GAO, Oregon/California Preparer Registration Study, *supra* note 3, at 25.

¹²⁰ An important caveat is that there are significant questions about the effect of a RCET regime on price of return preparation services. GAO specifically did not examine the effect of either California or Oregon’s regimes on pricing or supply, but it did note that Oregon taxpayers were less likely than taxpayers in other parts of the country to use paid preparers. *Id.* at 22. Interestingly, GAO considered the possibility that if the Oregon regime decreased the likelihood that noncompliant taxpayers would wish to use preparers, there might be a compliance effect on self-prepared returns. GAO, however, did not find that, and instead found that “[b]ecause Oregon self-prepared returns were no less accurate than returns elsewhere in the country, even if this switching occurred it likely would not completely offset the increased accuracy of paid preparer returns.” *Id.* at 17, note 33.

An Examination of the Oregon and California Regulatory Regimes

California

Registration

California paid preparers who are not attorneys, CPAs, or enrolled agents, must register with the California Tax Educational Council (CTEC) to become a CTEC Registered Tax Preparer (CRTP).¹²¹ As of June 6, 2008, 41,755 paid preparers registered with CTEC.¹²² In addition to registering with the CTEC, a CRTP must:

- Pay a \$25 registration fee to the CTEC and pay a \$25 renewal fee in subsequent years;
- Complete 60 hours of qualifying education and 20 hours of continuing education in subsequent years;
- Obtain a \$5,000 surety bond; and
- Submit renewal applications once a year to reregister with CTEC.¹²³

Paid preparers who fail to register can be fined up to \$5,000.¹²⁴ Preparers will initially be fined \$2,500, a fine which will be waived if preparers register with the CTEC within 90 days.¹²⁵ If they fail to register within 90 days, the fine will increase to \$5,000.¹²⁶ There are no criminal background checks required in California and no qualifying competency tests.¹²⁷

Enforcement

In California, CTEC reimburses the state Franchise Tax Board (FTB) for compliance costs.¹²⁸ FTB has one full-time and one part-time employee dedicated to the preparer regime.¹²⁹ Persons suspected of illegally preparing returns are issued penalty letters and encouraged to become preparers.¹³⁰ If they do not register within 90 days, FTB can issue fines of up to \$5,000.¹³¹ In the twelve month period beginning June 2005, FTB identified 77 individuals as unregistered; 56 of those people registered within the 90 day period and were not fined.¹³² Of the 21 who were fined, 11 registered in the following year, six were issued the

¹²¹ GAO, Oregon/California Preparer Registration Study, *supra* note 3, at 9.

¹²² *Id.*

¹²³ *Id.* at 9, 13-14.

¹²⁴ *Id.* at 10.

¹²⁵ *Id.* at 10, note 22.

¹²⁶ *Id.* at 10.

¹²⁷ *Id.*

¹²⁸ GAO, Oregon/California Preparer Registration Study, *supra* note 3, at 10.

¹²⁹ *Id.* at 19.

¹³⁰ *Id.* at 10.

¹³¹ *Id.*

¹³² *Id.* at 10, note 22 and surrounding text.

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\$5,000 penalty and four stopped preparing.¹³³ Many of these unregistered preparers were identified through on-site visits by two FTB employees.¹³⁴

Oregon

Registration

Oregon requires paid preparers who are not already licensed by the state as CPAs or attorneys, or working for a CPA, to obtain a state license to prepare tax returns.¹³⁵ The Oregon Board of Tax Practitioners (OBTP) issues two levels of paid preparer licenses: the Licensed Tax Preparer (LTP) license and the Licensed Tax Consultant (LTC) license.¹³⁶ Oregon's requirements for the two exams include:¹³⁷

LTP Requirements:

- A high school diploma or its equivalent;
- Completion of 80 hours of qualifying education and 30 hours of renewing education;
- Passage of a state administered exam, scoring 75 percent or higher;
- Payment of an \$80 initial fee, an \$80 renewal fee; and
- All LTPs must work under the supervision of an LTC, CPA or attorney.

LTC Requirements:

- Completion of a minimum of 780 hours of working as a tax preparer in two of the last five years;
- Within one year of submitting the application, completion of a minimum of 15 hours of qualifying education if already an LTP, or completion of 80 hours of qualifying education if not already an LTP;
- Annual completion of 30 hours of continuing education;
- Passage of a more advanced exam with a score of at least 75 percent, though enrolled agents need only take the section focused on Oregon laws; and
- Payment of \$95 initial and renewal fees (for LTPs, fee is \$65).

Enforcement

In Oregon, the OBTP can issue fines for each return prepared without a license.¹³⁸ OBTP also has the authority to assess \$5,000 civil penalties or to revoke or suspend the license of someone who engages in fraud or illegal conduct or who violates other provisions of

¹³³ GAO, Oregon/California Preparer Registration Study, *supra* note 3 at 10, note 22 and surrounding text.

¹³⁴ *Id.* at 11.

¹³⁵ *Id.*

¹³⁶ *Id.*

¹³⁷ *Id.* at 11-12. For a graphical view of these requirements, see *id.* at 13-14.

¹³⁸ *Id.* at 12.

the Oregon preparer statutes.¹³⁹ OBTP may also order restitution to consumers harmed by fraud.¹⁴⁰ From March 2001 to November 2007, OBTP imposed about \$2 million in fines through 48 disciplinary actions, with one person being fined more than \$800,000.¹⁴¹ Preparers in Oregon have administrative and judicial appeal rights relating to OBPR disciplinary actions.¹⁴²

A Comparison of Oregon and California's RCET Regimes

As GAO indicates, it is not clear why there are differing results in California as compared to Oregon. The study does indicate that there are significant differences between the two programs, and the following considers differences that may account for GAO's differing results.

Two-Tier Structure

Oregon uses a two-tiered structure, with a requirement that less experienced practitioners, LTPs, must work under more the experienced preparers, the LTCs.¹⁴³ Both tiers must pass examinations demonstrating competence, and LTP's are effectively required to work with more experienced practitioners.¹⁴⁴ The requirement that preparers work with more seasoned preparers (or an otherwise licensed professional, like a CPA or attorney), contributes to a possible mentoring relationship and also might check a new preparer with little institutional capital who might be more inclined to act unscrupulously.

Education

There are also additional education requirements in Oregon, compared with California, with 30 hours of continuing education in Oregon for both tiers, compared to California's 20 hours, and 80 hours of qualifying education in Oregon compared to 60 hours in California.¹⁴⁵ Given the frequency of tax law changes, the additional requirements may contribute to general competency and allow Oregon to focus preparers on new developments.

Examination

In addition, there is an entrance examination relating to competence in federal and state tax laws in Oregon for both tiers, and the test has a fairly high percentage of people failing: 46 percent of applicants failed the LTP test and approximately 70 percent failed the LTC test—the more experienced tier.¹⁴⁶ That a number of applicants seeking to prepare returns

¹³⁹ GAO, Oregon/California Preparer Registration Study, *supra* note 3, at 12.

¹⁴⁰ *Id.*

¹⁴¹ Only a small percentage of these fines, however, are ultimately collected. Between 2005 and 2007, roughly \$867,000 in fines were imposed, but only about \$75,000 in fines and interest were collected. *Id.* at 12.

¹⁴² Those penalized under the Oregon regime can appeal these decisions. OBTP has an arrangement with the Oregon Office of Administrative Hearings to provide an administrative law judge to hear these appeals. Appeals can also be brought in the Oregon Court of Appeals. *Id.* at 12-13.

¹⁴³ *Id.* at 11.

¹⁴⁴ *Id.*

¹⁴⁵ *Id.* at 9-11.

¹⁴⁶ *Id.* at 12.

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failed the tests suggests the possibility that a testing requirement might prevent incompetent or unskilled individuals from preparing returns.

Minimal Education & Scruples Disclosure

Oregon requires that applicants have a high school diploma or its equivalent, and applicants must also disclose prior criminal convictions or indictments relating to an applicant's honesty.¹⁴⁷ There are no such education prerequisites in California, and California requires no criminal background check.¹⁴⁸ California's program confers no authority to deny registration as long as an applicant completes the education requirements and pays the annual fee.¹⁴⁹ It is possible that Oregon's minimal education requirement provides a higher floor for preparers, and that Oregon's additional disclosure requirement deters unscrupulous people from entering the paid preparer business.

Small Size of Oregon's Preparer Community

Given the differences in population between the states, it is not surprising that Oregon has far fewer licensed tax preparers than California. According to recent census estimates, California's population as of July, 2007 is 36,553,215, compared to Oregon's population of 3,747,455.¹⁵⁰ The ratio of licensed preparers to population is similar, with California having 41,755 CRTPs and Oregon having 1,916 LTPs and 2,077 LTCs, or 3,933 total licensed preparers.¹⁵¹ The smaller size of Oregon's preparer community may contribute to a more effective relationship between regulator and regulatee.¹⁵²

Money Spent on the Program and Enforcement Costs

California budgeted approximately \$1.2 million for administrative and enforcement costs, with most of the money coming from the \$25 registration fees and other income including fees paid by education providers.¹⁵³ Total cost per CRTP was about \$29.¹⁵⁴ Oregon also charges for initial registration and renewals (\$80 and \$95, respectively for LTPs and LTCs), and also imposes fees of \$50 to take the LTP exam, and \$85 to take the LTC exam.¹⁵⁵ Both states incur enforcement expenses, with CTEC essentially outsourcing its efforts to the FTB, and OBTP directly incurring the costs.¹⁵⁶ Oregon's enforcement costs are relatively higher

¹⁴⁷ GAO, Oregon/California Preparer Registration Study, *supra* note 3, at 11-12.

¹⁴⁸ See *id.* at 10.

¹⁴⁹ See *id.*

¹⁵⁰ See United States Census Bureau, *United States—States; and Puerto Rico: 2007 Population Estimates*, available at http://factfinder.census.gov/servlet/GCTTable?_bm=y&-context=gct&-ds_name=PEP_2007_EST&-mt_name=PEP_2007_EST_GCTT1_US9&-CONTEXT=gct&-tree_id=807&-geo_id=&-format=US-9|US-9S|US-9Sa|US-9Sb|US-9Sc|US-9Sd|US-9Se|US-9Sf|US-9Sg|US-9Sh&-_lang=en [hereinafter Census Numbers].

¹⁵¹ GAO, Oregon/California Preparer Registration Study, *supra* note 3, at 9, 12.

¹⁵² Raskolnikov, *supra* note 35, at 36-37.

¹⁵³ GAO, Oregon/California Preparer Registration Study, *supra* note 3, at 18.

¹⁵⁴ CTEC's budget in 2007 was \$1.2 million, and CTEC reported 41,755 CRTPs in June, 2008, making the per-preparer cost of the program about \$29. *Id.*

¹⁵⁵ *Id.* at 19.

¹⁵⁶ See *id.*

than California's, given the far fewer preparers that the OBTP was regulating.¹⁵⁷ Given the administrative and enforcement costs, GAO estimates that California spent approximately \$29 per licensee, and Oregon approximately \$123 per licensee.¹⁵⁸

Additional Paid Preparer Costs

GAO found that education costs for preparers in both states were in the \$200-\$300 range per year, with the possibility of higher costs depending on type of program and whether the preparers were traveling to attend conferences or training sessions.¹⁵⁹ GAO estimated the total costs associated with Oregon's program to be \$6 million, with direct administrative costs amounting to \$490,000 of that total, and the balance reflective of preparer costs.¹⁶⁰

The Benefit of Oregon's Plan—Overall Impressions

The GAO study is an important development in consideration of a possible regulatory regime relating to RCET requirements for all paid preparers. The states themselves have not meaningfully analyzed tax returns to track performance and error rates, or otherwise mined data that would allow for detailed evaluations of the program's effectiveness.¹⁶¹ It is interesting, however, that both states believe that their programs have contributed to the professionalization of the industry and facilitated consumer confidence by, for example, allowing consumers to check quickly (*e.g.*, through online searches) as to whether a preparer is licensed.¹⁶²

The GAO analysis strongly supports the benefits of a program like Oregon's. Oregon's costs, including direct administrative and preparer costs (though as mentioned above, GAO did not examine the effect of costs on taxpayers), were relatively modest at \$6 million, and there was an additional \$390 million of taxes paid in Oregon as compared to what would have been paid if the accuracy of Oregon returns was comparable to that of the rest of the country.¹⁶³ While the study does not prove conclusively that Oregon's requirements contributed to higher accuracy, or that any one aspect of Oregon's program was the factor contributing to the results, it suggests that even if only a small portion of the increased revenue is attributable to the program, it is a very good investment. As GAO points out, one aspect of evaluating the effectiveness of compliance decisions is in relation to general

¹⁵⁷ In California, CTEC paid FTB \$270,000 for enforcement activities in 2007, while OBTP incurred roughly \$93,000 in enforcement costs. GAO did note, however, that while California's operating budget is about twice as much as Oregon's, California registers and regulates more than 10 times more preparers than Oregon. *Id.* at 19-20.

¹⁵⁸ *Id.* at 18-19.

¹⁵⁹ *Id.* at 19-20.

¹⁶⁰ GAO notes that this estimate is conservative, as it counted preparer education time for all licensees, including enrolled agents and employees of national chains who already have existing educational and testing requirements. *Id.* at 20. It may underestimate costs in that it fails to include possible additional taxpayer preparation fees or possible additional taxpayer travel time if there are fewer preparer offices than would otherwise exist if no regulatory requirements were in place. *Id.* at 20.

¹⁶¹ *Id.* at 22.

¹⁶² *Id.*

¹⁶³ *Id.* at 25.

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cost benefit calculations, and the IRS typically expects a four to one return on compliance expenditures.¹⁶⁴

Using the Oregon model as an estimate of a similar program's costs, it is of course likely that imposing a similar federal program will be a significant undertaking. The extent of the costs of such a program is limited by the lack of data the IRS currently has about the number of unenrolled preparers, but it is interesting that Oregon and California, while vastly different states, have a relatively similar ratio of paid preparers to the general population, with California's 41,755 paid preparers comprising 0.11423 percent of the population, compared to Oregon's 3,993 paid preparers comprising 0.10655 percent.¹⁶⁵

This equates to a range of approximately 300,000 to 350,000 unenrolled preparers at a national level.¹⁶⁶ These numbers are admittedly lower than previous IRS estimates.¹⁶⁷ To the extent that the testing, registration, and education requirements impose costs on those seeking to become paid preparers, they will act as a barrier to entry into the paid preparation market. Assuming direct administrative costs roughly estimated at \$100 per preparer,¹⁶⁸ using Oregon's figures as a base but reflecting a discount for likely economies of scale, that would equate to approximately \$30 to 35 million in government-incurred costs, with approximate additional preparer-incurred costs of \$337 million to \$393 million, using the same ratio GAO used in conservatively allocating cost for preparer time and educational classes.

How to Ensure that the Program Will Maximize Accountability, Visibility, and Responsibility

One aspect of a national program that neither California nor Oregon emphasizes is the possibility that a federal program will significantly enhance communication and monitoring of preparer performance. While both states use their lists to contact preparers to remind them of requirements and to let them know about changes in the tax law, "neither state uses their preparer information to track paid preparer accuracy or for enforcement

¹⁶⁴ GAO notes that this estimate is conservative, as it counted preparer education time for all licensees, including enrolled agents and employees of national chains who already have existing educational and testing requirements. *Id.* at 20. It may underestimate costs in that it fails to include possible additional taxpayer preparation fees or possible additional taxpayer travel time if there are fewer preparer offices than would otherwise exist if no regulatory requirements were in place. *Id.* at 21.

¹⁶⁵ California has 41,755 paid preparers at last count; Oregon has 3,993. *Id.* at 9,12. California and Oregon's respective population estimates are 36,553,215 and 3,747,455. Census Numbers, *supra* note 151.

¹⁶⁶ Using the above figures, Census Numbers, *supra* note 151, as endpoints, the exact range is 321,577-344,541 preparers. (Figures calculated by author).

¹⁶⁷ In 1999, the IRS estimated that there could be as many as 1.2 million paid preparers, though this number was given as a very rough estimate, with the IRS noting that the actual number could be significantly higher or lower. GAO, Oregon/California Preparer Registration Study, *supra* note 3, at 6. The National Taxpayer Advocate has estimated that of this 1.2 million preparers, as many as 300,000 to 600,000 are not subject to any licensing and educational requirements. National Taxpayer Advocate, 2003 Annual Report to Congress, 270.

¹⁶⁸ The costs would have to reflect that preparers and education providers would likely be the significant, if not whole source of these costs, through fees that would vary based upon the design of any program. The cost estimates below are estimates that assume that direct administrative costs of any national program would comprise approximately 8.16 percent of total costs, exclusive of additional costs that may be passed on to taxpayers in the form of increased preparation costs. This is the same ratio that GAO used in considering Oregon's direct and preparer costs, *i.e.*, \$490,000 of total \$6 million were direct administrative costs.

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purposes.¹⁶⁹ California does not require preparers to use registration numbers on returns they prepare, and while Oregon requires LTCs and LTPs to use registration numbers, the requirement is not consistently followed, as preparers use either their Preparer Tax Information Number, Social Security number, or an Employer's Identification Number.¹⁷⁰ And the GAO has noted that "neither state has a reliable means to track or analyze returns prepared by registered or licensed paid preparers in their states."¹⁷¹

To emphasize accountability, visibility, and responsibility, a federal undertaking would have to be backstopped by an identification requirement that the IRS would meaningfully enforce, as I suggest above in Part III.A. The current regime of the IRS not even being able to tell the number of preparers highlights the lack of scrutiny that preparers currently enjoy. To increase visibility of preparer actions, the IRS, if administering a federal program, should communicate with preparers to provide them information that bears on the likelihood of returns' accuracy or particular preparers' needs. This written communication could take different forms, including the issuance of an annual data sheet to preparers that would be delivered just prior to filing season. For example, that data sheet could inform preparers of the total number of returns they prepared last year, identify information about those returns (such as average tax owed or number of returns claiming refunds), and also emphasize data about issues that are related to areas of systemic noncompliance. In that report, the IRS could identify data points that demonstrate the preparers' differences from other benchmarks. For example, the IRS could inform preparers who prepare a significant amount of Schedule C returns of a low percentage of gross receipts to expenses, or for EITC preparers, of higher average or median refunds compared to other taxpayers in a region or state, or other similarly situated preparers.¹⁷² In effect, the IRS could demonstrate to preparers that their actions are visible, and borrow from some of the insights that have accompanied high compliance rates associated with items reported to the IRS.¹⁷³ The IRS could also identify and report trends that indicate potential compliance and service challenges to preparers, such as a high percentage of newly licensed preparers in an office, or a high concentration of returns claiming a particular credit at a rate inconsistent with national figures. To make this communication most effective, and to take into account

¹⁶⁹ GAO, Oregon/California Preparer Registration Study, *supra* note 3, at 13.

¹⁷⁰ *Id.*

¹⁷¹ *Id.*

¹⁷² One question for such a program is whether the national system would borrow from Oregon's two-tier approach, with the requirement that preparers work with more experienced preparers. I take no position as to whether such a requirement is feasible on a national level, or, even if feasible, desirable, given potential additional costs, although I note that the presence of more seasoned professionals may be a means of inculcating a sense of professionalism in an industry that appears to be lacking in a uniform sense of professionalism. If such a tiered approach is part of a national program, the senior preparer would receive information relating to preparers who identified him or her as their supervisor, to facilitate office responsibility for preparer conduct. Even if such a program is not adopted, any identification scheme would have to reflect and allow the IRS to track preparers within offices, especially given the prevalence of national chain preparers. I would expect that the IRS would have authority to share that information with national affiliates of chain offices, irrespective of whether the office were franchise-run or run directly by the chain itself.

¹⁷³ Leandra Lederman, *Tax Compliance and the Reformed IRS*, 51 U. Kan. L. Rev. 971, 973-74 (2003) (noting that scholars have pointed to several factors, including trust in government, taxpayer morale, and the use of tax compliance as a signal to explain compliance rates that exceed what would be expected if audit rates and penalties alone drove tax compliance).

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other resource demands on the IRS, the communication season should coincide with the time period prior to the beginning of filing season.

The benefits of such an approach are, in my view, significant. It reflects the possibility that the IRS, like modern service or product providers, can track data to more effectively tailor its communication, communicate the possibility of a potential sanction as a result of preparer noncompliance, and generate possibilities for preparers to meaningfully ask the IRS about resources that will enable preparers of good faith to do their jobs. Just as when I log on to the website Amazon.com my portal reflects recent purchases and likely future interests, the IRS can likewise effectively push out targeted information to its audience, in this case preparers. That many future services to preparers will be provided in an online environment enhances the potential for use of information and data, once mined.

The above assumes that a program will not have significant negative unintended consequences (such as pushing those who do not comply to self-prepare, or materially increase preparation costs), nor will it drive preparers underground to avoid additional federal responsibilities. Any federal program will require systematic evaluation of its effectiveness¹⁷⁴ and costs. Moreover, it is vital that enforcement backstop any program, with a special emphasis on preventing unlicensed preparers from entering and remaining in the system, and requiring preparer compliance with any identification requirements. The latter point will likely require a commitment on behalf of the IRS to emphasize the identification requirement, through on-the-ground investigators¹⁷⁵ and perhaps the possibility of expanding whistleblower provisions to include private reward for individuals who identify unlicensed preparers to the IRS.¹⁷⁶

¹⁷⁴ I note that GAO cautioned that other factors in its study had significant influence over whether returns were accurate, and especially noted the lower chances of accuracy among EITC and sole proprietor returns. GAO, *Oregon/California Preparer Registration Study*, *supra* note 3, at 32. It would be helpful to isolate effectiveness of additional regulation with respect to specific issues, including those primarily identified in this report, *i.e.*, EITC noncompliance and sole proprietor reporting of income.

¹⁷⁵ Oregon kept one full-time investigator on staff in the OBTP to impose fines on registered and unregistered preparers for misconduct. *Id.* at 19. Projecting this out on a national scale, using Oregon's 3,993 registered preparers as a baseline, would call for roughly 100 investigators working in a similar capacity at the IRS.

¹⁷⁶ Dennis J. Ventry, Jr., *Whistleblowers and Qui Tam for Tax*, 61 *Tax Law.* 357, §§ V, VI (2008) (urging that whistleblower provisions be expanded to allow private citizens to bring *qui tam* actions against taxpayers for violations of internal revenue laws). For a history of whistleblower laws, and their extension allowing the IRS to pay for tips they receive from people noticing tax problems at their workplace, in their day-to-day business, see *id.*, § II. The whistleblower regime pegs recovery to total tax recovered, thus limiting it as a model for preparers, but one possibility to make this more feasible in this context is to tie informant rewards to numbers of returns that an unlicensed preparer generates, rather than total amount of tax or other penalty recovered.

The Insights of Responsive Regulation

The Theoretical Background

Much has been written lately about the possible benefits of responsive regulation, both in the context of tax regulation¹⁷⁷ and government regulation more generally.¹⁷⁸ Responsive regulation is the idea that regulators must be responsive to the conduct of those they seek to regulate. The posture of regulator in a responsive regulatory regime is not adversarial—at least initially. The premise is that regulators should approach the group they seek to regulate cooperatively, with an eye toward solving problems collaboratively, changing toward a more adversarial environment only in the face of non-response or inadequate response to government efforts. A regulator, in “deciding whether a more or less interventionist response is required” must consider those who will be controlled by the regulations.¹⁷⁹ “Responsive regulation is not ‘a clearly defined program or set of perceptions concerning the best way to regulate’ but rather, a method that advances the proposition that regulation should be context-dependant.”¹⁸⁰ Responsive regulation sets forth a regulatory pyramid with a “series of options that a tax authority might use to win compliance, sequenced from the least intrusive at the bottom to the most intrusive at the top.”¹⁸¹

One key idea behind the insights from this approach is that in many (perhaps most) cases, the government does not need to automatically resort to coercion or sanction to produce its desired effect, given the resource-intensive nature of that approach and the potential that such efforts might backfire.¹⁸² Rather than a system based upon this responsive regulation model, the United States tax administration has a “command-and-control operational system to accomplish their mission of catching ‘the scoundrels’ who do not pay their taxes.”¹⁸³

There are several elements critical to effectively implementing a responsive regulatory program:¹⁸⁴

It refers to the practice of (a) influencing the flow of events (b) through systematic, fairly directed and fully explained disapproval (c) that is respectful to regulatees, helpful in filling information gaps and attentive to opposing or resisting arguments (d) yet

¹⁷⁷ See Valerie Braithwaite, *Responsive Regulation and Taxation: Introduction*, 29 *Law & Pol’y* 3, 4 (2007) [hereinafter Braithwaite Introduction].

¹⁷⁸ See Ian Ayres & John Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* (1992). See also Dennis Ventry, *The Collision of Tax and Welfare Politics: The Political History of the Earned Income Tax Credit, 1969-99*, 53 *Nat’l Tax J.* 983 (“[P]olicy alternatives, regardless of their theoretical or analytical appeal, will have to complement rather than conflict with social and cultural forces to prove successful.”).

¹⁷⁹ Braithwaite Introduction, *supra* note 178, at 4.

¹⁸⁰ Sagit Leviner, *A New Era of Tax Enforcement: From ‘Big Stick’ to Responsive Regulation*, at 264 in *Recent Research on Tax Administration and Compliance: Special Papers Given at the 2006 IRS Research Conference, June 14-15, 2006*, (quoting Ayres & Braithwaite, *supra* note 179) (internal footnotes omitted).

¹⁸¹ For a more detailed discussion of the regulatory pyramid, see Braithwaite Introduction, *supra* note 178, at 4.

¹⁸² *Id.* (emphasis original).

¹⁸³ *Id.*

¹⁸⁴ John Braithwaite, *Restorative Justice and Responsive Regulation* (Oxford University Press) (2002).

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firm in administering sanctions (e) that will escalate in intensity in response to the absence of genuine effort on the part of the regulatee to meet the required standards.¹⁸⁵

Tax administration usually operates on the presumption that tax law will influence the flow of events when sanctions are sufficiently certain and severe to offset the gains of non-compliance (*i.e.*, the traditional rational actor model).¹⁸⁶ Responsive regulation on the other hand “assumes that there is a responsible moral self that can be drawn out by a good regulator and that will enable offenders to change their ways and self-regulate more effectively in the future.”¹⁸⁷

Recent scholars have noted that IRS general compliance policy has suffered from a one-size-fits-all model,¹⁸⁸ and have questioned the ability of the IRS to act more nimbly as is required of a regime that incorporates at least some elements of a responsive regulatory framework. In my initial report and prior research I have emphasized that the IRS must more appropriately consider the varied nature of the tax gap.¹⁸⁹ To the IRS’s credit, it is acknowledging this in recent proposals to address the tax gap.¹⁹⁰

How do the insights of responsive-regulation scholars intersect with the reality of today’s relationship between the IRS and unenrolled paid preparers? Consider Professor Raskolnikov:

Success of responsive regulation depends critically on a regulator being able to decide whether regulatee is willing to comply voluntarily, needs a gentle nudge, a threat of substantial sanctions, or a full blown penalty and perhaps even criminal prosecution in order to cooperate or comply. To make this determination, the regulator must engage with each regulatee on a continuous basis.¹⁹¹

Raskolnikov notes that given these conditions, it is not surprising that until recent application in the Australian, New Zealand and East Timor tax systems, it was not surprising that the responsive-regulation concept has largely been applied to smaller regulatory communities, where there is more face-to-face contact between regulator and regulatee.¹⁹²

¹⁸⁵ Braithwaite Introduction, *supra* note 178, at 5.

¹⁸⁶ *Id.*

¹⁸⁷ *Id.*

¹⁸⁸ Raskolnikov, *supra* note 35, at 36-37.

¹⁸⁹ “Both gross and net tax gaps can be subdivided into three main components: the non-filing gap, the underreporting gap, and the underpayment gap.” Book, *Role of Preparers*, *supra* note 1, at 48 (citation omitted); see also *id.* at 51, 73 (discussing the IRS’s need for more complete understanding of nature of tax gap and ability to develop programs to remedy problems; Leslie Book, *Freakonomics and the Tax Gap: An Applied Perspective*, 56 Am. U. L. Rev. 1163, 1167-68 (discussing several sources of tax gap); GAO, Filing Season, *supra* note 63, at 3 (“[D]ue to lack of reliable data, IRS’s [tax gap] estimate does not include some types of noncompliance... Also, IRS is concerned with some of the outdated data and methodologies used to estimate the tax gap. Finally, it is difficult for IRS to identify and measure noncompliance ... when IRS has little or no information from third parties about payments made or taxes withheld.”).

¹⁹⁰ GAO, Filing Season, *supra* note 63, at 18 (discussing recent IRS efforts to remedy lack of information).

¹⁹¹ Raskolnikov, *supra* note 35, at 37.

¹⁹² *Id.* at 37 n.176.

Underlying this report is that the IRS increase preparer visibility and responsibility.¹⁹³ Relying on technology, the IRS can begin the task of understanding the preparer community. The current situation of the IRS not even having reliable estimates of the total number of paid preparers makes it difficult if not impossible for the IRS to meaningfully interact in the manner that will allow the IRS to gauge the appropriate conduct toward preparers.¹⁹⁴

Application to the EITC

In addition to providing a helpful framework for the need to provide service to preparers, the responsive-regulation approach offers additional insights with respect to preparers who are engaged in preparing and filing EITC returns. For example, responsive regulation changes the previously binary view of preparers associated with the EITC as either facilitators of fraud, or possible case workers to be employed in the traditional benefits model.¹⁹⁵ Administrators should emphasize explicitly what is implicit in the current arrangement with preparers: that there is a partnership between taxpayers, preparers and the government. The need to reward good behavior, rather than just ferret out bad actors, could change the dynamic in the partnership, and contribute to reinforcing compliance.¹⁹⁶ In addition, it provides a theoretical context for innovative proposals to encourage industry self-regulation,¹⁹⁷ such as codes of conduct or best practices, and allows the IRS to reward those who reach quality benchmarks or attend training programs that exceed what might even be required under a regulatory regime that contemplates licensing and registering preparers.

As others have written, the trick is to encourage positive behavior while keeping the powder dry to deal with those who need more than reward and encouragement.¹⁹⁸ This may be difficult if other actors are behaving improperly, but there are tools that the IRS and Congress can use to steer claimants toward better preparers. For example, with respect to EITC preparers, positive rewards include favored refund time, differing access to the Debt Indicator program or access to IRS information generally, differing recordkeeping or due

¹⁹³ See *supra* section IV.A.

¹⁹⁴ I had asked the IRS to develop a report that classified tax returns by their preparers and analyzed the data to estimate compliance benchmarks. The report was difficult to create, given the limited information available to the IRS. TAS researchers worked exceptionally hard putting it together, but despite all the hard work and effort, were still unable to classify a significant percentage—over 13 percent—of the returns. (Unpublished IRS Preparer Classification Analysis (Sept. 8, 2008)).

¹⁹⁵ See Jeff Engerman, “Administering the Earned Income Tax Credit: Paid Preparers, Problems, and Possibilities” 11-15 (May 13, 2006) (unpublished work, on file with author) (discussing the traditional caseworker model for public assistance programs, where the eligibility is determined *ex ante*, and the EITC model, where the self-reported tax filing undergoes an *ex post* review for eligibility).

¹⁹⁶ See Dennis J. Ventry, *Cooperative Tax Regulation* (Am. Univ. Washington Coll. of Law, Working Paper No. 2008-47, 2008) (describing a regulatory scheme that would “raise compliance by explicitly rewarding compliance”); Susan Cleary Morse, *The How and Why of the New Public Corporation Tax Shelter Norm Compliance*, 75 *Fordham L. Rev.* 961, 1012-13 (2006) (describing the Compliance Assurance Program as a cooperative program between corporate tax decision-making groups and the IRS); David Schizer, *Enlisting the Tax Bar*, 59 *Tax. L. Rev.* 331, 355-371 (proposing a regulatory framework to align the government’s and lawyers’ interests in tax administration).

¹⁹⁷ Block Comments, *supra* note 14, at nn. 120-125 and surrounding text (urging that industry self-regulation can play a role in alleviating concerns of non-compliance).

¹⁹⁸ Other metaphors include the velvet glove/iron fist duality or the talk softly and carry a big stick. Raskolnikov, *supra* note 35, at 36. See Ventry, *supra* note 197, at 16 (citing Leviner, *supra* note 180). Ventry offers an example of incentivizing timely and correct return filing by offering rebates. *Id.*

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diligence requirements, or explicit discretion from Congress for the IRS to modify or waive certain requirements or penalties for preparers who meet certain low-error thresholds. In addition, IRS recognition or publication of those who meet accuracy benchmarks or who otherwise employ best-practice approaches can help encourage those taxpayers who wish to comply to seek better preparers. Such an approach would also carry an implicit or even explicit threat that using preparers who are at different stages of the pyramid entails additional audit risk.

The Australian Example

An interesting example of how the IRS can climb the responsive-regulation pyramid comes to us by way of Australia. The Australian Taxation Office's (ATO) efforts to address noncompliance among barristers in New South Wales (NSW) show how agency action can respond to the actions of those the agency is regulating.¹⁹⁹

In 1999, a tax officer at the ATO noticed that those in the legal profession under her review had exceptionally high debts to the ATO.²⁰⁰ While investigating the cause, bankruptcy came up as the source of the debts time and time again.²⁰¹ Doubting that the legal market was doomed, she continued the investigation and discovered that wealthy lawyers were dodging income tax by repeatedly declaring bankruptcy, leaving the ATO as their only real creditor.²⁰²

Starting at the bottom of the responsive regulation pyramid, the ATO initially approached the NSW Bar Council to address the issue, seeking a self-regulatory solution as opposed to a more forceful intervention.²⁰³ The Bar Council considered the problem, and thought it more appropriate to have it regulated under the NSW Legal Services Tribunal as opposed to self-regulation.²⁰⁴ The Tribunal did not have the best track record with addressing problems of noncompliance by barristers, and the ATO quickly moved up the pyramid, aggressively bringing the most egregious cases before the courts.²⁰⁵ The Commissioner also spoke publicly about these schemes, and soon enough, the media got involved.²⁰⁶ Government officials quickly got into the mix, and began intimating that reform in the bankruptcy law might be in order.²⁰⁷

¹⁹⁹ See John Braithwaite, *Markets in Vice, Markets in Virtue* 178-81 (Oxford Univ. Press) (2005) (telling story of ATO efforts to fight noncompliance among barristers in Australia).

²⁰⁰ The rate of debt default was ten times higher than the rest of the Australian population. *Id.* at 178.

²⁰¹ *Id.*

²⁰² The ATO identified 62 licensed barristers who had declared bankruptcy between 1991 and 2001, with a third of them declaring bankruptcy repeatedly. Some of the lawyers had declared bankruptcy as many as three times in a decade. It was also revealed that barristers were one of the most active demographic groups investing in mass marketed aggressive tax planning schemes. *Id.* at 178-79.

²⁰³ John Braithwaite, *Markets in Vice, Markets in Virtue* at 179.

²⁰⁴ *Id.*

²⁰⁵ *Id.*

²⁰⁶ The Sydney Morning Herald, for instance, ran a series of front-page stories on the lifestyles of these bankrupt barristers. *Id.* at 180.

²⁰⁷ *Id.*

The possibility of prohibiting recently bankrupted attorneys from practicing law seemed to light a fire under the NSW Bar Association, which became interested in dealing with the problem.²⁰⁸ The end result of this turned out to be some “modest law reform,” efforts to de-license those barristers with the most egregious histories of noncompliance, and some considerable self-regulatory reform, all of which had the effect of increased tax payments by barristers, increased enforcement against those barristers who remained noncompliant, and a substantial increase in the number of barristers remaining current with their tax returns.²⁰⁹

Though the ATO’s efforts were focused on aggressive tax shelters and outright tax avoidance, the IRS can take a page from the ATO playbook in addressing supply-side and preparer-initiated errors in returns. Under this type of regulatory scheme, the IRS could seek out those return preparers with unacceptably high error rates, bring the problem to their attention, and work with those preparers to create internal controls to ensure increased compliance. An approach like this would likely involve more stringent preparer reporting requirements for a number of years. Those preparers who are able to demonstrate the internal controls’ success resulting in increased compliance would have lesser or more relaxed reporting requirements, or perhaps report at less regular intervals. The IRS would move up the regulatory pyramid for those who are unable to make a similar showing, subjecting them to audits and other more intrusive regulatory efforts.

Conclusion

The insights from the responsive-regulation literature present an intriguing model for IRS interaction with preparers, and provide a theoretical context for a more nuanced approach that the IRS should adopt when considering its return preparer strategies, and the specific proposals I prescribe for Congress and the IRS to adopt. To some extent, the IRS’s current emphasis on preparer education, including the significant resources expended on tax forums and other general outreach programs, reflects the IRS’s awareness that its interaction with preparers must take a varied approach. This report in part, though, is premised upon a paradigm of more personal contact with preparers, with those contacts facilitated by heightened identification requirements and a more dedicated IRS effort to mine preparer data, which will improve its ability to target communications. Thus, a prerequisite for this type of approach is that the IRS must have sufficient information regarding who the good and bad actors are in the return preparation industry. There is a deep need for the IRS to collect information by type of preparer, and to have a nuanced understanding of error rates by preparer and by issue, with a healthy dose of qualitative on-the-ground resources backing-up and contributing to understandings that the numbers suggest.²¹⁰ Encouraging

²⁰⁸ The Sydney Morning Herald, for instance, ran a series of front-page stories on the lifestyles of these bankrupt barristers.

²⁰⁹ John Braithwaite, *Markets in Vice, Markets in Virtue* at 180.

²¹⁰ Cf. GAO, 2007 Filing Season, *supra* note 63, at 18 (discussing the IRS plan to develop a database to “serve as a centralized repository of paid preparer information”).

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good behavior must start with the IRS knowing and acting on information about how certain preparers are interacting with taxpayers.

Changing preparer conduct through audits, heightened penalties, and the use of civil injunction proceedings should be undertaken only after the IRS encourages more positive steps, and only after the IRS communicates disapproval of what it perceives to be improper preparer conduct. For example, rather than defaulting to audit when faced with information about likely errors associated with a specific geographic region of a national chain, one approach would involve the IRS visiting preparers to discuss best practices, or consider why the preparer believes its practices are sufficient. Then, the IRS could reveal the existence of information suggesting impermissible error rates associated with that preparer's returns. The IRS could ask that the preparer report back on its internal quality control measures, review corporate culture and education, and encourage self-regulation before resorting to the resource-intensive exercise of audits, and the potential use of civil penalties and injunctions. The compliance stick would come at the tail end of government interaction.

The steps mentioned above are measures that Congress can take to encourage the IRS to move in this direction. For example, the possible legislative change that would require registration and certification of preparers²¹¹ could help facilitate this.²¹² This possible additional regulation could be the trigger for the IRS to meaningfully track information related to preparers and encourage better behavior, while at the same time keeping its powder dry for the egregious actors who need more traditional sanction-based approaches. It is to be hoped that the approaches I suggest will contribute to greater preparer visibility, responsibility and competence, and will ultimately allow for the IRS and preparers to genuinely work together to improve the accurate reporting of information on tax returns as well as make it more difficult for preparers to pass on inaccurate information to the IRS.

²¹¹ See Tax Administration Good Government Act, H.R. 1528, 108th Cong. § 141(a)(1)(A) (2004) (granting Secretary of Treasury with the power to require registration of federal income tax return preparers).

²¹² See GAO, 2007 Filing Season, *supra* note 63, at 18 (noting that in the event that Congress requires registration of preparers, a database could be used as a tracking system for enrollment and testing of preparers).

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