National Taxpayer Advocate
Annual Report to Congress

2011 Annual Report to Congress

NATIONAL TAXPAYER ADVOCATE

2011 ANNUAL REPORT TO CONGRESS

Volume Two: TAS Research & Related Studies

TAXPAYER ADVOCATE SERVICE

YOUR VOICE AT THE IRS

December 31, 2011

National Taxpayer Advocate

Annual Report to Congress

2011 Annual Report to Congress

NATIONAL TAXPAYER ADVOCATE

2011 ANNUAL REPORT TO CONGRESS

Volume Two: TAS Research & Related Studies

TAXPAYER ADVOCATE SERVICE

YOUR VOICE AT THE IRS

This page intentionally left blank.

Table of Contents

This page intentionally left blank.

National Taxpayer Advocate

Annual Report to Congress

2011 Annual Report to Congress

From Tax Collector to Fiscal Automaton: Demographic History of Federal Income Tax Administration, 1913-2011

From Tax Collector to Fiscal Automaton: Demographic History of Federal Income Tax Administration, 1913-2011[1]

[1] The principal author of this study is Eric A. San Juan, Senior Attorney-Advisor to the National Taxpayer Advocate.

EXECUTIVE SUMMARY

Background

Study of almost one hundred years of federal income tax administration reveals two trends. On one hand, the U.S. population as a whole grew, coupled with an increase in the percentage of the population required to file tax returns. On the other hand, the number of returns per Internal Revenue employee increased, not keeping pace with taxpayer population growth until the middle of the century. (See Table 1, Income Tax Demographic History.) These trends were facilitated by automation.

The automation of tax administration underlies the shift of revenue collection from an elite to a popular base, which has been famously titled in legal history as a transformation from "Class Tax to Mass Tax." What began as taxpayer interaction with local collectors became impersonal over the century.

Analysis

Taking the last 98 years under the federal income tax law in four parts, the period started with 1913 enactment, proceeded to 1939 codification, followed by 1954 recodification, and concluded with 1986 recodification and reform. In the end, this history poses questions for the future of tax administration.

Establishment of Income Tax as a "Class" Tax, 1913-1938

In 1913, Congress enacted a highly progressive income tax. This locally administered tax helped fund the American effort in World War I, and sustained the government during the Great Depression.

Transformation into a "Mass" Tax, 1939-1953

In 1942, a sweeping legislative transformation to fund the next war effort turned the mass of the populace into income taxpayers. Wartime popularization resulted in "a marriage of convenience that survived" between the American people and the income tax. The war revenue measure persisted into peacetime, forming a permanent national infrastructure.

Automation and Meltdown, 1954-1985

Post-World War II modernization proceeded along the lines of a centralized reorganization announced in 1952 as a dramatic break from a tradition of local collectors, which had become corrupted over time by bribery and its ilk. Centralization facilitated technological advancement in Service Centers and similar new sites. There, central processing proceeded in volumes that ultimately induced a computer and management meltdown in 1985. Thus, the risk associated with centralization appeared in this period.

Restructuring and an Emerging New Mission, 1986-2011

An accumulation of refundable credits in the last quarter century, after the 1975 enactment of the Earned Income Tax Credit (EITC), added disbursement to the IRS's role of revenue collection. In 1998, legislation eliminated vestiges of local administration by restructuring the IRS into functional divisions (each with nationwide scope). Modernized after the meltdown, IRS computer systems generated results like an automaton, without the intervention of human judgment. The uniformity of the mass tax thus arrived at an extreme.

Conclusion with Recommendations

In short, the IRS started as a revenue bureau but now administers social expenditures as well, through highly automated systems. Automation, with standard forms and procedures, was necessitated by the return volume of the mass tax introduced in 1942. As described by early 20th-century sociologists, formal standardization allowed government offices to administer a large volume of cases efficiently and dispassionately but at a cost of substantive discretion, "without regard for persons" in a "dehumanized" manner.

Automation was compounded by geographic centralization of command designed to combat local corruption. This combination of automation and centralization posed the question of whether the tax system had grown into a conglomerate beyond controls that could eliminate the risk of meltdown. Over time, this tax system was increasingly characterized by complexity. Ironically, complex, centralized automation could seem inappropriate in some respects for late 20th and early 21st-century mandates to deliver benefits to a diversity of targeted populations (such as low income workers qualifying for the EITC).

The lessons of history include the mid-century effort to popularize the income tax as well as reliance on automation, all in the context of a diversifying taxpayer base. History poses a question whether steadily increasing volume can be addressed simply by more automation, which presumably would work if taxpayers were uniform, or if increased diversity along with increased volume raises qualitatively different challenges.

Generally, history can be useful if studied systematically. Toward that end, Volume 1 of this report contains a Legislative Recommendation: *Appoint an IRS Historian.* Likewise, taxpayer diversity can be understood if studied systematically. Accordingly, Volume 1 in the Most Serious Problems section contains an Introduction to Diversity Issues: *The IRS Should Do More to Accommodate Changing Taxpayer Demographics*, with associated recommendations.

TABLE 1, Income Tax Demographic History

Year	Event	Indiv. returns (Mn)[2]	As a % of	U.S. pop. (Mn)[3]	Int. Rev. employees[4]	All returns (Mn)[5]	Returns/ employee
1913	Income tax law enacted	0.358	0.368	97.2	4,000	0.675	169
1914	F. 1040 introduced	0.358	0.361	99.1	3,972	0.657	165
1916	Emergency Revenue Act	0.437	0.429	102.0	4,718	0.778	165
1917	Withholding repealed; war profit tax	3.47	3.36	103.3	5,053	3.86	764
1924	Revenue Act, EIC, BTA	7.37	6.46	114.1	15,884	8.11	511
1930	*Lucas v. Earl, Poe v. Seaborn*	3.85	3.13	123.2	11,979	5.30	442
1935	Social Security Act	4.67	3.67	127.4	16,523	5.32	322
1939	IRC codified	6.47	4.94	131.0	22,623	7.16	316
1942	Revenue Act, Tax Court of U.S.	26.3	19.5	134.9	29,065	27.8	956
1943	Current Payment Tax Act	37.0	27.1	136.7	36,338	40.5	1,115
1944	Individual Income Tax Act	47.1	34.0	138.4	46,171	52.7	1,141
1948	Revenue Act, joint filing	52.1	35.5	146.6	52,143	74.4	1,427
1953	BIR renamed as IRS	57.8	36.1	160.2	53,463	93.2	1,743
1954	IRC recodified	56.7	34.8	163.0	51,411	88.9	1,729
1969	Tax Reform Act	75.8	37.4	202.7	66,064	110.7	1,676
1975	Tax Reduction Act	82.2	38.1	216.0	82,616	126.0	1,525
1976	Tax Reform Act	84.7	38.8	218.0	85,455	127.1	1,487
1978	TCE established	89.8	40.3	222.6	86,258	136.7	1,585
1982	TEFRA; F. 1040EZ introduced	95.3	41.0	232.2	83,756	170.4	2,034
1986	Tax Reform Act recodified IRC	103.0	42.8	240.7	96,395	188.0	1,950
1988	Taxpayer Bill of Rights	109.7	44.8	245.0	115,494	194.3	1,682
1996	Taxpayer Bill of Rights II	120.4	44.6	269.7	107,751	208.9	1,939
1998	Restructuring & Reform Act	124.8	45.2	276.1	111,712	224.5	2,009
2001	EGTRRA	130.3	45.6	285.5	97,707	227.9	2,332
2010	Affordable Care Act	141.2	45.7	308.7	107,621	230.4	2,141

2 IRS Statistics of Income (SoI) Hist. Summary (1913-1965) Table 38 at 207-08; Comm'r of Int. Rev. (CIR) Ann'l Rep'ts (1939-1943); SoI Bull. Hist. Data Table 9 (1950-2008); IRS Pub. 55B, Data Book (2010).

3 U.S. Bur. of the Census, Statistical Abstract of the U.S. (2003) No. HS-1, *Population*: 1900-2002; Census, *Population Distrib'n & Change*: 2000 to 2010 (Mar. 2011).

4 IRS Pub. 1694 at 249-50; Pub. 55B (1996-2010).

5 SoI, 1916 (1913-1916) at 14-15 (including personal & corporate income tax returns but no excises, which would have been measured more accurately by gallons, pounds, or warehouses, as the case may be, rather than returns); SoI, 1917 at 7 & 15 (including personal, corporate & partnership income tax returns but no excises); SoI, 1924 at 1 & 12 (including personal, corporate & partnership income tax returns but no excises); Work and Jurisdiction of Bir at XI, Table III (1927-1947) (including income, profit, estate & gift tax returns but not excises); Comm'r of Int. Rev. (CIR) Ann'l Rep'ts (1948-1988); Pub. 55B (1996-2010).

TABLE 2, Personal Exemptions and Lowest and Highest Bracket Tax Rates, and Tax Base for Regular Tax, 1913-2011[6]

Year	Personal exemptions			Tax rates for regular tax			
				Lowest bracket		Highest bracket	
	Single persons ($)	Married couples ($)	Dependents ($)	Tax rate (%)	Taxable income under ($)	Tax rate (%)	Taxable income over ($)
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
1913	3,000	4,000	N/A	1.0	20,000	7.0	500,000
1914	3,000	4,000	N/A	1.0	20,000	7.0	500,000
1915	3,000	4,000	N/A	1.0	20,000	7.0	500,000
1916	3,000	4,000	N/A	2.0	20,000	15.0	2,000,000
1917	1,000	2,000	200	2.0	2,000	67.0	2,000,000
1918	1,000	2,000	200	6.0	4,000	77.0	1,000,000
1919	1,000	2,000	200	4.0	4,000	73.0	1,000,000
1920	1,000	2,000	200	4.0	4,000	73.0	1,000,000
1921	1,000	2,500	400	4.0	4,000	73.0	1,000,000
1922	1,000	2,500	400	4.0	4,000	58.0	200,000
1923	1,000	2,500	400	3.0	4,000	43.5	200,000
1924	1,000	2,500	400	1.5	4,000	46.0	500,000
1925	1,500	3,500	400	1.125	4,000	25.0	100,000
1926	1,500	3,500	400	1.125	4,000	25.0	100,000
1927	1,500	3,500	400	1.125	4,000	25.0	100,000
1928	1,500	3,500	400	1.125	4,000	25.0	100,000
1929	1,500	3,500	400	0.375	4,000	24.0	100,000
1930	1,500	3,500	400	1.125	4,000	25.0	100,000
1931	1,500	3,500	400	1.125	4,000	25.0	100,000
1932	1,000	2,500	400	4.0	4,000	63.0	1,000,000
1933	1,000	2,500	400	4.0	4,000	63.0	1,000,000
1934	1,000	2,500	400	4.0	4,000	63.0	1,000,000
1935	1,000	2,500	400	4.0	4,000	63.0	1,000,000
1936	1,000	2,500	400	4.0	4,000	79.0	5,000,000
1937	1,000	2,500	400	4.0	4,000	79.0	5,000,000
1938	1,000	2,500	400	4.0	4,000	79.0	5,000,000
1939	1,000	2,500	400	4.0	4,000	79.0	5,000,000
1940	800	2,000	400	4.4	4,000	81.1	5,000,000
1941	750	1,500	400	10.0	2,000	81.0	5,000,000
1942	500	1,200	350	19.0	2,000	88.0	200,000

Table continued on next page.

6 Updated from IRS SoI Historical Table 23; for detailed annotations, see Table 23 at http://www.irs.gov/taxstats/article/0,,id=175910,00.html.

Year	Personal exemptions			Tax rates for regular tax			
				Lowest bracket		Highest bracket	
	Single persons ($)	Married couples ($)	Dependents ($)	Tax rate (%)	Taxable income under ($)	Tax rate (%)	Taxable income over ($)
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
1943	500	1,200	350	19.0	2,000	88.0	200,000
1944	500	1,000	500	23.0	2,000	94.0	200,000
1945	500	1,000	500	23.0	2,000	94.0	200,000
1946	500	1,000	500	19.0	2,000	86.45	200,000
1947	500	1,000	500	19.0	2,000	86.45	200,000
1948	600	1,200	600	16.6	4,000	82.13	400,000
1949	600	1,200	600	16.6	4,000	82.13	400,000
1950	600	1,200	600	17.4	4,000	84.36	400,000
1951	600	1,200	600	20.4	4,000	91.0	400,000
1952	600	1,200	600	22.2	4,000	92.0	400,000
1953	600	1,200	600	22.2	4,000	92.0	400,000
1954	600	1,200	600	20.0	4,000	91.0	400,000
1955	600	1,200	600	20.0	4,000	91.0	400,000
1956	600	1,200	600	20.0	4,000	91.0	400,000
1957	600	1,200	600	20.0	4,000	91.0	400,000
1958	600	1,200	600	20.0	4,000	91.0	400,000
1959	600	1,200	600	20.0	4,000	91.0	400,000
1960	600	1,200	600	20.0	4,000	91.0	400,000
1961	600	1,200	600	20.0	4,000	91.0	400,000
1962	600	1,200	600	20.0	4,000	91.0	400,000
1963	600	1,200	600	20.0	4,000	91.0	400,000
1964	600	1,200	600	16.0	1,000	77.0	400,000
1965	600	1,200	600	14.0	1,000	70.0	200,000
1966	600	1,200	600	14.0	1,000	70.0	200,000
1967	600	1,200	600	14.0	1,000	70.0	200,000
1968	600	1,200	600	14.0	1,000	75.25	200,000
1969	600	1,200	600	14.0	1,000	77	200,000
1970	625	1,250	625	14.0	1,000	71.75	200,000
1971	675	1,350	675	14.0	1,000	70.0	200,000
1972	750	1,500	750	14.0	1,000	70.0	200,000
1973	750	1,500	750	14.0	1,000	70.0	200,000
1974	750	1,500	750	14.0	1,000	70.0	200,000
1975	750	1,500	750	14.0	1,000	70.0	200,000
1976	750	1,500	750	14.0	1,000	70.0	200,000
1977	750	1,500	750	14.0	3,200	70.0	203,200
1978	750	1,500	750	14.0	3,200	70.0	203,200

Table continued on next page.

Year	Personal exemptions			Tax rates for regular tax			
				Lowest bracket		Highest bracket	
	Single persons ($)	Married couples ($)	Dependents ($)	Tax rate (%)	Taxable income under ($)	Tax rate (%)	Taxable income over ($)
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
1979	1000	2,000	1,000	14.0	3,400	70.0	215,400
1980	1000	2,000	1,000	14.0	3,400	70.0	215,400
1981	1000	2,000	1,000	14.0	3,400	69.1	215,400
1982	1000	2,000	1,000	12.0	3,400	50.0	85,600
1983	1000	2,000	1,000	11.0	3,400	50.0	109,400
1984	1000	2,000	1,000	11.0	3,400	50.0	162,400
1985	1040	2,080	1,040	11.0	3,540	50.0	169,020
1986	1080	2,160	1,080	11.0	3,670	50.0	175,250
1987	1900	3,800	1,900	11.0	3,000	38.5	90,000
1988	1950	3,900	1,950	15.0	29,750	28.0	29,750
1989	2000	4,000	2,000	15.0	30,950	28.0	30,950
1990	2050	4,100	2,050	15.0	32,450	28.0	32,450
1991	2150	4,300	2,150	15.0	34,000	31.0	82,150
1992	2300	4,600	2,300	15.0	35,800	31.0	86,500
1993	2350	4,700	2,350	15.0	36,900	39.6	250,000
1994	2450	4,900	2,450	15.0	38,000	39.6	250,000
1995	2500	5,000	2,500	15.0	39,000	39.6	256,500
1996	2550	5,100	2,550	15.0	40,100	39.6	263,750
1997	2650	5,300	2,650	15.0	41,200	39.6	271,050
1998	2700	5,400	2,700	15.0	42,350	39.6	278,450
1999	2750	5,500	2,750	15.0	43,050	39.6	283,150
2000	2800	5,600	2,800	15.0	43,850	39.6	288,350
2001	2900	5,800	2,900	10.0	6,000	39.1	297,350
2002	3000	6,000	3,000	10.0	12,000	38.6	307,050
2003	3050	6,100	3,050	10.0	14,000	35.0	311,950
2004	3100	6,200	3,100	10.0	14,300	35.0	319,100
2005	3200	6,400	3,200	10.0	14,600	35.0	326,450
2006	3300	6,600	3,300	10.0	15,100	35.0	336,550
2007	3400	6,800	3,400	10.0	15,650	35.0	349,700
2008	3500	7,000	3,500	10.0	16,050	35.0	357,700
2009	3650	7,300	3,650	10.0	16,700	35.0	372,950
2010	3650	7,300	3,650	10.0	16,750	35.0	373,650
2011	3700	7,400	3,700	10.0	17,000	35.0	379,150

TABLE 3, Tax Share by Income Level[7]

Year	Top % of Individual Returns[8]	Income Tax (%)[9]
2005	2.7	51.3
1995	1.9	36.6
1985	2.4	29.9
1975	1.2	22.1
1965	2.4	30.0
1955	1.8	29.8
1945	2.5	39.3
1935	2.6	83.7
1925	2.1	85.4
1915	2.1	49.5

TABLE 4, Individual Income Tax as a Percentage of Revenue[10]

Year	Income Tax ($ Bn)	Total Revenue ($ Bn)	%
1914	0.03	0.38	7
1927	0.91	2.87	32
1939	1.03	5.18	20
1953	32.5	69.7	47
1954	32.8	69.9	47
1985	396.7	742.9	53
1986	416.6	782.3	53
2010	1,176.0	2,345.1	50

7 TAS Research on IRS data from CIR Ann'l Rep't (1915), SoI (1925-2005).

8 For 1945-2005, by Adjusted Gross Income; 1915-1935, by net income. Note qualification as to completeness of data in CIR Ann'l Rep't (1915) at 24.

9 For 1955-2005, tax after credits; 1915-1945, tax liability.

10 *See infra* nn. 25, 46, 132, 183-84, & 290-91.

TABLE 5, Percentage of Women Filers

Year	Individual Income Tax Returns (Mn)	Women Filing as Single, Separate, or Head of Household (Mn)	%
1916[11]	0.437	0.0345	8
1938[12]	6.15	1.27	21
1953[13]	57.8	10.8	19
1969[14]	66.7	13.1	20
1979[15]	81.7	20.1	25
1989	94.4	26.5	28
1999	105.5	32.8	31

11 *See infra* n. 66.

12 *See infra* n. 68.

13 *See infra* n. 126.

14 For 1969, see Ellen Yau, Kurt Gurka & Peter Sailer, *Comparing Salaries and Wages of Women Shown on Forms W-2 to Those of Men, 1969-1999*, SOI Bull. (Fall 2003) 274, 278-79, Table 1 (relating to returns with net income).

15 For 1979-1999, *see id*.

I. Introduction

When the federal individual income tax was enacted in 1913, it applied to high-income taxpayers. At that time, the predecessor bureau to the IRS started as a hands-on collector of various tariffs, excise taxes, and other revenues. In 1942, Congress enacted the "greatest tax bill in American history" largely to fund the U.S. effort in World War II, expanding the income tax to the middle class.[16] At that time, the Treasury made an historic effort to popularize the income tax, famously deploying the Disney cartoon character Donald Duck as a mascot of the public fisc.[17] A parallel effort to popularize the income tax among a diversifying taxpayer base has not occurred since then.

In the second half of the last century, the tax system was automated. During this period, women became a more significant taxpayer population. In recent decades, a diverse low income population has emerged as an important customer base of an increasingly "faceless" IRS. In short, a history of the past century of income tax administration can be characterized as a transformation "From Tax Collector to Fiscal Automaton," because the IRS started as a revenue bureau but now administers social expenditures as well, through highly automated systems.

II. Establishment of Income Tax as a "Class" Tax, 1913-1938

During the first 25 of the years under study, the federal individual income tax was established as a levy on a high-income population. The income tax helped fund the American effort in World War I, and after reductions during a postwar economic expansion, sustained the government during the Great Depression. During this period, the number of employees of the Treasury's Bureau of Internal Revenue (BIR) multiplied,[18] while legislative, administrative, and decisional law formed a foundation for taxpayer rights.

A. Tax Law Events

1. Constitutional Amendment and World War I, 1913-1918

In 1913, a requisite number of states ratified the Sixteenth Amendment, affirming constitutional authority to tax income.[19] That year, Congress enacted, and President Woodrow Wilson signed, legislation imposing tax of one percent on individual income over $3,000 ($4,000 for married couples), up to seven percent on incomes over $500,000.[20] The average American worker, putting in 12 hours a day and earning $800 a year, remained unaffected

16 Randolph Paul, Taxation in the United States (Boston: Little, Brown & Co., 1954) 294 *ff.*

17 Carolyn Jones, *Class Tax to Mass Tax: The Role of Propaganda in the Expansion of the Income Tax During World War II*, 37 Buff. L. Rev. 685 (1989). "Public fisc" is a figure of speech for the Government's Treasury. *See, e.g., Ariz. Christian School Tuition Org'n v. Winn*, 563 U.S. ____, 131 S. Ct. 1436, 1457 (2011) (Kagan, J. dissenting); Exec. Ord. 12,630, 53 Fed. Reg. 8,859 (Mar. 15, 1988) §§ 1(c), 3(a), 3(e) (signed by Pres. Reagan).

18 In 1913, the BIR had 4,000 employees; in 1938, 22,045. IRS Pub. 1694, IRS Historical Fact Book: A Chronology, 1646-1992 at 249.

19 U.S. Const. 16th amend.

20 Pub. L. No. 63-16; *see also* Pub. 1694 at 86. This legislation allowed a personal exemption deduction of $3,000 (comparable to more than $65,000 in 2011) plus $1,000 for a spouse.

by the tax.[21] The legislation, which also taxed corporate income, provided for income tax withholding by certain payers of income.[22]

Until this time, the BIR had administered assorted excises and tariffs relating to alcohol, tobacco, oleomargarine, and stamps.[23] To implement the income tax, the BIR on January 5, 1914, issued a four-page tax return with instructions, numbered in the ordinary sequence of forms and still known as the ubiquitous Form 1040.[24] That year, individual income tax accounted for less than eight percent of BIR collections.[25]

On September 8, 1916, months before entering World War I, President Wilson signed a popularly-named Emergency Revenue Act, doubling the income tax from one to two percent on incomes above $3,000 ($4,000 for married couples).[26] A surtax on incomes above $20,000 was increased on a graduated scale to a maximum rate of 15 percent.[27]

In 1917, Congress declared war and subsequently raised the income tax as high as 67 percent.[28] That same year, after public criticism, especially complaints from employers and employees about administrative burden and effective pay reduction, and a recommendation from Treasury Secretary William McAdoo, Congress repealed withholding, also known as collection at the source, but left in its place information reporting, or information at the source.[29]

By 1918, only about 15 percent of American families had to pay income taxes, and the tax payments of the wealthiest one percent of American families accounted for about 80

21 Pub. 1694 at 86; *see also supra* Table 3, Tax Share by Income Level.

22 Pub. L. No. 63-16. Generally, this legislation required withholding by insurance companies or other payers of periodic income, and by fiduciaries or others in custody of income of another over $3,000.

23 Comm'r of Int. Rev. (CIR) Ann'l Rep't FYE June 30, 1920 (Washington, DC: Gov't Printing Ofc.) 8. Like alcohol and tobacco, oleomargarine was an agricultural product subject to government regulation through an excise tax, under the Oleomargarine Tax Act of 1886, 24 Stat. 209, forming a not insignificant subject of tax law. *See McCray v. U.S.*, 195 U.S. 27 (1904) (upholding tax); *Miller v. Standard Nut Margarine Co.*, 284 U.S. 498 (1932) (construing scope of tax). The oleomargarine tax had a history reflecting the role of an excise in the economics of a particular product (in competition with the dairy industry in this case) beyond the scope of this study on income tax demographic history. *See* S. Rept. 81-309, 81st Cong. 1st Sess. (Apr. 28, 1949). On Mar. 23, 1950, Pres. Truman signed the Margarine Act, Pub. L. No. 81-459, by which Congress repealed the oleomargarine tax.

24 Pub. 1694 at 87; *see infra* Appdx. 1, Form 1040, *Return of Ann'l Net Income of Individuals* (1913).

25 CIR Ann'l Rep't FYE June 30, 1914, at 3.

26 Pub. L. No. 64-271, 39 Stat. 756; *see also* Pub. 1694 at 90. In addition to impending war, expenses like those for Mexican border patrol required revenue. *See* Paul, Taxation in the U.S. at 110.

27 Pub. 1694 at 90. For rates and brackets, see *supra* Table 2, Personal Exemptions and Lowest and Highest Bracket Tax Rates, and Tax Base for Regular Tax, 1913-2011; Pub. 1694 at 251.

28 Paul, Taxation in the U.S. at 113; Pub. 1694 at 251. The highest rate applied to a $2,000,000 bracket. For rates and brackets, see *supra* Table 2, Personal Exemptions and Lowest and Highest Bracket Tax Rates, and Tax Base for Regular Tax, 1913-2011; *see also* Pub. 1694 at 251. The 1917 legislation allowed a personal exemption deduction of $200 (comparable to almost $3,500 in 2011) for a dependent child. *See* Pub. L. No. 65-50, § 1203; *see also infra* Appdx. 2, Form 1040, *Individual Income Tax Return* for CY 1917, pg. 4, line 6.

29 *See* Charlotte Twight, *Evolution of Federal Income Tax Withholding: The Machinery of Institutional Change*, 14 Cato J. 3 (Winter 1995); Rob't Higgs, *Wartime Origins of Modern Income-Tax Withholding*, The Freeman (Dec. 24, 2007). Information reporting required a Form 1099 "setting forth the amount of such gains, profits, and income and the name and address of the recipients of such income." Treas. Reg. 33, Art. 34 (1918), reflecting Pub. L. No. 65-50.

percent of the revenues from the individual income tax. This wealthiest one percent of taxpayers paid marginal tax rates ranging from 15 to 77 percent.[30]

2. Progressivity and Transparency, 1919-1925

In 1919, individual and corporate income including excess profit taxes amounted to almost 68 percent of BIR collections.[31] At the same time, the federal individual income tax was steeply progressive. "A married man earning the average family income of about $2,300 would have owed no income tax. A better-off family earning $5,000 would owe just $51, while a very wealthy family with income of $100,000 would owe $22,557."[32] By 1923, the income tax affected only 12 percent of families.[33]

In 1923, the Treasury, in a plan of Secretary Andrew Mellon, proposed rate reductions, an earned income credit (EIC), and capital loss provisions, along with repeal of certain excises.[34] Secretary Mellon defended his proposed EIC, which at that time was for the wealthy who paid income tax, as follows:

> The fairness of taxing more lightly incomes from wages, salaries, or from investments is beyond question. In the first case, the income is uncertain and limited in duration; sickness or death destroys it and old age diminishes it; in the other, the source of income continues; the income may be disposed of during a man's life and it descends to his heirs.[35]

At that time, Secretary Mellon did not criticize taxes on savings. On June 2, 1924, President Calvin Coolidge signed a Revenue Act significantly reducing income taxes and establishing the EIC.[36] Tax reduction came at a time of postwar return to normalcy, economic growth, and politics associated with the Administration and Secretary Mellon (who was perceived by some as a Wall Street icon) that commentators branded "benevolent oligarchy."[37]

The Revenue Act of 1924 also contained significant procedural provisions. First, it allowed for the public listing of the name, address, and payment amount of every taxpayer, as well

30 W. Elliot Brownlee, Federal Taxation in America: A Short History, 2nd ed. (Cambridge Univ. Press, 2004) 63; *see also supra* Table 3, Tax Share by Income Level.

31 CIR Ann'l Rep't FYE June 30, 1920, at 8. Excess profit taxes were war revenue measures imposed on income and gain of individuals and corporations over a floor enacted to approximate "normal" peacetime income. *See* Paul, Taxation in the U.S. at 118.

32 Anne L. Alstott & Ben Novick, *War, Taxes, and Income Redistribution in the Twenties: The 1924 Veterans' Bonus and the Defeat of the Mellon Plan*, 59 Tax L. Rev. 373, 393 (2006).

33 59 Tax L. Rev. at 394; *see also supra* Table 3, Tax Share by Income Level.

34 Paul, Taxation in the U.S. at 132.

35 Andrew W. Mellon, Taxation: The People's Business (NY: Macmillan, 1924) 56-57, quoted in Brownlee, Fed. Taxation at 77.

36 Pub. L. No. 68-176, 43 Stat. 253. Generally, the EIC was 25 percent of up to $10,000 (comparable to almost $130,000 in 2011) in wages, salary, and personal service compensation less allocable deductions, but unearned income up to $5,000 was creditable in any case. Pub. L. No. 68-176, § 209. Despite its particular name, the original EIC had a tax reduction effect across the board. By contrast, Congress was to enact a refundable Earned Income Tax Credit in 1975 as a targeted anti-poverty measure, a decade after the introduction of refundable credits, as discussed below.

37 Paul, Taxation in the U.S. at 132.

as disclosure on request of congressional committees, state officials, and as prescribed by regulation, the public.[38]

Second, the Act created a Board of Tax Appeals (BTA) as an adjudicator to supersede an administrative committee that had advised the Commissioner of Internal Revenue on appeals of assessments before payment.[39] Later that year, the appeal process was further professionalized when the BTA ruled that Certified Public Accountants and attorneys were the only representatives qualified to appear before them on behalf of taxpayers.[40] The BTA turned out to be popular enough that three years later, with 18,000 appeals pending, the Commissioner formed a committee of external members and revenue agents to help clear the docket.[41] This committee was to be the forerunner of the IRS Appeals function.[42]

3. Great Depression and Tax Enforcement, 1926-1934

As had those of 1921 and 1924, the Revenue Act of 1926 generally reduced taxes, lowering the top marginal individual income tax rate from 46 to 25 percent.[43] Nevertheless, post-World War I economic growth facilitated ongoing reliance on income tax rather than excises and tariffs, while policymakers continued to advocate for a broad income tax.[44] Progressive Congressman Cordell Hull (D-Tenn.) insisted that a "tax system vitally important as is the income tax should apply to a respectable number of persons."[45] In 1927, individual income tax alone accounted for almost 32 percent of BIR collections.[46]

The Revenue Act of 1928, which notably reduced corporate tax, expanded the BIR's interpretive power by authorizing prospective application of Treasury Regulations, even when a regulation reflected not new law but a court-ordered interpretation of pre-existing law.[47] Consequently, the BIR could be perceived as a lawmaker.[48] Practically, this legislation obviated a need to re-open settled cases upon a regulatory change; theoretically, the Act effectively elevated the tax regulator from the role of mere interpreter of pre-existing law.[49]

38 Pub. L. No. 68-176, § 257; *see also* Dep't of the Treas., *Rep't to the Congress on Scope and Use of Taxpayer Confidentiality and Disclosure Provisions* (Oct. 2000); Jt. Comm. on Tax'n (JCT), *Study of Present-Law Taxpayer Confidentiality and Disclosure Provisions as Required by Section 3802 of the Internal Revenue Service Restructuring and Reform Act of 1998*, JCS-1-00 (Jan. 28, 2000).

39 Paul, Taxation in the U.S. at 136.

40 BTA Rule 2, 1924-2 Cum. Bull. 428 (July 19, 1924).

41 Pub. 1694 at 114.

42 *Id*.

43 Pub. L. No. 69-20, 44 Stat. 9; *see also* Pub. 1694 at 252.

44 59 Tax L. Rev. at 384.

45 Quoted in Jos. J. Thorndike, *The Republican Roots of New Deal Tax Policy*, Tax Analysts (Aug. 28, 2003) at www.taxhistory.org.

46 CIR Ann'l Rep't FYE June 30, 1927, Table 1 at 53; *see also supra* Table 3, Tax Share by Income Level.

47 Pub. L. No. 70-562, 45 Stat. 791.

48 This perception arose at a time when a school of thought known as legal realism was casting aside a notion of law as a formal essence of which courts were mere interpreters in favor of a realist depiction of law as that which judges decide in practice. *See* Morton J. Horwitz, *Legal Realism, the Bureaucratic State, and the Rule of Law*, The Transformation of American Law, 1870-1960: The Crisis of Legal Orthodoxy (Oxford Univ. Press, 1992) 213-46.

49 Paul, Taxation in the U.S. at 140.

In 1929, the stock market crash brought an end to a decade of tax reduction, ushering in the Great Depression.[50] In 1930, high-level courts handed down three decisions affecting federal income taxation.

The Supreme Court denied the effect for federal tax purposes of California businessman Guy Earl's assignment of income to his wife.[51] Had the couple been able to split income by contract, each of them potentially could have come under a lower bracket.[52] Later, that result was achieved by operation of law for another West Coast couple, when the Court opined that the European-style community property regime in the State of Washington automatically made spouses owners of half of each other's income.[53]

The Federal Court of Appeals in New York created the so-called Cohan rule by allowing a reasonable amount of business deductions by Broadway star George M. Cohan even though he could not produce receipts.[54] Taken together, these court cases demonstrate that the federal income tax was inextricably involved in American family and business affairs.

The Revenue Act of 1934 imposed graduated tax on capital gain, and restored the EIC, which had lapsed two years earlier.[55] This Act also codified the positions of General Counsel of the Treasury and Assistant General Counsel for Internal Revenue, whose first incumbent was Robert Jackson, later to become a Supreme Court Justice.[56]

Underscoring the role of government tax attorneys, in 1934 the Roosevelt administration's Justice Department brought former Secretary Mellon before a grand jury, which declined to indict him for some $3 million of asserted deficiencies.[57] Instead, the BTA heard and ultimately accepted the magnate's version of his case, revolving around deductions of charitable donations intended for a National Gallery of Art.[58] This case exemplifies how high-profile tax enforcement had become.

4. Social Security and Tax Compliance, 1935-1938

In 1935, Congress enacted and President Roosevelt signed the popularly-named Wealth Tax Act, increasing surtax rates on income above $50,000 from 63 to 79 percent.[59] Moreover, that year saw enactment of the Social Security Act, financing new social insurance benefits

50 *See* Paul, Taxation in the U.S. at 148.

51 *Lucas v. Earl*, 281 U.S. 111 (1930).

52 Patricia A. Cain, *The Story of Earl: How Echoes (and Metaphors) from the Past Continue to Shape the Assignment of Income Doctrine*, Tax Stories: An In-Depth Look at Ten Leading Federal Income Tax Cases (NY: Foundation Press, 2002).

53 *Poe v. Seaborn*, 282 U.S. 101 (1930).

54 *Cohan v. Comm'r of Int. Rev.*, 39 F.2d 540 (2nd Cir. 1930).

55 Pub. L. No. 73-216, 48 Stat. 680. The 1934 Act allowed marital exemptions and dependency credits for surtax purposes. Paul, Taxation in the U.S. at 179. Subsequently, the Rev. Act of 1943, Pub. L. No. 78-235, § 107, 58 Stat. 21, would repeal the EIC.

56 Pub. 1694 at 122.

57 Paul, Taxation in the U.S. at 151.

58 *Mellon v. Comm'r*, 37 BTA 977 (1937).

59 Pub. L. No. 74-407, 49 Stat. 1014; *see also* Pub. 1694 at 127.

through a payroll tax on employers and employees of one percent of the first $3,000 of salaries and wages (comparable to almost $50,000 in 2011), collected through withholding administered by the BIR on behalf of a Trust Fund.[60] The same year, less than a quarter century after the enactment of the income tax, the Supreme Court famously characterized taxes as "the lifeblood of government, and their prompt and certain availability an imperious need."[61]

In 1937, concern with tax ethics prompted legislation to prevent tax avoidance. For example, a reported tax avoidance device was to incorporate country estates as businesses to convert personal expenses into business deductions.[62] In 1938, legislation expanded the use of closing agreements, which had been in place for ten years, as a settlement mechanism between a taxpayer and the BIR.[63] Thus, concerns with compliance and compromise that persist today already had appeared before World War II.

B. Demographic Trends

While the federal income tax grew from a minor into a major source of government revenue, the economy went from post-World War I growth to the Great Depression. Unemployment peaked, but before "and after the Great Depression, unemployment was largely a blue-collar affliction."[64] Meanwhile, the income tax affected a high-income population composed largely of white businessmen and professionals.[65]

In 1916, married women filing separately and single women filed less than eight percent of income tax returns reflecting less than ten percent of income or of tax.[66] Merchants, manufacturers, lawyers, and doctors filed more than 27 percent of returns.[67] In 1938, married and single women filed on their own (not counting community property filings) almost 21 percent of returns reflecting more than 15 percent of income.[68]

Despite the boom and bust of economic cycles, attitudinal trends established in the first quarter of the century stabilized, as measured by the following items within

60 Pub. L. No. 74-271, 49 Stat. 620; *see also* Pub. 1694 at 127.

61 *Bull v. U.S.*, 295 U.S. 247, 259 (1935).

62 Paul, Taxation in the U.S. at 207.

63 Pub. L. No. 75-554 (1938), § 801, 52 Stat. 447, amending Pub. L. No. 70-562 (1928), § 606.

64 Theo. Caplow, Louis Hicks & Ben J. Wattenberg, The First Measured Century: An Illustrated Guide to Trends in America, 1900-2000 (Amer. Enterprise Inst. 2001) 46.

65 Although taxpayer statistics were not reported by race, between 1910 and 1920, 31 to 23 percent of the population identified as "Negro and other" was illiterate, compared to five to four percent of the Native and Foreign-born White population. U.S. Bur. of the Census, Historical Statistics of the U.S.: Colonial Times to 1970 (1975) H664-668 at 382. At least in the early years, a significant proportion of people subject to income tax were in occupations requiring literacy. By 1938, the scope of the income tax had expanded, yet there was still a $1,000 exemption (comparable to more than $15,000 in 2011). *See supra* Table 2, Personal Exemptions and Lowest and Highest Bracket Tax Rates, and Tax Base for Regular Tax, 1913-2011; Pub. 1694 at 252.

66 CIR, Statistics of Income, 1916 (Washington: GPO, 1918) 6-7.

67 Statistics of Income, 1916 at 5 & 7.

68 Statistics of Income, 1938, Pt. I at 20.

a questionnaire administered in a famous long-term study of the pseudonymous Middletown, which has become a bellwether in American sociology:[69]

- It is entirely the fault of a man himself if he does not succeed.
- The fact that some people have so much more money than others shows that there is an unjust condition in this country that ought to be changed.

In 1924, 47 percent of respondents agreed with the first statement, and 30 percent, the second; 1977, 47 and 38 percent, respectively; and 1999, 65 and 44 percent, respectively.[70] According to the pollsters, rates of agreement or disagreement with these statements "did not vary dramatically" over these years in general.[71] To the extent that an individualist ethic has prevailed in the U.S., it has not wavered greatly. While some were to argue that the federal income tax was a shared responsibility, this evidently did not alter social attitudes as surveyed in Middletown.

C. Implications for Service

In 1913, the BIR added to its organizational design a Personal Income Tax Division, a Correspondence Unit to answer questions about the new tax, and a legal counsel function to prepare opinions interpreting the legislation, totaling 277 employees in Washington, D.C. and 3,723 around the country.[72] In 1914, field personnel included 63 Collectors (who were political appointees), 1,568 deputy collectors, 40 Internal Revenue Agents, 34 income tax agents, 13 corporate agents, and two corporate inspectors.[73] Even then

> a steady stream of employees with valuable training and experience flowed out of the Bureau to more lucrative jobs in private offices. In the nine months between October 1, 1919, and June 31, 1920, nearly one thousand employees left the revenue service.[74]

---

69 Caplow, First Measured Century at 188. Since 1923, Middletown (Muncie, Indiana) has been the subject of landmark research on American social institutions, where replication of surveys over time permits inferences about evolution of values. *See* Rob't & Helen Lynd, Middletown: A Study in Modern American Culture (NY: Harcourt Brace, 1929), Middletown in Transition: A Study in Cultural Conflicts (NY: Harcourt Brace, 1937); Caplow, *et al*., Middletown Families: Fifty Years of Change and Continuity (Minneapolis: Univ. of Minn. Press, 1982), All Faithful People: Change and Continuity in Middletown's Religion (Minneapolis: Univ. of Minn. Press, 1983).

70 Caplow, First Measured Century at 189.

71 *Id*. at 188 ("the percentage of Middletown adolescents agreeing with the Protestant Ethic remained level from 1924 to 1977 but increased from 1977 to 1999, while the proportion agreeing with action against economic inequality increased in each of the three surveys from 1924 to 1999").

72 Pub. 1694 at 87.

73 CIR, The Work and Jurisdiction of the Bureau of Internal Revenue (Washington: GPO, 1948) 95. From the Civil War through codification in 1939, Collectors (or their predecessors) were appointees of the President upon the advice and consent of the Senate. *See* Rev. Act of 1862, ch. 119, § 5, 12 Stat. 422, 423 (June 7, 1862); Rev. Act of 1872, ch. 13, 17 Stat. 401 (Dec. 24, 1872); Int. Rev. Code of 1939, § 3941. In 1862, their salary was $3,000 per year (comparable to more than $65,000 in 2011). *See* 12 Stat. 423. In 1914, 53 Collectors received $4,500 (comparable to $100,000 in 2011) in salary while the other 10 received between $3,442 and $4,329. *See* CIR Ann'l Rep't FYE June 30, 1914, at 8. In addition to salary, the '39 Code memorializes the authority of the Treasury Secretary "to make such further allowances, from time to time, as may be reasonable, in cases in which, from the territorial extent of the district, or from the amount of internal revenue taxes collected, it may seem just to make such allowances" to Collectors or Deputy Collectors. Int. Rev. Code of 1939, §§ 3944, 3990. The Commissioner could suspend for cause but not dismiss a Collector. *See* Int. Rev. Code of 1939, § 3944. As of mid-century, the position of Collector was "not, strictly speaking, subordinate to that of the Commissioner of Internal Revenue, although he is bound by the rules and regulations of the Bureau. Until recent years the deputy collectors had no civil service status and were appointed and discharged at the will of the collectors," although internal revenue agents were civil servants. Work and Jurisdiction of BIR at 85-86.

74 Paul, *Taxation in the U.S*. at 127.

In 1930, the Treasury devoted some $10 million to erect a Constitution Avenue building, which still contains the IRS National Office, originally housing 3,391 Internal Revenue employees, 147 from the BTA, 22 from the Customs Court and Patent Appeals, and 252 from the Public Buildings and Public Parks Commission.[75]

Initially, individual income tax returns came before Collectors for audit, which then meant detection of errors on the face of the return.[76] Taxpayers could appeal to the Commissioner.[77] Soon this process was to be formalized, with the 1918 organization of the BIR Solicitor's office, followed the next year by the empanelment of an Advisory Tax Board to advise the Commissioner on appeals.[78] In 1924, the Solicitor created a Reviews Division to hear and determine all protests against the determination of a deficiency by the Income Tax Unit.[79] As discussed above, taxpayers also now had judicial recourse to the BTA.

Thus, the first quarter century of the federal income tax introduced a workplace that was burgeoning yet not without contestation from outside the government, both in terms of competition from private employers as well as substantive challenges from taxpayers. A celebrated legal scholar who visited America from Germany around this period developed a number of relevant observations about bureaucracy that were to form part of the foundation of the discipline of sociology. In pertinent part, he observed that formal standardization allowed government offices to administer a large volume of cases efficiently and dispassionately but at a cost of substantive discretion, *i.e.*, "without regard for persons" in a "dehumanized" manner.[80] This trade-off may be observed in the history of the BIR.

III. Transformation into a "Mass" Tax, 1939-1953

The second period in the past century of federal income taxation witnessed a monumental expansion of the application of the tax from less than five to approximately 36 percent of the U.S. population, who generally saw the tax as helping to lift the country out of the Great Depression, finance World War II, and ultimately reestablish the economy.[81] The BIR floated through this sea change with navigation by wartime administration helmsmen.

A. Significant Tax Laws

1. Internal Revenue Code of 1939

In 1939, a highly successful businessman netting $16,000 paid income tax of some $1,000, and an average lawyer or doctor paid about $25, but an average blue-collar worker paid

75 Pub. 1694 at 117.

76 Work and Jurisdiction of BIR at 101.

77 *Id*. at 90.

78 Work and Jurisdiction of BIR at 96, 105.

79 Pub. 1694 at 107.

80 Max Weber, *Bureaucracy* [1913], From Max Weber: Essays in Sociology, trans. H.H. Gerth & C. Wright Mills (Oxford Univ. Press, 1946) 215-16.

81 *See supra* Table 1, Income Tax Demographic History.

nothing.[82] By the end of the Great Depression, while the economics of John Maynard Keynes had influenced policymakers, the "conscious purpose of public spending was more to provide help to distressed citizens than it was to stimulate recovery."[83] That year, Congress codified the various revenue acts into the Internal Revenue Code, simplifying the tax law.[84]

2. Revenue Act of 1942

In 1942, America was at war. President Roosevelt told Congress: "In this time of grave national danger, when all excess income should go to win the war, no American citizen ought to have a net income, after he has paid his taxes, of more than $25,000."[85] On October 21, 1942, Congress enacted the "greatest tax bill in American history."[86]

The Revenue Act of 1942 sharply increased income tax by lowering the top bracket from $5 million to $200,000 while raising the top marginal rate to 88 from 81 percent, introduced the Victory Tax (a five percent surcharge on income over $624), and lowered exemptions to $500 from $750 ($1,200 from $1,500 for married couples), but allowed deductions for medical expenses.[87] More than 27 percent of the population would now have to file returns.[88] Treasury General Counsel Randolph Paul observed: "The income tax was now a mass tax."[89]

To herd this new mass into the fold of taxpayers, the Administration conducted a mass media campaign. On June 13, 1942, President Roosevelt established an Office of War Information (OWI).[90] That year, listeners could hear songs from Irving Berlin and Danny Kaye advertising tax payment as part of the war effort.[91] Furthermore, over 32 million viewers in 12,000 theaters saw Donald Duck announce that taxes "will keep democracy on the march" in a cartoon scripted by the Treasury.[92] Some in Congress took umbrage at the $80,000 cost of this animation, and Walt Disney suffered characterization as a "propagandist."[93] Yet he would be in good company within a few years when popular and

82 Pub. 1694 at 132.

83 Paul, Taxation in the U.S. at 225. "The Keynesian remedy for depression was . . . an increase in public expenditures which would compensate for an excess of savings or a deficiency of investment." *Id*. at 229.

84 Pub. L. No. 76-1, 53 Stat. pt. 1.

85 Seven-Point Economic Stabilization Program (Apr. 27, 1942), Public Papers and Addresses of Franklin Delano Roosevelt 1942, ed. Sam'l I. Rosenman (NY: Harper & Bros. 1950) ch. 47 at 221. The value of $25,000 in 1942 would be comparable to a little less than $340,000 in 2011.

86 Pub. 1694 at 136.

87 Pub. L. No. 77-753, 56 Stat. 798; *see also* Pub. 1694 at 252. The Rev. Act of 1942, § 504, also changed the name of the BTA to the Tax Court.

88 Table 1, Income Tax Demographic History.

89 Paul, Taxation in the U.S. at 318.

90 Exec. Ord. cited in 37 Buff. L. Rev. at 701 (1989).

91 37 Buff. L. Rev. at 714.

92 Brownlee, Fed. Taxation at 118.

93 37 Buff. L. Rev. at 717.

classical stars Roy Rogers, the Andrews Sisters, George Burns and Gracie Allen, and Yehudi Menuhin joined the cast of wartime Treasury promoters.[94]

In an early exercise of targeted marketing, the Treasury promoted tax compliance among the rich, the poor, women, and minorities. Foreshadowing product placement, an OWI manual suggested characters for motion pictures, one of whom emerged in a Hollywood movie as a wealthy man saying that it "suits me if they tax me 100 percent!"[95] A 1944 OWI magazine advertisement for "plain folks" stated: "We'll pay our taxes willingly" because "these sacrifices are chicken feed, compared to the ones our sons are making."[96] That year an OWI guide for women advised: "Tell homemakers that even if they personally are not going to fill out their tax return this year, they should urge their husbands to do so early."[97] In 1945, Commissioner Joseph Nunan announced tax requirements in newsreels, at least one of which was tailored "to some 400 theatres catering to Negroes."[98]

3. Current Payment Tax Act of 1943

This media blitz was only the surface of mass income tax implementation. Treasury officials realized that collection at the source would "achieve a more convenient method for the payment of income taxes," waging a political campaign against concerns articulated by Commissioner Guy Helvering, who cautioned against forcing "upon industry the payment of large sums for the administrative cost of the withholding tax."[99] A compromise plan emerged, named for Beardsley Ruml, an official of the New York Federal Reserve Bank and of Macy's department store, who would agree to start withholding if the Treasury would forgive taxes otherwise due that year (*i.e.*, for the last year before there was withholding).[100] Ultimately, legislation

> provided for current payment of all individual income tax liabilities and the cancellation of 75 percent of one year's existing taxes (the lower of either the 1942 or 1943 tax liability). Unforgiven liabilities were payable in two installments, one on March 15, 1944, and the other on March 15, 1945.[101]

On June 9, 1943, Congress enacted and President Roosevelt signed the Current Tax Payment Act, imposing a 20-percent withholding tax and establishing a system of withholding and quarterly estimated tax payment still recognized today.[102] The withholding

94 37 Buff. L. Rev. at 710-14.

95 *Id*. at 718. The cited motion picture was David O. Selznick's *Since You Went Away*, "a film of wartime domestic life," portraying a "radiant ideal" of the American family, despite "anxiety about the family's financial plight" since "Papa is only a captain and they must presumably subsist on his pay." Bosley Crowther, Movie Rev., New York Times (July 21, 1944).

96 37 *Buff. L. Rev*. at 727.

97 *Id*. at 715.

98 *Id*. at 718.

99 Quoted in Paul, Taxation in the U.S. at 330-31.

100 *See* Dennis J. Ventry, Jr. & Jos. J. Thorndike, *The Plan that Slogans Built: The Revenue Act of 1943*, Tax Analysts (Sept. 1, 1997).

101 Ventry & Thorndike, *The Plan that Slogans Built* ¶ 26.

102 Pub. L. No. 78-68, 57 Stat. 126; *see also* Pub. 1694 at 137.

system under this Act became effective on July 1, 1943.[103] Then-Treasury economist Milton Friedman, not now known as a champion of the welfare state, has reminisced that withholding was an inevitability in the quest for war revenue.[104]

4. Individual Income Tax Act of 1944

Despite the convenience of withholding, the mass population of taxpayers still had to file tax returns.[105] Observing an hour and a half of administrative burden to fill out a return in 1943, Treasury Secretary Henry Morgenthau asked his aides to "think of some way of bending the law to make this thing more palatable."[106] Even after the BIR rolled out the 1944 Form 1040 with "its junior sister Form 1040A," journalists criticized the tax returns as "so complicated as to defy description in a newspaper during a paper shortage."[107] On January 10, 1944, President Roosevelt recommended, beyond form design, legislative "simplification to reduce the burdens of compliance of the many million taxpayers by elimination of returns where feasible."[108]

On May 29, 1944, Congress enacted the Individual Income Tax Act, introducing a ten-percent standard deduction and replacing the Victory Tax with a three-percent tax.[109] The standard deduction relieved taxpayers with adjusted gross income of at least $5,000 (comparable to $62,500 in 2011) of the burden of itemizing deductions generally relating to business.[110] Although the income tax now affected the masses, in 1945 the richest one percent of households paid 32 percent of the revenue.[111]

5. Revenue Act of 1948

On April 2, 1948, over the veto of President Harry Truman, for whose administration tax reduction was unacceptable in an inflationary economy, Congress enacted legislation that among other relief measures allowed married couples the option of filing joint returns, with an increased standard deduction.[112] Whereas joint returns — optional since 1918 — had merely aggregated spousal income (producing a marriage penalty in some cases), the 1948 Act resulted in a tax double what a single person would pay on half the aggregate

103 Paul, Taxation in the U.S. at 348. Under the Int. Rev. Code of 1939, § 53, returns were due for the calendar year on March 15, while returns for the fiscal year were due on the fifteenth day of the third month thereafter.

104 Milton & Rose D. Friedman, Two Lucky People: Memoirs (Univ. of Chicago Press, 1998) 120-23.

105 As of 1942, the BIR had offered as an alternative to the four-page Form 1040 a two-page Form 1040A, *Optional Individual Income Tax Return*, to "be filed instead of Form 1040 by citizens (or resident aliens) reporting on the cash basis if gross income is not more than $3,000 [comparable to more than $40,500 in 2011] and is only from salary, wages, dividends, interest, and annuities." *See infra* Apps. 3 & 4.

106 Quoted in 37 Buff. L. Rev. at 731.

107 Quoted in Paul, Taxation in the U.S. at 383.

108 Ann'l Budget Message (Jan. 10, 1944), Public Papers and Addresses of FDR 1944-45, ch. 3 at 28.

109 Pub. L. No. 78-315, §§ 9(a) & 106(a), 58 Stat. 231; *see also* Pub. 1694 at 138.

110 *See* S. Rept. 78-885, 78th Cong. 2nd Sess. (May 16, 1944) 2.

111 Brownlee, Fed. Taxation at 116 citing Statistics of Income, 1945; *see also supra* Table 3, Tax Share by Income Level.

112 Pub. L. No. 80-471, 63 Stat. 110. Prof. Surrey, who had served as Tax Legislative Counsel in the Truman Administration, argued that "a strong tax structure would at this time be our most effective anti-inflationary weapon," in *Federal Taxation of the Family – The Revenue Act of 1948*, 61 Harv. L. Rev. 1097, 1098 (1948).

income.[113] Thus, the Act leveled the field for couples who did not reside in states with European-style community property regimes (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, and Washington).[114] As discussed above, in 1930 the Supreme Court had confirmed that couples could split community income equally, avoiding a marriage penalty, but common law states did not so split property.[115] A federal joint income tax bracket resolved this problem. Professor Stanley Surrey, who had served as Tax Legislative Counsel in the Truman and Roosevelt administrations, explained that now the "married couple is thus viewed as a unit" (instead of two individual taxpayers) for federal tax purposes.[116]

B. Demographic and Governmental Trends

Emergence from the depths of the Great Depression and the demands of World War II was a turning point for the U.S. economy and population. Business as well as Social Security and other government programs begin to expand.[117] Nevertheless, the "corporate share of business activity increased at the expense of proprietorships and partnerships."[118]

The number of high-school and college graduates continued to increase in the re-established economy,[119] while homeownership grew, especially among middle-aged whites.[120] In the postwar period, the effect of the home mortgage interest deduction cannot be overlooked.

> After World War II, and the ebbing of patriotism as a factor in income-tax compliance, Congress relied increasingly on tax expenditures and other measures — including the introduction of the income-splitting joint return for husbands and wives and the acceptance of community-property status – to enhance the popularity of the new tax regime. However, a deduction that had been in the tax code since 1913 — that for home mortgage interest — also favored the middle class and was one of the most expensive tax expenditures.[121]

As the position of the traditional middle class solidified, the place of minorities and women also began to expand. In the general population, the proportion of minorities began to

113 Patricia A. Cain, *Taxing Families Fairly*, 48 Sta. Clara L. Rev. 805, 808-17 (2008).

114 Randolph E. Paul, Taxation for Prosperity (Indianapolis: Bobbs-Merrill, 1947) 290.

115 *Poe v. Seaborn*, 282 U.S. 101 (1930).

116 Stanley S. Surrey, 61 Harv. L. Rev. at 1114.

117 *See* Caplow, First Measured Century at 196.

118 *Id*. at 246.

119 *Id*. at 52.

120 Caplow, First Measured Century at 96.

121 Brownlee, Fed. Taxation at 129. Nevertheless, the "income tax code instituted in 1913 contained a deduction for all interest paid, with no distinction between interest payments made for business, personal, living, or family expenses. There is no evidence in the legislative history that the interest deduction was intended to encourage home ownership or to stimulate the housing industry at that time. In 1913 most interest payments represented business expenses. Home mortgages and other consumer borrowing were much less prevalent than in later years." Cong. Res. Serv., Tax Expenditures: Compendium of Background Material on Individual Provisions, S. Print 110-667, 110th Cong. 2nd Sess., Comm. on the Budget (Dec. 2008) 330-31.

increase dramatically.[122] In the workforce, demographic diversification proceeded as the proportion of adult and older men declined.[123] In 1939, women, either separately from their husbands, as family heads in their own right, or singly, filed 1.8 million or 23.4 percent of individual income tax returns.[124] In 1951, the tax law officially recognized head of household filing status.[125] In 1953, women filed 10.8 million or 18.7 percent of returns.[126] From 1939 to 1953, the U.S. population increased from 131 million to 160 million; for those same years, the proportion of return filers within the population multiplied from five to 36 percent.[127]

Additional recognitions of population segments were enacted, such as the 1943 $500 deduction for the blind,[128] later converted into a 1948 $600 exemption along with an equal one for the elderly.[129] Expansions of the tax law, economy, and population segments all portended diversification of the taxpayer pool.

C. Implications for Service

From 1939 to 1953, the BIR workforce more than doubled from 22,623 to 53,463.[130] At the same time, individual income tax became a major federal revenue source, rising from approximately $1 to $33 billion.[131] These amounts lifted the individual income tax from 20 to 47 percent of total BIR collections of $5.2 and $69.7 billion in fiscal year (FY) 1939 and 1953 respectively.[132] In addition to sheer manpower, streamlined processing methods enabled the BIR to handle a large increase in the volume of returns.[133] Inside the BIR, a major reorganization confirmed its transformation into a modern bureaucracy, cleaning house of old-fashioned political appointments.

On November 1, 1943, the BIR established a Processing Division in New York City as a central location, equipped with electronic typewriters, to receive the first wave of increased volume of income tax returns.[134] Four years later, the Processing Division moved to Kansas City, where within a couple of years the BIR employed mass mailing to send forms and instructions to every corner of the growing country.[135] In 1948, the BIR introduced punch

122 Caplow, First Measured Century at 18.

123 "The labor force participation rate of adult men gradually decreased from 86 percent in 1900 to 75 percent in 1998. * * * The decline in labor force participation was most conspicuous for men aged sixty-five and older." *Id*. at 32.

124 Statistics of Income, 1939, Pt. I at 18.

125 Rev. Act of 1951, Pub. L. No. 82-183, § 301.

126 IRS Pub. 79, Statistics of Income, 1953, Pt. I at 10.

127 Table 1, Income Tax Demographic History.

128 Rev. Act of 1943, Pub. L. 78-235, § 115, 58 Stat. 21.

129 Pub. L. No. 80-471, § 201; *see also* Pub. 1694 at 142.

130 Pub. 1694 at 249.

131 CIR Ann'l Rep't FYE June 30, 1939, at 2; 1953, at 5.

132 Pub. 447 at 39.

133 Table 1, Income Tax Demographic History.

134 Pub. 1694 at 137.

135 *Id*. at 142 & 145.

card equipment in Cleveland, and the following year deployed the technology in seven more Collectors' districts.[136] By the filing season in the first quarter of 1950, the BIR added computers to its complement of equipment for calculating liability on returns.[137]

While methods and technology advanced, the BIR still had to modernize its political organization, a system of appointments that already was entrenched by mid-century. On February 27, 1951, Commissioner George Schoeneman testified that the BIR fired more than 50 employees each year for taking bribes.[138] On September 14 and October 11, 1951, two BIR Collectors in Boston and St. Louis, Dennis Delaney and James Finnegan, were indicted for bribery.[139] In 1953, the House Ways and Means Committee, chaired by Rep. Cecil King (D-Cal.) and later by Rep. Robert W. Kean (R-N.J.), reported on an investigation of the BIR, revealing more improprieties.[140] Ultimately, seven more Collectors, an Assistant Commissioner, the Chief Counsel, and the Assistant Attorney General of the Tax Division of the Justice Department left office in disgrace.[141]

Evidently, the patronage position of Collector in place at the inception of the federal income tax had proven unworthy to a mass tax. Originally, locally recognized Collectors may have achieved better tax compliance in their own communities.[142] Yet by 1924, corruption had warranted a Senate investigation of the BIR,[143] and apparently the temptation created by the massive 1942 expansion of the tax was too great for appointees of the prevailing President to withstand. President Truman made the following observation:

> Since the collectors are not appointed and cannot be removed by the Commissioner of Internal Revenue or the Secretary of the Treasury, and since the collectors must accommodate themselves to local political situations, they are not fully responsive to the control of their superiors in the Treasury Department.[144]

On January 14, 1952, President Truman proposed Reorganization Plan No. 1 in part to clean out the corruption by replacing patronage appointments with a career civil service.[145] On March 15, 1952, the plan took effect upon congressional review.[146] The Commissioner and

136 Pub. 1694 at 145.

137 *Id*. at 148.

138 *Id*. at 150.

139 *Id*. at 151-52.

140 H.R. Rep. No. 82-2518, 82nd Cong. (1953).

141 Improprieties extended to conspiracy with organized crime, false certification of tax payments, and similar corruption. *See* Jos. J. Thorndike, *Reforming the Internal Revenue Service: A Comparative History*, 53 Admin L. Rev. 717, 755-59 (2001); Bryan T. Camp, *Theory and Practice in Tax Administration*, 29 Va. Tax Rev. 227, 241 (2009).

142 53 Admin L. Rev. at 756.

143 Pub. 1694 at 108.

144 *Special Message to the Congress Transmitting Plan I of 1952* quoted in 53 Admin L. Rev. at 761.

145 Pub. 1694 at 154.

146 *Id*.

Chief Counsel were the only remaining political appointees.[147] The reorganization integrated most field revenue programs under district directors, instituted regional commissioners, and consolidated inspection functions under a separate Inspection Service. The reorganization established the basis for a three-tiered geographical structure comprising the National Office, regional offices, and district offices. Cross-cutting this structure were functions (*e.g.*, assessment, collection) in place of offices organized by type of tax (*e.g.*, income, excise).[148] On July 9, 1953, the reorganized agency got a fresh start under the new name of Internal Revenue Service.[149]

Overall, this 14-year period showed that an agency administering a law applicable to little more than a twentieth of the population could be massively reorganized by an administration determined to reach every third person.[150] What began as recruitment of nationally recognized show business personalities ended in the streamlining of a bureaucratic machine reaching into every district of the country through regional directorates reporting to the National Office, already ensconced on Constitution Avenue in Washington, DC. No more was the face of the IRS that of a local partisan Collector.

The question will arise whether tax compliance popularized by heroic government intervention can be matched in periods when less than world-historical imperatives prevail. In any case, mid-century wartime revenue imperatives successfully popularized the income tax in what the IRS Historian aptly called "a marriage of convenience that survived."[151] Since then, federal income tax has been embedded with the American people.

IV. Automation and Meltdown, 1954-1985

During the three decades of the third period under study, the U.S. underwent post-World War II modernization, experienced in the IRS as automation. Substantively, the federal income tax system became a source of fiscal stability. Demographically, the volume of individual taxpayers slightly outpaced national population growth.[152] Administratively, the IRS tried to do more with machines, gradually leading to a meltdown.

A. Significant Tax Laws

If the federal income tax and World War II had "a marriage of convenience that survived," the implication would seem to be that mass revenue thereafter was sufficient to fund government expenditures as they arose in wartime or peacetime. Whereas specific tax legislation had raised revenue for World Wars I and II, U.S. military expenditures in Korea

147 Pub. L. No. 76-1 (Int. Rev. Code '39), §§ 3900, 3931; Pub. L. No. 83-591 (Int. Rev. Code '54), §§ 7801, 7803.

148 53 Admin L. Rev. at 762.

149 Treas. Ord. 150-29 cited in Pub. 1694 at 158.

150 Table 1, Income Tax Demographic History.

151 Pub. 1694 at 135.

152 *See infra* Table 1, Income Tax Demographic History.

and Vietnam during this ensuing period arose from existing, if high, taxes.[153] Additionally, the tax structure lent itself to social spending through tax expenditures forming a "hidden welfare state."[154] In particular, tax policy commentators have focused on research to "show that the benefits of tax expenditures accrue disproportionately to more affluent citizens and powerful corporations."[155]

Whatever may have been the political and social turmoil from 1954 to 1985 — encompassing the Cold War, civil rights movements, and ultimately a conservative shift associated with the "Reagan revolution"[156] — to some extent the tax system may have acted as a foil to prevent them from becoming fiscal upheavals of a magnitude seen earlier in the century. Significant rules and policies of the tax system during this period included codification of social tax expenditures as well as an alternative minimum tax, and administrative provisions to streamline and professionalize the tax system.

1. Substantive Provisions

On August 16, 1954, Congress with President Dwight D. Eisenhower's signature recodified the Internal Revenue Code, making some 3,000 income tax rule changes.[157] In a provision that ultimately was to grow into "the largest source of federal financial support for child care," child-care expenses became deductible for widows, single parents, and certain other taxpayers.[158]

On December 30, 1969, Congress enacted with President Richard Nixon's signature a Tax Reform Act (TRA 69) lowering tax rates and increasing the personal exemption but imposing an alternative minimum tax.[159] TRA 69 included tax relief for single taxpayers through a modification to the rate schedules that collaterally "had the consequence of generating a marriage penalty" for the first time since 1948.[160] This reflected a congressional response to complaints of "a new class of taxpayers — singles and unmarried couples."[161]

On March 29, 1975, Congress enacted with President Gerald Ford's signature a Tax Reduction Act (TRA 75) which inter alia created a new Earned Income Tax Credit (EITC), supplementing the wages of low income working married couples or heads of household

153 Brownlee, Fed. Taxation at 128 ("The highly elastic revenue system paid for the strategic defense programs of the Cold War and, without any general or permanent increases in income taxation, for the mobilizations for the Korean and Vietnam Wars as well. . . . the post-World War II increases in federal revenues went largely for the expansion of domestic programs").

154 Christopher Howard, The Hidden Welfare State: Tax Expenditures and Social Policy in the United States (Princeton Univ. Press, 1997).

155 Howard, Hidden Welfare State at 6; *see also* National Taxpayer Advocate 2010 Annual Report to Congress, vol. 2 at 101 (Research Study: *Evaluate the Administration of Tax Expenditures*).

156 Brownlee, Fed. Taxation at 147.

157 Pub. L. No. 83-591; *see also* Pub. 1694 at 160.

158 Mary Louise Fellows, *Rocking the Code: A Case Study of Employment-Related Child-Care Expenditures*, 10 Yale J. L. & Feminism 307, 310 n. 11 (1998).

159 Pub. L. No. 91-172, 83 Stat. 287; *see also* Pub. 1694 at 191. TRA 69, § 951, Int. Rev. Code § 7441, also moved the Tax Court from the Executive to the Judicial Branch under Art. I, § 8, U.S. Const.

160 Edw. McCaffery, Taxing Women (Univ. of Chicago Press, 1997) 34.

161 *Id*.

with children.[162] The EITC's historic innovation was refundability, or the use of a tax provision to effectuate a net payment from the government, rather than a collection. A "negative tax" for purposes of maintaining income security among the populace had been anticipated (if not welcomed) at least as early as the Kennedy administration by then Treasury Assistant Secretary for Tax Policy Stanley Surrey.[163] Another innovation of TRA 75 was advance rebate of tax reductions by check disbursement.[164] In other words, TRA 75 enacted tax reductions that were monetized and delivered to taxpayers "approximately six weeks after the date of enactment of this bill" rather than implemented as decreases in withholding over the course of a year.[165] In these two key provisions, TRA 75 marked a reversal of the traditional IRS role by turning the revenue collection agency into one of fiscal disbursement.

The administration of President Ronald Reagan set the stage for the next major tax reform that was to surpass the 1954 recodification that started this period. On September 3, 1982, Congress had enacted with President Reagan's signature the Tax Equity and Fiscal Responsibility Act (TEFRA 82) imposing "the first major tax increase during an election year in peacetime since 1932," closing loopholes, expanding information reporting, and enhancing penalties.[166] Yet it was a conservative "revolution" that was to reform the tax law.[167]

In January 25, 1984, President Reagan's State of the Union speech announced "an historic reform for fairness, simplicity, and incentives for growth. I am asking Secretary Don Regan for a plan for action to simplify the entire tax code so all taxpayers, big and small, are treated more fairly."[168] On November 27, 1984, Treasury Secretary Regan presented to the President a report that would become known as Treasury I, drafted by the Office of Tax Policy (OTP), recommending reduced rates on income and capital gain, increased personal exemptions, and base broadening through repeal of many deductions.[169]

2. Administrative Provisions

On February 7, 1956, the Treasury Department confirmed representation of taxpayers before the IRS by enrolled agents, who "must observe the ethical standards of the accounting profession," in addition to attorneys, under Circular 230.[170] In October of 1958, the

162 Pub. L. No. 94-12. For 2010, the EITC "may be described as a wage supplement, with a $5,666 maximum, administered by the IRS to low income workers." *Hearing on Improper Payments in the Administration of Refundable Tax Credits, Before Subcomm. on Oversight, Comm. on Ways & Means* 4, 112th Cong. (May 25, 2011) (statement of Nina E. Olson, National Taxpayer Advocate).

163 Stanley S. Surrey, *The Federal Tax System – Current Activities and Future Possibilities*, Speech to Boston Econ. Club, May 15, 1968, Tax Pol'y & Tax Reform, 1961-1969: Selected Speeches & Testimony, ed. Wm. Hellmuth & Oliver Oldman (Chicago: Commerce Clearing House, 1973) 158.

164 IRC § 6428 added by Pub. L. No. 94-12, § 101.

165 H. Rep. 94-19, 94th Cong. 1st Sess. (Feb. 25, 1975) 9.

166 Brownlee, Fed. Taxation at 154.

167 *Id*. at 147.

168 20 Wkly. Comp. Pres. Docs. (Fed. Reg.) 90 (Jan. 30, 1984).

169 Dep't of the Treas., Tax Reform for Fairness, Simplicity, and Economic Growth: Rep't to the Pres. (1984); *see also* Pub. 1694 at 221.

170 21 Fed. Reg. 833; *cf.* Circ. 230 (Dec. 7, 1951), 31 Code Fed. Regs. § 10.3(a)(1) (allowing enrollment of attorneys and CPAs), (j) (allowing special enrollment by examination).

Treasury proposed rules,[171] finalized the following Valentine's Day, effective on March 15, 1959, expanding enrollment beyond attorneys and certified public accountants to applicants who passed a written examination as well as to former IRS employees, and permitting unenrolled agents to represent taxpayers in District Directors' offices with respect to examination of returns they prepared.[172] In a decade, Congress was to impose by law penalties on paid tax return preparers for certain infractions.[173]

On October 16, 1962, Congress enacted with President John F. Kennedy's signature a Revenue Act adding to the tax Code third-party information reporting, effectively recruiting payers of interest and dividends into the tax compliance system.[174] The legislation required the IRS to develop an Income Information Document Matching Program to find unreported income and to identify individuals who failed to file a tax return.[175]

On November 2, 1966, Congress enacted with President Lyndon Johnson's signature a law allowing the IRS to designate a so-called Service Center, instead of a District Director's office, as an official place for filing tax returns.[176] The IRS had piloted the first Service Center in Kansas City 11 years earlier.[177] Service Centers were to play an important role in the expansion of automation and de-personalizing tax administration.

On October 4, 1976, Congress enacted with President Ford's signature a Tax Reform Act (TRA 76) that, as mentioned above, imposed negligence or fraud penalties on paid tax return preparers. Moreover, TRA 76 wholly amended the taxpayer privacy law.[178] As previously noted, tax return information historically had been publicly accessible subject only to Executive Branch rules. In 1970, White House officials had obtained IRS information on political enemies of then President Nixon, who later left office in disgrace after the Watergate burglary scandal.[179] Thereafter, the 1976 statute essentially restricted the use of return information to tax administration purposes.[180]

3. Summary

Between the Internal Revenue Codes of 1954 and 1986, tax law complexity increased, especially in the form of social tax expenditures. At the same time, tax procedure and

171 Notice of Proposed Rule-making (NPRM), 23 FED. REG. 8427 (Oct. 31, 1958); NPRM, 23 FED. REG. 7702 (Oct. 4, 1958).

172 24 FED. REG. 1157 (Feb. 14, 1959); 31 Code Fed. Regs. § 10.7(a), (e); 1959-1 C.B. 745.

173 TRA 69, H. Conf. Rep't 91-782, 91st Cong. 1st Sess. 229-30 (Dec. 21, 1969).

174 Pub. L. No. 87-834, 76 Stat. 960.

175 Pub. 1694 at 177.

176 Pub. L. No. 89-713.

177 Pub. 1694 at 161.

178 Pub. L. No. 94-455.

179 Dep't of the Treas. (OTP), *Rep't to the Congress on Scope and Use of Taxpayer Confidentiality and Disclosure Provisions* at 21; *see also* JCT, *Study of Present-Law Taxpayer Confidentiality and Disclosure Provisions*, vol. 1 at 255 (relating to Pres. Nixon's authorization of the U.S. Dep't of Agriculture to inspect tax returns of all farmers for statistical purposes).

180 IRC § 6103.

administration became more regimented. This regimentation was to facilitate standardization and thus automation.

B. Demographic and Filing Trends

From 1954 to 1985, the U.S. population increased from 163 million to 238 million, or about 46 percent.[181] The volume of individual income tax returns increased from 56.7 to 102 million or almost 80 percent.[182] In FY 1954, the IRS collected $69.9 billion, of which individual income taxes were almost 47 percent or $32.8 billion.[183] In FY 1985, the IRS collected $742.9 billion, of which individual income taxes were more than 53 percent or $396.7 billion, which in turn was twelve times the number of dollars collected in FY 1954.[184]

The post-World War II decades were prosperous, especially for middle-class families whose real income continued to rise.[185] Although people began to pay more taxes, their benefits, such as health insurance, expanded.[186] At the same time, poverty decreased significantly, from 22 percent in 1959 to 12 percent in 1999.[187]

During this period, women continued to enter the workforce in greater numbers.[188] The marriage rate decreased as the average age at marriage and the divorce rate increased.[189] Cohabitation increased, especially among young, white, adults without high school diplomas.[190] Tax filing appears to reflect this trend. In 1954, heads of household filed a million returns, less than two percent of the total.[191] In 1985, heads of household filed ten million returns, almost ten percent of the total.[192]

In Middletown, the bellwether for social surveys, patriotic attitudes continued to decline.[193] In sum, demographic trends during the third period under study reflect economic security and social independence for segments of the population.[194]

---

181 Census, Statistical Abstract of the U.S. (2003), Table No. HS-1, *Population*: 1900-2002.

182 IRS Pub. 79, Statistics of Income, 1954, Pt. I, Table 1 at 3; IRS Pub. 1304, *Individual Income Tax Returns*, 1985 (SoI) Table B at 6.

183 CIR Ann'l Rep't FYE June 30, 1954, at 4.

184 *Id*. at 2. For 2011, $32.8 billion in 1954 would be comparable to $269 billion; $396.7 billion in 1985, $816 billion, or three times $269 billion.

185 Caplow, First Measured Century at 164.

186 *Id*. at 152 & 164 (indicating "fringe benefits . . . were far more extensive and valuable than they had been in the past").

187 *Id*. at 174-75.

188 *Id*. at 38.

189 *Id*. at 68, 78.

190 *Id*. at 72 (stating "Those most likely to cohabit were young adults, non-Hispanic whites, and people who never graduated from high school.").

191 Pub. 79, SoI, 1954, Pt. I, Table C at 11.

192 Pub. 1304 (1985) Table 1.3, cols. (1) & (7) at 19.

193 Researchers asked survey respondents in Middletown High School to agree or disagree with statements including the following: the U.S. is unquestionably the best country in the world; and every good citizen should act according to the following statement, "My country – right or wrong!" In 1924, more than nine of ten students agreed that the U.S. was the best; in 1977, more than seven of ten agreed; and in 1999, about six of ten. Similarly, the proportions favoring the slogan in the second statement declined in successive replications of the survey. Caplow, First Measured Century at 210.

194 Commentators may associate government-supported socio-economic security with a "welfare state," variously defined as "an instrument of social control or social betterment; as a part of the state or a particular stage in the development of capitalist states; as a minimal safety net for those in need; social insurance for the middle classes; or everything the government does to improve the well-being of individuals and families." Howard, Hidden Welfare State at 5.

C. Implications for Service

To match the increased return volume from 1954 to 1985, the number of IRS employees rose from 51,411 to 92,792.[195] Managing the work involved both equipment and organization.

1. Automation and Meltdown

In FY 1955, the Midwest Service Center used IBM computers to process all 1.1 million Forms 1040A from the ten districts of the IRS Omaha Region, ushering in central processing.[196] The next step in computerization on June 1, 1961, was to break ground in Martinsburg, West Virginia (beyond the 20-mile national security perimeter around Washington, D.C.) for an IRS National Computer Center.[197] The same year, an Automated Data Processing Division, with responsibility for return processing, revenue accounting, and Service Centers, split off from the Collection Division.[198] In August 1961, the IRS created a position of Assistant Regional Commissioner (Data Processing) in its Atlanta Region, to be the site of a new Service Center equipped with computers.[199]

These IRS actions reflected what Professor Surrey explained in 1961:

> With population growth and a broadened tax base, paperwork threatened to engulf tax administration. In self-defense, more and more attention had to be given to the development of means and methods for improving the processing of the paperwork. Invariably, a key element in this effort was the substitution of mechanical for manual methods of processing data.[200]

In 1964, Commissioner Mortimer Caplin cautioned

> There may be a tendency to overcentralize operations, to overextend capabilities and, yes, to capitulate to overmechanization and underhumanization of tax administration. In brief IRS must constantly weigh machine capability against the actual and psychic costs to the nation.[201]

195 Pub. 1694 at 249-50.

196 *Id*. at 161.

197 *Id*. at 170, 173.

198 *Id*. at 172.

199 *Id*. at 174.

200 Stanley S. Surrey, *Automatic Data Processing and Tax Administration: The Potentialities of ADP & Factors Involved in its Adoption*, Buenos Aires Conf. on Tax Admin., Oct. 1961, Tax Pol'y & Tax Reform 497-98.

201 Mortimer M. Caplin, *Commissioner Caplin Reviews his Record as IRS Chief* [1964], 29 Va. Tax Rev. 177, 180 (2009).

Nevertheless, the IRS forged ahead.

In 1966, the IRS opened an Individual Master File with a mainframe account for every individual taxpayer to process returns nationwide the following year.[202] In 1969, the IRS deployed the so-called Discriminant Income Function (DIF) to statistically select individual returns for audit.[203] The same year, the IRS piloted an Integrated Data Retrieval System (IDRS) and implemented it nationally by 1973.[204]

In 1977, the Carter administration approved IRS plans for a $1.8 billion computerized Tax Administration System, but Congress did not fund this initiative due in part to concern that increased computer accessibility could degrade taxpayer privacy in the post-Watergate era.[205] In 1979, the IRS embarked on a long-range plan to replace obsolete computer equipment used for return processing. In March 1982, a pilot Service Center in Memphis installed new equipment, and the other nine Service Centers followed the next year.[206] Additional applications were scheduled for "complete conversion" by January 1985.[207]

Despite optimistic projections, IRS managers in the field attempted to notify National Office executives that the new computers had insufficient capacity, exacerbated by inefficient software, a lack of digitally proficient employees, and a need for equipment such as tape drives.[208] Evidently, warnings went unheeded. As tax returns poured in, IRS employees were unable to process them. To paraphrase Professor Surrey, mechanical failure left employees to defend themselves from paperwork that threatened to engulf them. News reports told of IRS staff around the country taking matters into their own hands.

In an investigation ordered by House Ways and Means Oversight Subcommittee Chairman J.J. Pickle (D-Tex.), the General Accounting Office (GAO, now the Government Accountability Office) confirmed:

> Newspaper accounts alleged that between 4,000 and 6,000 requests from businesses that IRS adjust their accounts were inappropriately destroyed at the Austin Service Center.

---

202 Pub. 1694 at 184-85. Recently, the IRS explained that it "maintains records of individual taxpayers' accounts on the Individual Master File (IMF). Each module on the IMF represents a specific tax return of a specific taxpayer for a specific tax period. IMF modules are further classified by type of return, known as the MFT Code. The IRS uses MFT Code 30 for Form 1040 returns." National Taxpayer Advocate 2009 Annual Report to Congress 279 (IRS Response to Most Serious Problem: *The IRS Mismanages Joint Filers' Separate Accounts*).

203 Pub. 1694 at 191. Recently, the DIF has been described as a computer algorithm that estimates the likelihood that an audit of a particular return would produce an adjustment, forming a criterion for exam selection. The DIF is based on data obtained and periodically updated from IRS National Research Program examinations. See National Taxpayer Advocate 2010 Annual Report to Congress, vol. 2 at 86 n. 49 (Research Study: *Researching the Causes of Noncompliance*) (citing Internal Revenue Manual (IRM) 4.1.1.2.6 (Oct. 24, 2006), 4.1.24.1 (Mar. 23, 2010), Exhibit 4.1.7-1(12) (May 19, 1999)).

204 Pub. 1694 at 191, 201. Today, the "IDRS consists of databases and operating programs that support IRS employees working active tax cases within each business unit. This system manages data retrieved from the Master Files, allowing employees to take actions on account issues, track status, and post updates back to the Master Files." National Taxpayer Advocate 2009 Annual Report to Congress 258 n. 12 (Most Serious Problem: *IRS Power of Attorney Procedures Often Adversely Affect the Representation Many Taxpayers Need*).

205 Pub. 1694 at 210.

206 CIR Ann'l Rep't FYE Sept. 30, 1982, at 22.

207 CIR Ann'l Rep't FYE Sept. 30, 1983, at 26.

208 See Shelley L. Davis, Unbridled Power: Inside the Secret Culture of the IRS (NY: HarperCollins, 1997) 53.

> Service center officials told us that taxpayer correspondence was destroyed over a 3 day period in December 1984, without the knowledge and approval of service center management. A unit manager in the Adjustments/Correspondence Branch allegedly instructed one tax examiner to destroy the correspondence without having the cases quality reviewed. Service center officials said the unit manager, who has since resigned from IRS, denied that she instructed the tax examiner to destroy the correspondence.[209]

A parallel GAO investigation authorized by Senate Finance Committee Chairman Bob Packwood (R-Ore.) revealed that on July 26, 1984, a Philadelphia Service Center (PSC) custodian emptying a trash can in the women's restroom found thirty-five Form 1040s.[210] On April 26, 1985, a PSC janitor

> found envelopes containing unprocessed documents and remittances in a trash barrel on the loading dock. Service center management and Inspection determined that several trash barrels contained 109 discarded envelopes from which all information had not been extracted. The 109 envelopes included: 94 remittances for $333,440; 36 individual income tax returns; 24 Forms 1040 ES (Estimated Tax for Individuals); and 49 miscellaneous documents. Of the 94 remittances, 47 were not associated with documents. The remittances ranged from $1 to $68,000.[211]

When the infrastructure failed, one can only imagine hard-pressed frontline managers telling employees, "I want these files gone by morning." Ironically, reliance on machine processing had led to a meltdown. Ultimately, GAO reported, the IRS National Office scheduled delivery of the necessary hardware and software to the affected Service Centers in time for the 1986 processing season.[212]

It is unclear if any IRS official was ever held accountable for the meltdown of 1985.[213] Perhaps they escaped through a thicket of bureaucracy, or perhaps there is another explanation. Around the same time, an actual nuclear meltdown had almost occurred in March 1979 at Three Mile Island, a power plant near Harrisburg, Pennsylvania. There, analysts identified a series of discrete events leading to the disaster, without pinning blame on any one.[214] In modern systems in which complex technological and organizational components are concentrated, disaster as an aggregate of numerous minor failures may be so inevitable as to be called "normal."[215] Here the question arises whether the post-World War II tax

209 GAO, *Information on IRS Service Centers in Austin, Texas and Fresno, California*, GGD-85-89 (Sept. 30, 1986) 59.

210 GAO, *Information on IRS Philadelphia Service Center*, GD-86-25FS (Nov. 1985) 36.

211 *Id*. at 33 (quoting May 30, 1985, memo from IRS Int. Audit Div. to PSC Dir.).

212 GAO, *Info. on IRS Service Ctrs. in Austin and Fresno* 3.

213 Davis, Unbridled Power at 52 (asserting that "none of these culprits was ever held accountable for the massive IRS mishap of 1985").

214 Chas. Perrow, Normal Accidents: Living With High Risk Technologies rev. ed. (Princeton Univ. Press, 1999).

215 *See Id.*; *see also* Chas. Perrow, *The Meltdown Was Not an Accident*, Markets on Trial: The Economic Sociology of the U.S. Financial Crisis, ed. Michael Lounsbury & Paul M. Hirsch, 30 Res. in the Sociol. of Org'ns 309 (2010).

system had grown into a complex "unto itself" beyond controls that could eliminate the risk of meltdown.[216]

2. Targeting Needs and Appointing an Ombudsman

In the face of automation gone haywire, distinct populations presented needs for taxpayer service. In 1956, the IRS responded to rural America by collaborating with the U.S. Department of Agriculture to publish a 64-page *Farmers' Tax Guide* and distribute a million copies.[217] Targeting continued, this time launched from the metropolitan centers of New York, Miami, and Los Angeles, with the 1972 publication for readers of Spanish.[218] In 1970, the IRS sponsored Volunteer Income Tax Assistance (VITA) to prepare returns for low income taxpayers,[219] followed eight years later by Tax Counseling for the Elderly (TCE), a volunteer program to assist taxpayers 60 and over.[220] To simplify returns for individuals with limited types of income, the IRS issued Form 1040EZ in 1982.[221]

Meanwhile, the infrastructure to support taxpayer service and problem solving evolved from ad hoc responses by revenue agents and officers into an ombudsman in the National Office. In 1959, the IRS created a Taxpayer Service function within the Collection Division, relieving revenue agents and officers of responsibility for taxpayer inquiries.[222] In 1971, the Taxpayer Service function received an upgrade to the status of a Division under an Assistant Commissioner for Accounts, Collection, and Taxpayer Service.[223] In 1971, the IRS established a Problem Resolution Program, protecting taxpayer rights on a case-by-case basis.[224] On January 4, 1980, Commissioner Jerome Kurtz appointed within his office, to supervise all Problem Resolution functions and represent taxpayer interests, a Taxpayer Ombudsman, predecessor to the National Taxpayer Advocate.[225]

3. Summary

The third period under study began with groundbreaking work at Service Centers and similar new sites that allowed central processing to soar so high as to induce a meltdown at the end of this period. Between 1954 and 1985, automation became both an inevitability and a cautionary tale. As this course of events played out, the IRS was insulated from outside influence by stable fiscal policy sealed with the stringent amendment of the taxpayer privacy

216 For other reasons, commentators have characterized the IRS as a "law unto itself." David Burnham, A Law unto Itself: Power, Politics, and the IRS (NY: Random House, 1989).

217 Pub. 1694 at 162.

218 *Id*. 199.

219 *Id*. at 196.

220 *Id*. at 213.

221 *See infra* Appdx. 5, Form 1040EZ, *Income Tax Return for Single Filers with no Dependents* (1982).

222 Pub. 1694 at 167.

223 *Id*. at 197.

224 IRM 13.2.1.1.1 (July 16, 2009) (recounting history of Problem Resolution Program, which "limited its advocacy role, protecting taxpayers' rights only on a case-by-case basis").

225 Pub. 1694 at 216.

law. At the same time, taxpayer service and problem resolution continued to present needs to be met in small but significant ways.

V. Restructuring and an Emerging New Mission, 1986-2011

The last quarter-century of federal income taxation reflected a maturation of a mass tax that was broadly administered using electronic media, yet was imbued with taxpayer rights. The sobering experience of the meltdown of 1985 gave way to legislative iterations of taxpayer rights, IRS restructuring, and refundable credits. Cumulatively, these provisions were to change the nature of tax administration. The persistence of taxpayer service needs was to become more poignant as Congress charged the IRS with the delivery of more socio-economic benefits.

A. Significant Tax Legislation

1. Internal Revenue Code of 1986

On October 22, 1986, President Reagan signed a Tax Reform Act (TRA 86) that was the culmination of the Treasury proposals discussed above, as revised after public comment, and historic congressional effort, led in large part by House Ways and Means Committee Chairman Dan Rostenkowski (D-Ill.).[226] TRA 86 not only recodified the tax law but simplified it by broadening the base, affording a reduction in rates from 50 to under 40 percent that garnered political support.[227] Base broadening came through repeal of tax expenditures, especially for business, notably the investment tax credit.

While the story of TRA 86 has been amply told,[228] two provisions are relevant here. TRA 86 eliminated filing requirements for some six million low income people through increased personal exemptions and standard deductions.[229] For low income workers who remained on the tax rolls, the legislation significantly expanded the EITC, raising the maximum credit from $550 to $800 and the phase-out ceiling from $11,000 to $13,500, while indexing the EITC for inflation.[230]

2. Rights, Reconciliation, Responsibility, and Refundability

As the IRS added benefit disbursement to the traditional role of tax collector, it could not ignore those who were more like "customers" than taxpayers *per se*. On November 1, 1988, the IRS seemed to recognize these developing roles when it issued a leaflet as Publication 1, *Your Rights as a Taxpayer*.[231]

226 Pub. L. No. 99-514, 100 Stat. 2085.

227 Pub. 1694 at 254.

228 *See, e.g.*, Jeffrey H. Birnbaum & Alan S. Murray, Showdown at Gucci Gulch: Lawmakers, Lobbyists, and the Unlikely Triumph of Tax Reform (NY: Random House, 1987).

229 Brownlee, Fed. Taxation at 174.

230 Pub. L. No. 99-514, § 111, 100 Stat. 2085, 2107; Jt. Comm. on Tax'n, General Explanation of TRA 86, JCS-10-87 (May 4, 1987) 28.

231 Pub. 1694 at 230.

Nine days later, Congress enacted with President Reagan's signature the Technical and Miscellaneous Revenue Act of 1988 (TAMRA 88) containing a Taxpayer Bill of Rights (TBOR) that codified dissemination of taxpayer rights information.[232] Additionally, TAMRA 88 authorized the IRS Ombudsman to issue a Taxpayer Assistance Order on behalf of a taxpayer suffering significant hardship as a result of the IRS' manner of tax administration.[233] Further, TAMRA 88 mandated the delivery of an annual report to Congress on taxpayer service by the Ombudsman in conjunction with an Assistant Commissioner (Taxpayer Service), whose portfolio had been created by Commissioner Lawrence Gibbs on July 2, 1987.[234]

This legislation was succeeded by the Taxpayer Bill of Rights (TBOR) II, enacted by Congress and signed by President Bill Clinton in 1996. TBOR II created a statutory Office of the Taxpayer Advocate to supersede the Ombudsman and take over annual reporting to Congress, with coverage of objectives, problems, and recommendations.[235]

Meanwhile, Congress enacted and President George H.W. Bush signed the Omnibus Budget Reconciliation Act of 1990 (OBRA 90). OBRA 90 historically expanded the EITC by increasing the credit rate above that of the aggregate employer and employee Social Security tax, the payroll tax that the EITC had been enacted to offset.[236]

Further EITC amendment came in the Personal Responsibility and Work Opportunity Reconciliation Act of 1996 (PRWORA 96), which substantially reformed traditional welfare programs.[237] As a central component of welfare reform, PRWORA 96 expanded the EITC with respect to the amount of work incentive while curtailing it with respect to immigration and work status in the U.S., essentially to limit access by undocumented workers.[238]

In 1997, Congress enacted and President Clinton signed a Taxpayer Relief Act including a child tax credit, giving taxpayers who were parents up to $500 per qualifying child.[239] Like the EITC, a portion of the child tax credit was to be refunded even in excess of liability.[240]

3. IRS Restructuring and Reform Act of 1998

On September 23, 1997, Senate Finance Committee Chairman William Roth (R-Del.), opened hearings on IRS practices, procedures, oversight, and ultimately restructuring, that were to stretch well into the following year. In confronting the IRS, Senator Roth intoned:

232 Pub. L. No. 100-647, 102 Stat. 3342; H. Conf. Rep't 100-212, 100th Cong. 2nd Sess. vol. 2 at 1104 (Oct. 21, 1988) (requiring future editions of Pub. 1 to conform to TBoR).

233 IRC § 7811.

234 Pub. 1694 at 228.

235 Pub. L. No. 104-168, § 101, 110 Stat. 1452, 1453-54 (July 30, 1996).

236 Pub. L. No. 101-508, § 11111.

237 Pub. L. No. 104-193, § 451, 110 Stat. 2105, 2276 (1996).

238 IRC § 32(m).

239 Pub. L. No. 105-34, § 101, 111 Stat. 796.

240 IRC § 24(d), amended by Pub. L. No. 107-16, § 201 (expanding refundability).

"There is no other agency in this country that directly touches the lives of more Americans, nor is there any agency which strikes more fear into their hearts."[241]

Scores of witnesses included the former IRS Historian, who had left the job frustrated with officials' unwillingness to preserve and release historical documents;[242] a journalist who had authored a book-long exposé of the IRS;[243] four witnesses who testified on their troubles as innocent spouses wrongfully saddled with the liabilities of their husbands (or ex-husbands); former Commissioners Sheldon Cohen (1965-69), Donald Alexander (1973-77), Fred Goldberg (1989-92), and Margaret Richardson (1993-97), as well as sitting Commissioner Charles Rossotti and Treasury Secretary Robert Rubin.

Early in the hearings, a half-dozen anonymous IRS employees revealed internal excesses. For example, one such witness testified that in the context of negotiating payments supposed to be affordable to taxpayers, "I have seen the IRS punish a taxpayer by not allowing reasonable, necessary living expenses."[244] Nina Olson, a public-interest tax lawyer who ultimately was to become National Taxpayer Advocate, confirmed that among IRS collection employees, "from managers down to ACS phone technicians, they adopt an adversarial attitude toward the taxpayer."[245] Promising "fundamental change," Commissioner Rossotti acknowledged the seemingly arbitrary audit selection mechanism by saying that, "I will personally not believe that we are doing the right thing with respect to audits until I feel I can explain the process to the average American taxpayer."[246]

Meanwhile, on the other side of Congress, Speaker of the House Newt Gingrich (R-Ga.) had primed his caucus for reform through a Contract with America calling for both tax cuts and a balanced budget. According to a senior academic tax historian, the 1998 tax legislation was "the only direct accomplishment of Gingrich's Contract for America and its attacks on the IRS."[247]

In 1998, Congress enacted and President Clinton signed the IRS Restructuring and Reform Act (RRA 98) that among other provisions:[248]

- Created an Oversight Board to stay on top of the IRS;
- Granted the Commissioner the certainty of a five-year term;
- Split the Chief Counsel's reporting duties, leaving him to report to the Treasury General Counsel on tax policy but to the Commissioner on tax administration and litigation;

241 *Practices & Procs. of the IRS*, Hrgs. Before the Comm. on Finance, U.S. Sen., S. Hrg. 105-190, 105th Cong. 1st Sess. (Sept. 23-25, 1997) 1.

242 Davis, Unbridled Power.

243 Burnham, A Law unto Itself.

244 S. Hrg. 105-190 at 145.

245 *IRS Restructuring, Hrgs. Before the Comm. on Finance, U.S. Sen.* 125, S. Hrg. 105-529, 105th Cong. 2nd Sess. (Jan. 28, 29; Feb. 5, 11 & 25, 1998).

246 *IRS Oversight, Hrgs. Before the Comm. on Finance, U.S. Sen.* 201, S. Hrg. 105-598, 105th Cong. 2nd Sess. (Apr. 28-30 & May 1, 1998).

247 Brownlee, Fed. Taxation at 214.

248 Pub. L. No. 105-206. The underlying bill, H.R. 2676, was passed by votes in the House of Reps. of 426 to 4, and Sen. of 97 to 0. H.R. Roll Call 577 (Nov. 5, 1997); Sen. Vote No. 126 (May 7, 1998).

- Named the National Taxpayer Advocate as a Secretarial appointee not subject to removal by the Commissioner;
- Elevated the IRS Chief Inspector into a Senate-confirmed appointee to be known as the Treasury Inspector General for Tax Administration, who would report over the Commissioner's head to the Secretary;
- Reorganized the IRS from the 1952 geographic scheme into divisions serving taxpayer groups which, after consultation with management professionals, were identified as Wage & Investment, Small Business/Self-Employed, Tax-Exempt/Government Entities, and Large & Mid-Size Business (on October 1, 2010, renamed Large Business & International);[249]
- Funded Low Income Taxpayer Clinics;
- Expanded innocent spouse relief and made numerous reforms to procedural, collection, interest and penalty provisions, including the requirement for Collection Due Process hearings triggered by the first lien or levy action with respect to a tax liability; and
- Set goals for electronic filing.[250]

RRA 98 effectively laid the foundation for taxpayer service in the current era. By restructuring into functional divisions, each of which had nationwide scope, RRA 98 took the IRS another step away from local service, furthering a trend initiated by national centralization in 1952.

4. Economic Growth and Recession

In 2001, Congress enacted the Economic Growth and Tax Relief Reconciliation Act (EGTRRA 01), inaugurating President George W. Bush's tax cuts at the height of an economy that had boomed in the previous decade. Generally, EGTRRA 01 reduced income tax rates, in part by creating a ten-percent bracket for low income taxpayers, reduced marriage penalties, and expanded favorable provisions for education and retirement savings.[251] Tax cuts were immediately delivered through advance rebate checks.[252] In a sign of congressional rules permitting tax cuts only to a budgeted extent, the tax cuts generally were scheduled to expire in 2010.

In 2002, Congress enacted and President Bush signed a Trade Act that was not primarily a tax bill. Nevertheless, this Trade Act codified in the tax law a refundable credit to help pay for the health-insurance premiums of families of American workers laid off by employers who moved to a country that had a free trade agreement with the U.S.[253]

249 IRS News Release, *IRS Realigns and Renames Large Business Division, Enhances Focus on International Tax Administration*, IR-2010-88 (Aug. 4, 2010).

250 H. Conf. Rep't 105-599, 105th Cong. 2nd Sess. (June 24, 1998).

251 Pub. L. No. 107-16, 115 Stat. 38.

252 IRC § 6428 as amended by Pub. L. No. 107-16, § 101.

253 IRC § 35 added by Pub. L. No. 107-210, § 201; *see also* H. Conf. Rep't 107-624, 107th Cong. 2nd Sess. (July 26, 2002) 122.

In 2004, Congress enacted and President Bush signed the Working Families Tax Relief Act (WFTRA 04) containing a Uniform Definition of Child.[254] Acting on proposals from the National Taxpayer Advocate, Treasury, American Bar Association, American Institute of Certified Public Accountants, and Tax Executives Institute, Congress simplified the requirements for purposes of head of household filing status, child-care credit, child tax credit, EITC, and dependency deduction.[255] Generally, WFTRA 04 eliminated the need to document expenses for supporting a child of a prescribed age, relationship, and residence.

In response to a serious market downturn in 2008, Congress enacted and President Bush signed the Housing and Economic Recovery Act (HERA 08).[256] Under the leadership of House Ways and Means Committee Chairman Charles Rangel (D-N.Y.), HERA 08 enacted a First-Time Homebuyer Tax Credit for a portion of the purchase price. In another nod to congressional budgetary rules, the revenue cost of the legislative provision was offset by recapture over 15 years, effectively transforming the refundable credit into an interest-free loan to the taxpayer.[257] The following year, amendment would repeal recapture for later purchases.[258]

Another piece of recovery legislation was the Economic Stimulus Act of 2008 (ESA 08), which generated tax rebate checks to low and moderate-income individuals.[259] This was the fifth time that the IRS had become a disbursing agent for rebates.[260]

Weeks after his inauguration, President Barack Obama signed the American Recovery and Reinvestment Act of 2009 (ARRA 09), containing a signature Making Work Pay provision intended to support economic recovery through a refundable credit for low income workers in the amount of the payroll tax, expeditiously implemented by reductions in the withholding tables.[261] Parallel in some respects to the EITC, Making Work Pay was not, however, calibrated to increase with respect to any qualifying children.[262] Additionally, ARRA 09 temporarily modified and renamed the Hope Scholarship Credit, which Congress had enacted under President Clinton, as the refundable American Opportunity Tax Credit.[263]

254 Pub. L. No. 108-311, § 201 *ff.*, 118 Stat. 1166, 1169.

255 National Taxpayer Advocate 2001 Annual Report to Congress 76 (Legislative Recommendation: *Family Status Issues*); Dept. of the Treasury, *Proposal for Uniform Definition of a Qualifying Child* (Apr. 2002); ABA/AICPA/TEI *Tax Simplification Recommendations* (Sept. 13, 2002).

256 Pub. L. No. 110-289, 122 Stat. 2654.

257 IRC § 36.

258 Worker, Homeownership, and Business Assistance Act of 2009, Pub. L. No. 111-92, § 11.

259 IRC § 6428 as amended by Pub. L. No. 110-185. For business taxpayers, 2008 economic emergency legislation, in a provision that would be expanded by the Amer. Recovery & Reinvestment Act of 2009 as well as 2010 extender legislation, created an election to accelerate alternative minimum tax (AMT) or research credits in lieu of that year's bonus depreciation and made the amount refundable. *See* IRC § 168(k)(4) as amended by Pub. L. Nos. 110-289, § 3081, 122 Stat. 2654, 2903 (2008), 111-5, Div. B, § 1201, 123 Stat. 115, 333 (2009) & 111-240, § 2022, 124 Stat. 2504, 2558 (2010).

260 IRC § 6428 enacted by TRA 75, and amended by the Economic Recovery Tax Act of 1981, Pub L. No. 97-34, § 101, EGTRRA 01, and ESA 08; IRC § 6429 amended by Jobs & Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, § 101.

261 Pub. L. No. 111-5, 123 Stat. 115; H.R. Conf. Rep't 111-16, 111th Cong. 1st Sess. (Feb. 12, 2009) at 517-18.

262 IRC § 36A.

263 IRC § 25A.

In 2010, Congress enacted the Patient Protection and Affordable Care Act (PPACA), reflecting a major goal of the Obama Administration to extend health coverage to millions of uninsured Americans.[264] PPACA contained four health-care provisions of significance to income tax administration: a temporary credit for employers who pay for health insurance for a small number of employees;[265] a refundable credit for low and moderate-income individuals to subsidize the purchase of health insurance;[266] a penalty for individuals who fail to obtain health coverage;[267] and an excise tax on large employers who fail to offer health coverage.[268] In another reinvigoration of a Clinton-era social tax expenditure, PPACA temporarily made refundable the credit for parents who incur expenses of adopting children.[269]

B. Economic and Demographic Trends

In 2011, research by economists associated with the Treasury Office of Tax Analysis showed that income inequality had reached levels not seen since the Great Depression.[270] In 2008, the top one percent of earners received approximately 20 percent of personal income in the U.S.[271] Of the top 0.1 percent who earned $1.7 million or more, 60 percent were corporate executives or other managers.[272]

Meanwhile, income was only a part of compensation, which was increasingly supplemented by fringe benefits in the last quarter of the 20th century.[273] This trend would not have been unaffected by generous tax expenditures for retirement benefits and other non-wage compensation.[274]

The data above are consistent with class trends toward inequality through the end of the twentieth century. College tuition rose sharply in the last couple of decades.[275] While a plethora of special tax breaks subsidized college tuition (Hope Scholarship, Lifetime Learning, and American Opportunity Tax Credits; tuition and student loan interest deductions; exclusion of interest on U.S. saving bonds; deferral under Qualified Tuition Plans and Coverdell Education Savings Accounts),[276] some economists argued that college tuition

264 Pub. L. No. 111-148.

265 IRC § 45R (allowing credit that is partially refundable to small tax-exempt employers).

266 IRC § 36B.

267 IRC § 5000A.

268 IRC § 4980H.

269 IRC § 36C.

270 See Jon Bakija, Adam Cole & Bradley T. Heim, *Jobs and Income Growth of Top Earners and the Causes of Changing Income Inequality: Evidence from U.S. Tax Return Data* (Nov. 2010) *available at* http://www.indiana.edu/~spea/faculty/pdf/heim_JobsIncomeGrowthTopEarners.pdf.

271 Peter Whoriskey, *With Executive Pay, Rich Pull Away From Rest of America*, Wash. Post (June 18, 2011) A-1; *see also* Bakija, Cole & Heim, *Jobs and Income Growth*; IRS (SoI), *Individual Income Tax Rates & Shares*, 2008.

272 Wash. Post (June 18, 2011) A-1; *see also* Bakija, Cole & Heim, *Jobs and Income Growth*.

273 Caplow, First Measured Century at 160 (adding that: "Benefits such as employer-provided health insurance, bonuses, stock options, child care, tuition assistance, and vision and dental benefits expanded dramatically.").

274 See National Taxpayer Advocate 2010 Annual Report to Congress, vol. 2, 112 (Research Study: *Evaluate the Administration of Tax Expenditures*).

275 Caplow, First Measured Century at 62.

276 See National Taxpayer Advocate 2004 Annual Report to Congress 403 (Legislative Recommendation: *Simplification of Provisions to Encourage Education*).

rose to absorb certain federal subsidies.[277] In any case, rising cost formed another barrier between educated and uneducated.

An indicator of a major increase in private fortunes after 1980 was private philanthropy on an unprecedented scale.[278] Around the same time, personal debt, composed primarily of home mortgages, soared to new heights.[279] Previously mentioned tax expenditures loom large in both the formation of and response to this trend (home mortgage interest deduction, first-time home buyer credit). The combination of personal fortunes and personal debt portray a population divided by economic inequality.

This portrait of inequality was refracted diversely, even as refundable credits proliferated for low income taxpayers, statistically associated with particular populations.[280] In 2011, researchers reported that wealth gaps between whites and minorities had grown to their widest levels in a quarter-century.[281] In 2009, typical household wealth was $5,677, $6,325, and $113,149 for blacks, Hispanics, and whites, respectively.[282] Analyzing Census data, researchers attributed the statistics to plummeting house values.[283]

At the end of the twentieth century, Asian and Hispanic immigrants had joined African-Americans in large cities.[284] Distinct populations took on certain socio-economic characteristics with attendant tax consequences. For example, an academic analysis of Census data showed that "African-American households are more likely to pay a marriage penalty and White households are more likely to receive a marriage bonus."[285] This is because of "the significantly high percentage of African-American wives who contribute between 40 and 60% to total household income."[286]

Finally, the proportion of young to old continued to decline, reflecting both a decline in birth rate and increased longevity.[287] Not only did the end of the century confront growing inequality, but also a question of how many people of working age ultimately would remain to support a retiring generation.

277 *See* Bridget Terry Long, *The Impact of Federal Tax Credits for Higher Education Expenses*, College Choices: The Economics of Which College, When College, and How to Pay for it. ed. Caroline M. Hoxby (Univ. of Chicago Press, 2004), Nat'l Bur. of Econ. Res. Working Paper No. 9553; Jt. Econ. Comm., U.S. Cong., *College Affordability: Tuition Tax Credits vs. Saving Incentives* (Oct. 1997).

278 Caplow, First Measured Century at 168.

279 *Id*. at 170 (stating "Approximately three-quarters of this personal debt represented residential mortgages").

280 In 2008, 24.7 and 23.2 percent of blacks and Hispanics, respectively, but only 13.2 percent of the whole population, were below poverty. *See* Census, Statistical Abstract of the U.S. (2011), Table 710 at 464, *People Below Poverty Level & Below 125 Percent of Poverty Level by Race & Hispanic Origin: 1980 to 2008*.

281 *Census Data Show Wealth of Whites Is 20 Times that of Blacks, Widest U.S. Gap in Quarter-Century*, Wash. Post (July 26, 2011).

282 Rakesh Kochhar, Richard Fry & Paul Taylor, *Wealth Gaps Rise to Record Highs Between Whites, Blacks and Hispanics* 1, Pew Research Ctr. (July 26, 2011).

283 Kochhar, *Wealth Gaps* at 2.

284 Caplow, First Measured Century at 20.

285 *See* Dorothy A. Brown, *The Marriage Penalty/Bonus Debate: Legislative Issues in Black & White*, 16 N.Y.L. Sch. J. Human Rights 287 (1999).

286 16 N.Y.L. Sch. J. Human Rights at 294.

287 Caplow, First Measured Century at 6.

Another feature of this last period under study is that economic trends in part reflected prior tax policy. In particular, tax rates declined from a post-World War II high of 92 percent (in 1952 and 1953) to below 40 percent after 1986 (along with favorable rates for dividends and capital gains).[288] According to a commentator, the "dramatic increase in U.S. economic inequality over the past four decades is probably attributable to several causes, including changes in U.S. tax law . . ."[289] In sum, postwar prosperity turned into turn-of-the-century inequality.

C. Implications for Service

1. Electronic Administration

In 1986, the IRS collected $782.3 billion, of which more than half, $416.6 billion, was individual income taxes.[290] In 2010, the IRS collected $2.3 trillion, of which more than half, $1.2 trillion, was individual income taxes.[291] While the U.S. population and number of individual income tax returns increased, IRS staffing remained relatively level.[292] Automation continued even as new provisions would warrant face-to-face service.

Overcoming the meltdown of 1985, automation continued through the last quarter-century in the form of electronic filing and matching of information. On January 24, 1986, a tax return preparer filed a return electronically for the first time;[293] four years later, electronic filing was possible nationwide.[294] In the summer of 1986, the IRS deployed optical disk equipment with laser technology (a forerunner of CDs) to store and retrieve tax return information at the Fresno Service Center.[295] Incidentally, this deployment underscores the continued crucial role of Service Center campuses since their establishment three decades previously. In 1990, the Automated Underreporter (AUR) Control System came online with capacity for some nine million cases annually, modernizing the process by which the IRS tracked whether taxpayers declared income reported by third parties, such as banks that paid interest.[296]

2. Behavioral Analysis

Nevertheless, tax administration could not go on autopilot. This last quarter-century of tax administration would begin with a tax gap of $100 billion (according to a prediction

288 See Sol Bull. Hist. Data Table 23 (1913-2008).

289 Stephen B. Cohen, *Inequality and the Deficit*, 132 Tax Notes 273, 280, 2011 T.N.T. 139-6, Tax Analysts Doc. No. 2011-13967 (July 18, 2011), similar version released as Geo'town Business, Econ. & Reg. L. Res. Paper No. 11-13.

290 CIR Ann'l Rep't FYE Sept. 30, 1986, at 8. The value of $782.3 billion in 1986 would be comparable to $1.58 trillion in 2011.

291 IRS Pub. 55B, *Data Book* (2010), Table 1 at 3.

292 Table 1, Income Tax Demographic History (reflecting income tax returns but not, in the first half-century, excise tax workload, which would have been measured more accurately by gallons, pounds, or warehouses, as the case may be, rather than returns).

293 Pub. 1694 at 223.

294 *Id*. at 234.

295 *Id*. at 224.

296 *Id*. at 235.

Commissioner Roscoe Egger had made in 1982).[297] In 1985, IRS receipts totaled $742.9 billion.[298] On November 15, 1991, the IRS sponsored a Research Conference entitled "Closing the Tax Gap: Alternatives to Enforcement."[299] On April 27, 1992, the IRS issued a policy statement that penalties supported the IRS mission only if they enhanced voluntary compliance.[300] While internal researchers analyzed how to affect taxpayer decision-making, for 2001, the IRS estimated that the tax gap, the difference between what taxpayers should have paid and what they actually paid on a timely basis, grew over $300 billion (when IRS receipts totaled $2.1 trillion).[301]

Meanwhile, academicians pushed the study of economics, including public finance, beyond a neo-classical paradigm into the territory of behavioral and other social sciences.[302] In 2008, Professor Cass Sunstein, who soon would be appointed to lead the Office of Information and Regulatory Affairs within the Obama administration, co-authored a behavioral economic best-seller, including passages on tax incentives and compliance, entitled *Nudge: Improving Decisions About Health, Wealth, and Happiness.*[303] New approaches to the perennial problem of tax compliance were emerging.[304]

In the face of electronic efficiency, in 2009 the National Taxpayer Advocate observed a "taxpayer preference for personal interaction with the IRS" which "is good news for tax administration because it affords the tax administrator the opportunity to engage and educate the taxpayer."[305] This observation brought tax compliance back to human behavior.

3. Refunds and Rebates

Despite the reform of 1986, special tax breaks were accumulating in such a quantity as to change the quality of tax administration. While tax expenditures had been born with the income tax, the last quarter-century witnessed a proliferation of social tax benefits. Previously, Assistant Secretary Surrey had announced the advent of negative taxes, and the Excise Tax Reduction Act of 1965 had made a fuel tax credit refundable, when the purchaser may have been a farmer fueling a tractor.[306]

297 Richard B. Malamud & Richard O. Parry, *It's Time to Do Something About the Tax Gap*, 9 Houston Bus. & Tax L.J. 2 (2008).

298 CIR Ann'l Rep't FYE Sept. 30, 1985, at 2.

299 Pub. 1694 at 236.

300 IRS Policy Statement P-1-18 (as of Aug. 20, 1998).

301 IRS News Release, New IRS Study Provides Preliminary Tax Gap Estimate, IR-2005-38 (Mar. 29, 2005); IRS Pub. 55B, Data Book (2001), Table 1 at 6; *see also* Berdj Kenadjian, *Gross Tax Gap Trends According to New IRS Estimates, Income Years 1973-1992*, 8 Statistics of Income Bull. 23, 26 (1988) Fig. C (reporting that tax compliance historically remained between 81 and 84 percent).

302 Isaac Wm. Martin, Ajay K. Mehrotra & Monica Prasad, *The Thunder of History: The Origins and Development of the New Fiscal Sociology*, The New Fiscal Sociology: Taxation in Comparative and Historical Perspective (Cambridge Univ. Press, 2009).

303 Richard H. Thaler & Cass R. Sunstein, Nudge (New Haven, Conn.: Yale Univ. Press, 2008).

304 *See* National Taxpayer Advocate 2007 Annual Report to Congress 156 (Most Serious Problem: *Taxpayer Service and Behavioral Research*); vol. 2, 138-50 (Research Study: Marjorie E. Kornhauser, *Normative and Cognitive Aspects of Tax Compliance*).

305 Nina E. Olson, *Minding the Gap: A Ten-Step Program for Better Tax Compliance*, 20 Stan. L. & Pol'y Rev. 7, 30 (2009).

306 Pub. L. No. 89-44, § 809; H. Con'f Rep't 89-525, 89th Cong. 1st Sess. 11 (June 16, 1965).

After the 1975 enactment of the EITC, a latter-day parade of refundable credits, in response to both good and bad economic conditions, brought in the additional child tax credit, trade adjustment health credit, first-time homebuyer credit, Making Work Pay credit, American Opportunity Tax Credit, PPACA individual credit, and adoption credit. Most of these refundable credits were targeted at low income taxpayers, a diverse population not particularly well served by electronic mass media.[307] Starting in 1975, the IRS similarly had to apply reverse engineering to the revenue collection apparatus to issue tax rebate checks under legislation again in 1981, 2001, 2003, and 2008.

In 2010, the National Taxpayer Advocate observed that the IRS mission *de facto* had expanded beyond collecting taxes to administering social and economic benefit programs, justifying a recommendation for formal revision of the mission statement with concomitant staffing and appropriations.[308] Tax administration had moved beyond enforcement not only as a practical matter but as a matter of a new fiscal mandate codified in special tax breaks.

4. Service and Diversity

In terms of taxpayer service, the number of returns per employee essentially leveled off after the mid-century shift to a mass population of income taxpayers, even as return volume increased steadily.[309] As recounted above, information technology and audit techniques facilitated staff efforts to tackle an increasingly complex workload.[310]

Automation and audit techniques call to mind the "technique of power"[311] observed by post-modern historians after the British philosopher Jeremy Bentham of the eighteenth-century Enlightenment period, when many principles of Anglo-American law were enunciated. To assure "the automatic functioning of power . . . Bentham laid down the principle that power should be visible and unverifiable."[312] Foreshadowing deterrence by apparently arbitrary audit selection techniques (of the sort bemoaned by Commissioner Rossotti above), Bentham suggested that a subject "must never know whether he is being looked at at any one moment; but he must be sure that he may always be so."[313]

---

307 *See infra* vol. 1, Most Serious Problem: *The IRS Needs to Accommodate Changing Taxpayer Demographics*.

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

309 Table 1, Income Tax Demographic History (reflecting income tax returns but not, in the first half-century, excise tax workload, which would have been measured more accurately by gallons, pounds, or warehouses, as the case may be, rather than returns).

310 Tax complexity deserves its own history, yet suffice it to say that simplification has been a concern at least since mid-century, an impetus behind TRA 86, and an imperative in the last decade. *See* Paul, Taxation in the U.S. at 379-92; Dep't of the Treas., Tax Reform for Fairness, Simplicity, and Economic Growth (1984); Pres. Advisory Panel on Fed. Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System* (Nov. 2005); *The Moment of Truth: Rep't of the Nat'l Comm. on Fiscal Responsibility & Reform* (Dec. 2010); National Taxpayer Advocate 2004 Annual Report to Congress 2 (Most Serious Problem: *The Confounding Complexity of the Tax Code*); National Taxpayer Advocate 2008 Annual Report to Congress 3 (Most Serious Problem: *The Complexity of the Tax Code*); National Taxpayer Advocate 2010 Annual Report to Congress 3 (Most Serious Problem: *The Time for Tax Reform Is Now*).

311 Michel Foucault, Discipline & Punish (NY: Vintage Books, 1979) 199.

312 Foucault, Discipline & Punish 201.

313 *Id*.

On the contrary, Commissioner Rossotti had welcomed the enactment of RRA 98 with an insistence "on fairness and accountability throughout the agency."[314] To achieve this, he had offered "a flatter management structure that will foster better communication."[315] For Commissioner Rossotti, the promise of modernized technology and management was to "de-mystify the audit process."[316]

Nevertheless, a sort of "automatic functioning of power" pervaded tax administration. In particular, "tax policies and procedures applied using automated systems and software applications" escaped not only publication but internal verification.[317] Unlike rules and regulations subject to a promulgation protocol for application on a case-by-base basis, IRS guidance programmed into computer systems generated results like an automaton, without the intervention of human judgment.[318]

Human judgment would become all the more important in the face of the demographic diversity of today's taxpayer population.[319] History poses a question whether steadily increasing volume can be addressed simply by mass production, which presumably would work if taxpayers were uniform, or if increased diversity along with increased volume raises qualitatively different challenges.

VI. Conclusion

Legislatively, the last 98 years of federal income taxation fell into four periods from enactment in 1913, to codification in 1939, recodification in 1954, and recodification with reform in 1986. In the first quarter-century, income tax was a concern largely to wealthy, white businessmen, doctors, and lawyers, who dealt with their Collectors, who in turn were locally prominent political appointees. All this changed during the second phase, when the exigency of World War II transformed the income tax into a mass revenue generator, popularized by a forward-leaning Treasury. The old-fashioned infrastructure of the BIR proved too quaint and prone to corruption for the modern regime, which reorganized the IRS into a machine controlled from Washington, D.C. The 1952 reorganization marked a shift from local to centralized tax administration, embodied in Service Centers. Automation carried out in Service Centers across the country continued apace through the third period until burning out in a tragic failure of technology and management in 1985. Thus sobered, the last quarter century brought increased oversight to the IRS, personified by the National Taxpayer Advocate, Treasury Inspector General for Tax Administration, and IRS Oversight Board. Nevertheless, an inevitable modernization of computers with their promise of

314 *IRS Oversight* at 197.

315 *Id*. at 200-201.

316 *Id*. at 201.

317 National Taxpayer Advocate 2010 Annual Report to Congress 71 (Most Serious Problem: *IRS Policy Implementation Through Systems Programming Lacks Transparency and Precludes Adequate Review*).

318 National Taxpayer Advocate 2010 Annual Report to Congress 75 (contending "Automation is not a substitute for an employee's independent judgment and discretion.")

319 *See infra* vol. 1, *Introduction to Diversity Issues: The IRS Should Do More to Accommodate Changing Taxpayer Demographics*.

efficiency overshadowed old-fashioned staff with human judgment. Meanwhile, the tax system was increasingly characterized by complexity, especially after the Second World War. At the same time, the perennial temptation of tax expenditures effectively charged the tax collector, who since mid-century had been the face of government to the populace, with socio-economic benefit administration. Assuming the duties on both sides of the fisc of disbursement, in effect, through tax rebates and refundable credits, as well as revenue collection, the IRS in the electronic age had become a fiscal automaton.

Appendix 1. Form 1040, *Return of Annual Net Income of Individuals* (1913)

TO BE FILLED IN BY COLLECTOR.

List. No. .....

..... District of .....

Date received .....

Form 1040.

INCOME TAX.

THE PENALTY
FOR FAILURE TO HAVE THIS RETURN IN THE HANDS OF THE COLLECTOR OF INTERNAL REVENUE ON OR BEFORE MARCH 1 IS $20 TO $1,000.
(SEE INSTRUCTIONS ON PAGE 4.)

TO BE FILLED IN BY INTERNAL REVENUE BUREAU.

File No. .....

Assessment List .....

Page ..... Line .....

UNITED STATES INTERNAL REVENUE.

RETURN OF ANNUAL NET INCOME OF INDIVIDUALS.

(As provided by Act of Congress, approved October 3, 1913.)

RETURN OF NET INCOME RECEIVED OR ACCRUED DURING THE YEAR ENDED DECEMBER 31, 191 ....
(FOR THE YEAR 1913, FROM MARCH 1, TO DECEMBER 31.)

Filed by (or for) ..... (Full name of individual.) *of* ..... (Street and No.)

in the City, Town, or Post Office of ..... *State of* .....
(Fill in pages 2 and 3 before making entries below.)

1. GROSS INCOME (see page 2, line 12)	$
2. GENERAL DEDUCTIONS (see page 3, line 7)	$
3. NET INCOME	$

Deductions and exemptions allowed in computing income subject to the normal tax of 1 per cent.

4. Dividends and net earnings received or accrued, of corporations, etc., subject to like tax. (See page 2, line 11)	$
5. Amount of income on which the normal tax has been deducted and withheld at the source. (See page 2, line 9, column A)	
6. Specific exemption of $3,000 or $4,000, as the case may be. (See Instructions 3 and 19)	
Total deductions and exemptions. (Items 4, 5, and 6)	$
7. TAXABLE INCOME on which the normal tax of 1 per cent is to be calculated. (See Instruction 3)	$

8. When the net income shown above on line 3 exceeds $20,000, the additional tax thereon must be calculated as per schedule below:

	INCOME.	TAX.
1 per cent on amount over $20,000 and not exceeding $50,000	$	$
2 " " 50,000 " " 75,000		
3 " " 75,000 " " 100,000		
4 " " 100,000 " " 250,000		
5 " " 250,000 " " 500,000		
6 " " 500,000		
Total additional or super tax		$
Total normal tax (1 per cent of amount entered on line 7)		$
Total tax liability		$

2

GROSS INCOME.

This statement must show in the proper spaces the entire amount of gains, profits, and income received by or accrued to the individual from all sources during the year specified on page 1.

DESCRIPTION OF INCOME.	A. Amount of income on which tax has been deducted and withheld at the source.	B. Amount of income on which tax has NOT been deducted and withheld at the source.
1. Total amount derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form paid	$	$
2. Total amount derived from professions, vocations, businesses, trade, commerce, or sales or dealings in property, whether real or personal, growing out of the ownership or use of interest in real or personal property, including bonds, stocks, etc.		
3. Total amount derived from rents and from interest on notes, mortgages, and securities (other than reported on lines 5 and 6)		
4. Total amount of gains and profits derived from partnership business, whether the same be divided and distributed or not		
5. Total amount of fixed and determinable annual gains, profits, and income derived from interest upon bonds and mortgages or deeds of trust, or other similar obligations of corporations, joint-stock companies or associations, and insurance companies, whether payable annually or at shorter or longer periods		
6. Total amount of income derived from coupons, checks, or bills of exchange for or in payment of interest upon bonds issued in *foreign countries* and upon *foreign mortgages* or like obligations (not payable in the United States), and also from coupons, checks, or bills of exchange for or in payment of any dividends upon the stock or interest upon the obligations of foreign corporations, associations, and insurance companies engaged in business in foreign countries		
7. Total amount of income received from fiduciaries		
8. Total amount of income derived from any source whatever, not specified or entered elsewhere on this page		
9. TOTALS		
NOTES.—Enter total of Column A on line 5 of first page.		
10. AGGREGATE TOTALS OF COLUMNS A AND B		$
11. Total amount of income derived from dividends on the stock or from the net earnings of corporations, joint-stock companies, associations, or insurance companies subject to like tax (To be entered on line 4 of first page.)		$
12. TOTAL **"Gross Income"** (to be entered on line 1 of first page)		$

3

GENERAL DEDUCTIONS.

1.	The amount of necessary expenses actually paid in carrying on business, but not including business expenses of partnerships, and not including personal, living, or family expenses	$			
2.	All interest paid within the year on personal indebtedness of taxpayer				
3.	All national, State, county, school, and municipal taxes paid within the year (not including those assessed against local benefits)				
4.	Losses actually sustained during the year incurred in trade or arising from fires, storms, or shipwreck, and not compensated for by insurance or otherwise				
5.	Debts due which have been actually ascertained to be worthless and which have been charged off within the year				
6.	Amount representing a reasonable allowance for the exhaustion, wear, and tear of property arising out of its use or employment in the business, not to exceed, in the case of mines, 5 per cent of the gross value at the mine of the output for the year for which the computation is made, but no deduction shall be made for any amount of expense of restoring property or making good the exhaustion thereof, for which an allowance is or has been made				
7.	Total "GENERAL DEDUCTIONS" (to be entered on line 2 of first page)				

AFFIDAVIT TO BE EXECUTED BY INDIVIDUAL MAKING HIS OWN RETURN.

I solemnly swear (or affirm) that the foregoing return, to the best of my knowledge and belief, contains a true and complete statement of all gains, profits, and income received by or accrued to me during the year for which the return is made, and that I am entitled to all the deductions and exemptions entered or claimed therein, under the Federal Income-tax Law of October 3, 1913.

Sworn to and subscribed before me this .....

day of ....., 191

.....
(Signature of individual.)

SEAL OF OFFICER TAKING AFFIDAVIT.

.....

.....
(Official capacity.)

AFFIDAVIT TO BE EXECUTED BY DULY AUTHORIZED AGENT MAKING RETURN FOR INDIVIDUAL.

I solemnly swear (or affirm) that I have sufficient knowledge of the affairs and property of ..... to enable me to make a full and complete return thereof, and that the foregoing return, to the best of my knowledge and belief, contains a true and complete statement of all gains, profits, and income received by or accrued to said individual during the year for which the return is made, and that the said individual is entitled, under the Federal Income-tax Law of October 3, 1913, to all the deductions and exemptions entered or claimed therein.

Sworn to and subscribed before me this .....

day of ....., 191

.....
(Signature of agent.)

ADDRESS IN FULL .....

.....

SEAL OF OFFICER TAKING AFFIDAVIT.

.....

.....
(Official capacity.)

[SEE INSTRUCTIONS ON BACK OF THIS PAGE.]

INSTRUCTIONS.

1. This return shall be made by every citizen of the United States, whether residing at home or abroad, and by every person residing in the United States, though not a citizen thereof, having a *net income* of $3,000 or over for the taxable year, and *also* by every *nonresident alien* deriving income from property owned and business, trade, or profession carried on *in the United States* by him.

2. When an individual by reason of minority, sickness or other disability, or absence from the United States, is unable to make his own return, it may be made for him by his *duly authorized* representative.

3. The *normal tax* of 1 per cent shall be assessed on the total net income less the specific exemption of $3,000 or $4,000 as the case may be. (For the year 1913, the specific exemption allowable is $2,500 or $3,333.33, as the case may be.) If, however, the normal tax has been deducted and withheld on any part of the income at the source, or if any part of the income is received as dividends upon the stock or from the net earnings of any corporation, etc., which is taxable upon its net income, such income shall be deducted from the individual's total *net income* for the purpose of calculating the amount of income on which the individual is liable for the normal tax of 1 per cent by virtue of this return. (See page 1, line 7.)

4. The *additional or super tax* shall be calculated as stated on page 1.

5. This return shall be filed with the Collector of Internal Revenue for the district in which the individual resides if he has no other place of business, otherwise in the district in which he has his *principal place of business;* or in case the person resides in a foreign country, then with the collector for the district in which his principal business is carried on in the United States.

6. This return must be filed on or before the first day of March succeeding the close of the calendar year for which return is made.

7. The *penalty for failure to file the return within the time specified by law* is $20 to $1,000. In case of refusal or neglect to render the return within the required time (except in cases of sickness or absence), 50 per cent shall be added to amount of tax assessed. In case of *false or fraudulent return,* 100 per cent shall be added to such tax, and any person required by law to make, render, sign, or verify any return who makes any false or fraudulent return or statement with intent to defeat or evade the assessment required by this section to be made shall be guilty of a misdemeanor, and shall be fined not exceeding $2,000 or be imprisoned not exceeding one year, or both, at the discretion of the court, with the costs of prosecution.

8. When the return is not filed within the required time by reason of sickness or absence of the individual, an extension of time, not exceeding 30 days from March 1, within which to file such return, *may be* granted by the collector, *provided* an application therefor is made by the individual within the period for which such extension is desired.

9. This return properly filled out must be made under oath or affirmation. Affidavits may be made before any officer *authorized by law* to administer oaths. If before a justice of the peace or magistrate; not using a seal, a *certificate of the clerk of the court as to the authority* of such officer to administer oaths should be *attached to the return.*

10. Expense for medical attendance, store accounts, family supplies, wages of domestic servants, cost of board, room, or house rent for family or personal use, *are not expenses that can be deducted from gross income.* In case an individual owns his own residence he can not deduct the estimated value of his rent, neither shall he be required to include such estimated rental of his home as income.

11. The farmer, in computing the net income from his farm for his annual return, shall include all moneys received for produce and animals sold, and for the wool and hides of animals slaughtered, provided such wool and hides are sold, and he shall deduct therefrom the sums actually paid as purchase money for the animals sold or slaughtered during the year.

When animals were raised by the owner and are sold or slaughtered he shall not deduct their value as expenses or loss. He may deduct the amount of money actually paid as expense for producing any farm products, live stock, etc. In deducting expenses for repairs on farm property the amount deducted must not exceed the amount actually expended for such repairs during the year for which the return is made. (See page 3, item 6.) The cost of replacing tools or machinery is a deductible expense to the extent that the cost of the new articles does not exceed the value of the old.

12. In calculating losses, only such losses as shall have been actually sustained and the amount of which has been definitely ascertained during the year covered by the return can be deducted.

13. Persons receiving fees or emoluments for professional or other services, as in the case of physicians or lawyers, should include all actual receipts for services rendered in the year for which return is made, together with all unpaid accounts, charges for services, or contingent income due for that year, if good and collectible.

14. Debts which were contracted during the year for which return is made, but found in said year to be worthless, may be deducted from gross income for said year, but such debts can not be regarded as worthless until after legal proceedings to recover the same have proved fruitless, or it clearly appears that the debtor is insolvent. If debts contracted prior to the year for which return is made were included as income in return for year in which said debts were contracted, and such debts shall subsequently prove to be worthless, they may be deducted under the head of losses in the return for the year in which such debts were charged off as worthless.

15. Amounts due or accrued to the individual members of a partnership from the net earnings of the partnership, whether apportioned and distributed or not, shall be included in the annual return of the individual.

16. United States pensions shall be included as income.

17. Estimated advance in value of real estate is not required to be reported as income, unless the increased value is taken up on the books of the individual as an increase of assets.

18. Costs of suits and other legal proceedings arising from ordinary business may be treated as an expense of such business, and may be deducted from gross income for the year in which such costs were paid.

19. An unmarried individual or a married individual not living with wife or husband shall be allowed an exemption of $3,000. When husband and wife live together they shall be allowed jointly a total exemption of only $4,000 on their aggregate income. They may make a joint return, both subscribing thereto, or if they have separate incomes, they may make separate returns; but in no case shall they jointly claim more than $4,000 exemption on their aggregate income.

20. In computing net income there shall be excluded the compensation of all officers and employees of a State or any political subdivision thereof, except when such compensation is paid by the United States Government.

Appendix 2. Form 1040, *Individual Income Tax Return* (1917)

Form 1040 (Revised January, 1918)—United States Internal Revenue — Page 1

INDIVIDUAL INCOME TAX RETURN FOR CALENDAR YEAR 1917

INSTRUCTIONS

1. Persons Required to Make a Return of Net Income.

Every citizen of the United States, whether residing at home or abroad, and every person residing in the United States, though not a citizen thereof, whose net income for the calendar year 1917 (see item O, page 4) amounted to $1,000 if the individual is single or does not live with wife (or husband) or $2,000 if he is married and lives with wife (or husband), is required to make a return.

If the combined income of husband and wife, living together, and dependent children equaled or exceed $2,000, all such income must be reported, either on one return or on separate returns. Husband and wife should make separate returns if either is subject to surtax (see instruction 6).

Executors and administrators of the estates of deceased persons must make returns covering the part of the taxable year during which such persons were alive, and also returns for the estates during the period of settlement. If the income of a trust estate was distributed, the fiduciary should get a copy of Form 1041 and comply with the instructions thereon. If the income from a trust estate was not distributed, the fiduciary must make a return for the estate on this form.

Guardians must make returns for their wards. Duly authorized agents may make returns for persons who by reason of sickness or other disability or absence from the United States are unable to make their own returns.

2. Income Exempt from Tax.

The following kinds of income need not be reported on this return:

(a) Proceeds of life-insurance policies paid to individual beneficiaries upon death of the insured.

(b) The amount received by the insured as a return of premium or premiums paid by him under life insurance, endowment, or annuity contracts, either during the term or at the maturity of the term mentioned in the contract, or upon the surrender of the contract.

(c) The value of property acquired by gift, bequest, devise, or descent (but the income from such property should be included as income).

(d) Interest upon the obligations of a State or any political subdivision thereof.

(e) Interest upon the obligations of the United States, except, in the case of such obligations issued since September 1, 1917, upon the amount by which an individual's holdings exceed $5,000 par value.

(f) Interest upon obligations of the possessions of the United States.

(g) Interest upon securities issued under the provisions of the Federal Farm Loan Act of July 17, 1916.

(h) The compensation of all officers and employees of a State, or any political subdivision thereof, except when such compensation is paid by the United States Government.

3. Personal Exemption.

A single person or a married person not living with wife or husband and having no dependents is entitled to a personal exemption of $1,000.

A married person living with wife or husband, or a head of family, is entitled to a personal exemption of $2,000, plus $200 for each child dependent upon him or her, if under 18 years of age or incapable of self-support because mentally or physically defective.

A "head of family" is a person who in accordance with some moral or legal obligation actually supports and maintains one or more individuals closely related to him or her by blood, marriage, or adoption.

The amount by which the net income exceeds the foregoing exemption is subject to a normal tax of 2 per cent under the act of October 3, 1917, further exemption of $2,000 is allowed before computing the normal tax of 2 per cent imposed by the act of September 8, 1916.

If a husband and wife make separate returns, their total exemption may be claimed by either (but not by both), or it may be divided between them.

The exemption is determined by the individual's status on December 31, 1917. A deceased individual's exemption is determined by his status at the time of his death.

An estate or trust paying income tax is entitled to an exemption of $1,000.

4. Tax Withheld at Source.

No credit should be claimed in this return for tax withheld on any income except 2 per cent of the interest on tax-free-covenant bonds (see item 31, page 4). If tax on any other income has been withheld (except from nonresident aliens), the law provides that it shall be paid over by the withholding agent to the person from whom it was withheld.

5. Basis of Return of Income.

This return must show the income actually received and expenses actually paid during the year, unless the taxpayer keeps accounts (available for examination by internal revenue officers) showing income accrued and expenses incurred.

6. Surtax.

If your total net income (item O, page 4) exceeds $5,000 you are subject to a surtax on the amount of net income in excess of $5,000 at a rate dependent on the amount of your total net income. To compute the amount of surtax, use the table and instructions at the bottom of this page.

7. Excess Profits Taxes.

If your net income reported under A on page 3 exceeded $6,000, you are subject to an excess profits tax at the rate of 8 per cent on the amount by which the net total under A exceeds $6,000.

If your total net income from all sources exceeded $6,000 and you received any income from a trade or business with invested capital, you should get a copy of the excess profits tax return (Form 1101), and calculate the amount of your tax, if any, as directed therein.

Enter the amounts of your excess profits taxes, if any, as items 34 and 35, page 4, and their total as item L, page 4.

For further instructions, see the Excess Profits Tax Regulations.

8. Affidavit.

The affidavit must be executed by the person whose income is reported unless he is a minor or unless he is ill, absent from the country, or otherwise incapacitated, in which case an agent may execute the affidavit.

The oath will be administered without charge by any collector or deputy collector of internal revenue or (if you are in the military or naval service of the United States) by any military or naval officer who is authorized to administer oaths for purposes of military or naval justice and administration. If you are not in the military or naval service and an internal revenue officer is not available, the return should be sworn to before a notary public, justice of the peace, or other person authorized to administer oaths.

It is not necessary to show the statement of net income or of tax due to the officer who administers the oath.

9. What Form Should be Used.

An individual whose net income for 1917 did not exceed his personal exemption by more than $2,000, and also did not exceed $5,000, may use the smaller return form (1040-A) instead of this form (1040). For copies of Form 1040-A or additional copies of Form 1040, inquire of your collector of internal revenue or at your post office or bank.

10. When the Return Must be Made.

This return must reach the collector's office on or before March 1, 1918.

The collector of internal revenue may, in case of sickness or absence of the individual, grant an extension of time not exceeding 30 days from March 1, 1918, provided a written application therefor is made within the period for which such extension may be granted.

The Commissioner of Internal Revenue is authorized to grant a reasonable extension of time for any reason he considers adequate.

11. Where the Return Should be Sent.

The return should be delivered or mailed to the collector of internal revenue for the district in which the individual resides.

If the individual has no residence in the United States the return should be sent to the collector for the district in which his principal business is carried on in the United States.

If the individual has neither residence nor place of business in the United States, the return should be sent to the collector of internal revenue at Baltimore, Md.

It is suggested that a copy of the return be retained.

12. When and to Whom Tax Must be Paid.

You may pay your tax by sending cash, check, or money order with this return to the collector of internal revenue.

You must pay it on or before June 15, 1918, to the collector to whom the return is sent.

13. Information at Source.

Every individual, firm, or corporation who during 1917 paid to another person salary, wages, interest, commissions, rentals, etc., of $800 or more, is required to make a true and accurate return to the Commissioner of Internal Revenue showing the nature and source of such payments and the name and address of the person receiving them. Forms for reporting such information will be furnished by any collector of internal revenue.

TABLE FOR COMPUTATION OF SURTAX ON NET INCOME (Item O, Page 4) IN EXCESS OF $5,000.

INSTRUCTIONS.

To compute amount of surtax due on any amount of net income in excess of $5,000: First, find in Column A the largest sum which is less than the amount of the total net income reported on the return; then find in Column E the corresponding amount of total surtax. To this amount add an amount computed as follows:

Subtract from the net income the sum found in Column A and multiply the remainder by the rate shown on the next line below in Column C.

The sum of these two amounts is the total surtax due.

For example, the surtax on a net income of $22,500 is computed below:

1. Largest sum in Column A which is less than the amount of the total net income	$20,000
2. Total surtax thereon shown in Column E	500
3. Remainder of net income after subtracting item 1, above	2,500
4. Surtax on this remainder at rate (8%) shown in Column C on line below that from which item 1 was taken	200
5. Total surtax due (sum of items 2 and 4)	700

Amount of net income.	Amount subject to surtax at rate shown in Column C.	Rate.	Amount of surtax at each rate.	Total surtax on each amount.
A	B	C	D	E
$5,000	$ 000	0%	$00	$00
7,500	2,500	1%	25	25
10,000	2,500	2%	50	75
12,500	2,500	3%	75	150
15,000	2,500	4%	100	250
20,000	5,000	5%	250	500
40,000	20,000	8%	1,600	2,100
60,000	20,000	12%	2,400	4,500
80,000	20,000	17%	3,400	7,900
100,000	20,000	22%	4,400	12,300
150,000	50,000	27%	13,500	25,800
200,000	50,000	31%	15,500	41,300
250,000	50,000	37%	18,500	59,800
300,000	50,000	42%	21,000	80,800
500,000	200,000	46%	92,000	172,800
750,000	250,000	50%	125,000	297,800
1,000,000	250,000	55%	137,500	435,300
1,500,000	500,000	61%	305,000	740,300
2,000,000	500,000	62%	310,000	1,050,300
Over 2,000,000	.....	63%	.....	.....

COMPUTATION.

1. Largest sum in Column A which is less than the amount of the total net income . . $ .....
2. Total surtax thereon shown in Column E . $ .....
3. Remainder of net income after subtracting item 1, above . . . . . $ .....
4. Surtax on this remainder at rate (8%) shown in Column C on line below that from which item 1 was taken . . . . . $ .....
5. Total surtax due (sum of items 2 and 4) . . $ .....

This total (item 5) should be entered as item 33, page 4.

PENALTIES.

For failing to make return on time.—Not less than $20 nor more than $1,000, and, in addition, 50 per cent of the amount of tax due.

For making false or fraudulent return.—Not exceeding $2,000 or not exceeding one year's imprisonment, or both, in the discretion of the court, and 100 per cent of the tax due.

For failing to pay tax on time.—Five per cent of the amount of tax due and 1 per cent interest for each full month during which the tax remains unpaid.

This return must reach the Collector of Internal Revenue at ..... , or his deputy, on or before MARCH 1, 1918.

Page 2

DETAILS OF TAXABLE INCOME

All income must be reported gross, except income received from partnerships or through fiduciaries, which should be reported net.

Income of any kind amounting to $800 or more received from any one source, or any income regardless of amount received from a partnership or through a fiduciary, should be reported separately, together with the name and address of the person, association, corporation, partnership, or fiduciary from whom received.

Your share of partnership profits should be reported under H, page 4, except the part of such profits which was originally derived (1) from interest on obligations of the United States issued since September 1, 1917, held by the partnership in excess of $5,000 par value (to be entered under E); (2) from dividends on stock of domestic and resident corporations (to be entered under F); and (3) from interest on securities not subject to Federal income tax.

If the partnership's fiscal year differs from the calendar year so that a part of the fiscal year fell within the calendar year 1916, a proportionate part of your share of the partnership profits for the fiscal year (with the exceptions noted), assignable to the calendar year 1916 should be entered under H in the column for deductions, and the balance in the final column. The total of these two amounts should be entered in the column for "Gross income." For normal tax, partnership profits assignable to 1916 but received in 1917 should be added to item 27, page 4. For surtax, they should be added to dividends (if any) accumulated in 1916, and treated as directed for such dividends under F, below. Dividends received through a partnership should be reported (like other dividends) under F for the year in which accumulated, regardless of the fiscal year of the partnership.

If income reported on this return was received by wife (or husband), or child, enter it in the same manner as your own income and write the word "wife," "husband," or "child," on the line on which the income is reported.

If this form has not space enough for all entries, make additional entries on a separate sheet of paper and attach it securely to page 3 or 4.

A. INCOME FROM SALARIES, WAGES, COMMISSIONS, BONUSES, DIRECTORS' FEES, AND PENSIONS, AND FROM PROFESSIONS.

Salaries, wages, etc., paid by States or political subdivisions thereof and gifts not forming part of your compensation for services rendered should not be reported.

Expenses charged against your compensation or professional income should be explained on the blank lines marked "Explanation of deductions."

State whether the salaries, etc., were received by yourself, wife (or husband), or child.

Brokers and commission merchants should report their income under B if they buy and sell on their own account, advance money to their customers, or in any way use more than a nominal capital in their business.

B. INCOME FROM BUSINESS (INCLUDING FARMING).

Report income under B only if you are engaged in farming or in business for yourself. Do not report here your share of partnership profits.

Report under C sales of land, buildings, equipment, stocks, bonds, and other property not connected with your regular business, and sales of your business plant and equipment.

If you have a complete profit and loss statement, showing all the information called for under "Cost of goods sold" and "Other business deductions," you may attach it to page 3 of this return and enter the amount of net income under B, page 3.

Gross sales and income from business services.—Individuals deriving income from the sale of merchandise or of products of farming, manufacturing, mining, or construction should report the total amount of such sales less any discounts or allowances from the sale price. Income from business services such as transportation, storage, etc., carried on with invested capital, should also be reported here.

Cost of goods sold.—If you make inventories of merchandise or securities, state under "Explanations" the basis on which such inventories are made, that is, whether (a) at cost or (b) at cost or market value, whichever is lower.

If in your books of account you do not regularly inventory unsold goods or securities on hand, make no entries referring to inventories, but use one of the following methods:

(1) Report as cost of goods sold the total cost of goods purchased or produced during the year. This method may be used by manufacturers and dealers in merchandise, but not by dealers in real estate or securities.

(2) Report the cost of the particular articles sold during the year, in accordance with the instructions under C. This method may be used by dealers in real estate and securities.

Taxes.—See instructions under J, below.

Repairs.—Ordinary repairs required to keep property in usable condition, are deductible. Replacements, on the other hand, may not be deducted, unless no deduction for wear and tear or depreciation has been claimed. Expenditures for permanent improvements are not deductible under this or any other heading.

This item should be explained in the table at the bottom of page 3.

Wear and tear.—A deduction may be claimed on account of wear and tear or depreciation during the year of property used exclusively in business or trade, only to the extent that such wear and tear or depreciation is not covered by deductions claimed in this return or in previous returns for repairs, replacements, and losses. The amount claimed for wear and tear or depreciation should not exceed the original cost of the property divided by its total estimated life in years. When the amount of depreciation allowed equals the cost of the property, no further claim should be made.

Do not claim any deduction for depreciation in the value of a building occupied by the owner as his dwelling, or of other property held for personal use. Do not claim any deduction for depreciation of real estate (exclusive of improvements thereon), nor for depreciation of stocks, bonds, and other securities.

This item should be explained in the table at the bottom of page 3.

Depreciation of patents, copyrights, etc., and depletion of mines, etc.—If you wish to claim a deduction on account of depreciation in the value of patents, copyrights, franchises, and other legal privileges, or on account of depletion of mines and oil and gas wells, see paragraphs 7 and 8, section 5a, of the act of September 8, 1916, and the regulations thereunder, or communicate with your collector of internal revenue.

Property losses.—Report only losses of property used in your business or trade from fire, storm, shipwreck, or other casualty, or theft, not covered by insurance and not offset by repairs or replacements reported. The property lost should be valued at cost less depreciation to date of loss.

Any such losses of property not used in your business, such as your dwelling or household furniture, should be reported under J, "Other deductions," on page 4.

Do not report any losses for which a claim against an insurance company is pending. Wait until the claim is settled and deduct from the cost of the property, less depreciation, the amount of insurance collected. Report the net loss, if any, in the return of income for the year in which the settlement by the insurance company is made.

This item should be explained in the table at the bottom of page 3.

Bad debts.—Report only debts which you have ascertained to be worthless and have charged off during the year.

A bad debt offsetting income accrued since March 1, 1913, will not be allowed as a deduction unless the amount was reported as income for the year in which the debt was created.

State under "Explanations" how the debts were ascertained to be worthless. Insolvency of the debtor, inability to collect by legal proceedings, or inability of debtor to pay, ascertained by a mercantile agency, would be a sufficient indication of worthlessness.

If at any future time a debt charged off as worthless and allowed as a deduction is collected the amount collected must be returned as income for the year in which received.

Unpaid debts are not deductible if made good by recovery of property sold or retention of property pledged.

Bad debts arising out of personal loans should be reported under J, "Other deductions."

Other expenses.—Do not include any personal, living, or family expenses.

Do not deduct interest on your own investment in your business or farm, or salary for your own services or services of your family, unless these items are entered as income elsewhere on this return or in other returns.

C. PROFITS FROM SALE OF REAL ESTATE, STOCKS, BONDS, AND OTHER PROPERTY.

Sales connected with your regular business should be reported under B, unless they would thereby become confused with sales of merchandise whose cost is computed by a different method (see "Cost of goods sold," under B, above).

If the profits or losses on sales made through any one broker aggregated $800 or more, report the transactions on a separate line with the name and address of the broker.

Kind of property.—Describe the property as definitely as you can in a word or two, as "farm," "dwelling," "stocks," "bonds," etc.

Cost.—If the property was acquired before March 1, 1913, report the estimated market value on that date instead of the cost and explain the basis of your estimate.

Expenses incidental to the purchase of property may be included in the cost if never claimed in income-tax returns as a deduction from income.

Losses.—If total cost of all property sold exceeded total sale price, the loss will not be allowed as a deduction unless the sales out of which the loss arose were connected with your regular business. If a deduction is claimed on account of losses reported under C, explain what connection the sales had with your regular business and enter the amount of the loss under J, "Other deductions."

D. INCOME FROM RENTS AND ROYALTIES.

Kind of property.—Describe briefly, as "farm," "dwelling," "mine," and also state kind of material of which buildings (if any) are constructed as "brick" or "wood."

Amount of rent.—If tenant rents your farm on a cash rental basis, state the amount of the rent, whether paid in cash or in crops. If he works it on shares, report your share as income in your return for the year in which it is sold.

Repairs, wear and tear, and property losses.—See instructions relating to repairs, wear and tear, depreciation of patents, copyrights, etc., depletion of mines, etc., and property losses under B above.

E. INTEREST ON BONDS AND OTHER OBLIGATIONS OF THE UNITED STATES ISSUED SINCE SEPTEMBER 1, 1917.

Exemption.—No return should be made of interest on any amount of such obligations up to and including $5,000, par value, owned by one individual. The benefit of this exemption may be claimed in this return not only on behalf of the individual making this return, but also on behalf of wife, husband, or any member of the family owning such obligations whose income has been included in this return.

Interest paid.—If indebtedness has been incurred for the purchase of such obligations, find what percentage the amount of such obligations held in excess of $5,000 is of the total amount of such obligations held, and enter in column 5 the same percentage of the interest paid on the indebtedness.

F. DIVIDENDS ON STOCK OF CORPORATIONS ORGANIZED OR OPERATING IN THE UNITED STATES AND SUBJECT TO INCOME TAX.

Dividends which were paid out of profits or surplus accumulated by the distributing corporation prior to the year for which this return is made but not prior to March 1, 1913, should be reported under the year in which the profits or surplus was accumulated.

The amount of dividends paid out of profits or surplus accumulated in 1916 is subject to surtax at the rate or rates imposed by the act of September 8, 1916, on a corresponding amount of income in excess of the amount on item O, page 4.

The sum of the amounts accumulated from March 1, 1913, to December 31, 1915, is subject to surtax at the rate or rates imposed by the act of October 3, 1913, on a corresponding amount of income in excess of the sum of item O and the amount accumulated in 1916.

The amount of these surtaxes should be computed and entered on line 37, page 4. Otherwise an additional assessment will be made by the Commissioner of Internal Revenue.

G. INTEREST ON TAX-FREE-COVENANT BONDS ON WHICH ONE NORMAL TAX OF 2 PER CENT WAS WITHHELD AT SOURCE.

Report under G interest received on bonds of corporations organized or doing business in the United States, containing a clause by which the debtor corporation agrees to pay the interest without any deduction for taxes, provided exemption from withholding of the tax and payment thereof at the source was not claimed with respect to such interest. If exemption was claimed, the interest received must be reported under H, "Other income," on page 4.

H. OTHER INCOME.

Report under H interest received on bank deposits, notes, mortgages, etc., and all other income that is not reported elsewhere on this return, with the exceptions stated in instruction 2, page 1.

State each kind of income separately. (See also instructions at top of page.)

Income received from partnerships or through fiduciaries.—If taxable income other than that falling under E and F was received from a partnership or if taxable income other than that falling under E, F, and G was received through a fiduciary, enter the name of the partnership or fiduciary and the amount received on a separate line.

Deductions, if any.—Explain expenses claimed as deductions on any vacant lines or on a separate sheet of paper (to be attached securely to page 3 or 4 of the return).

J. GENERAL DEDUCTIONS.

Interest.—Interest on personal indebtedness is deductible except on indebtedness incurred for the purchase of obligations or securities the interest on which is exempt from taxation as income.

Taxes.—Do not report inheritance taxes, Federal income taxes, or taxes specially assessed for local improvements or betterments, such as roads, streets, sidewalks, sewers, etc.

Excess profits taxes, if any, should not be included under J, but should be reported as item L, and also as items 34 and 35, page 4.

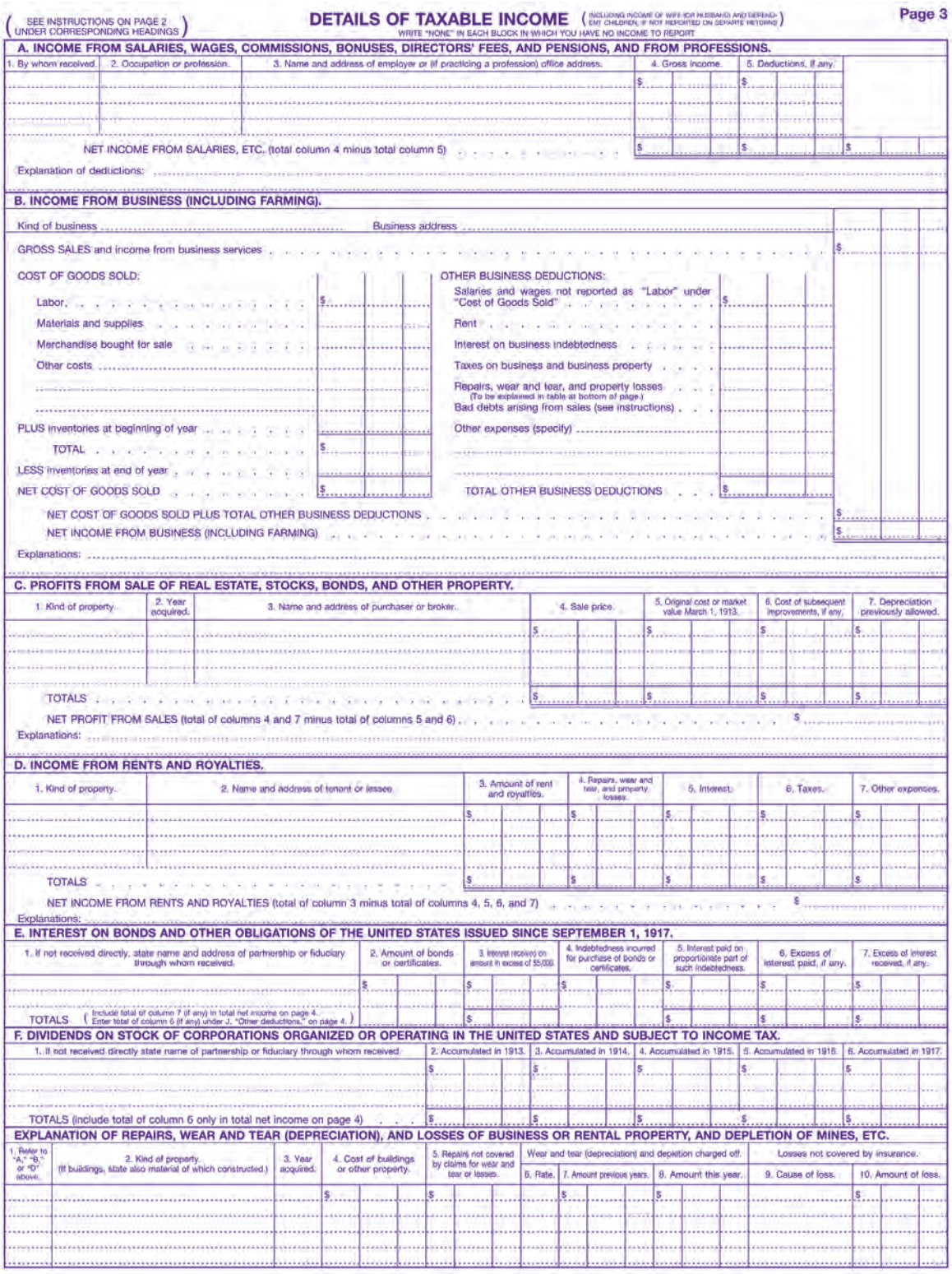
Other deductions.—Do not include your personal exemption, which should be entered on line 21, page 4, or any personal, living, or family expenses.

If you wish to claim a deduction on account of losses of personal property or bad debts arising out of personal loans, see instructions under B, "Property losses," and "Bad debts."

If a net loss is reported under B, D, or H, or if an excess of interest paid is reported under E (in column 6), it may be claimed as a deduction. If a net loss reported under C is claimed as a deduction, explain how the transactions were connected with your business.

N. CONTRIBUTIONS.

The following are deductible: Contributions or gifts actually made within the year to corporations or associations organized and operated exclusively for religious, charitable, scientific, or educational purposes, or to societies for the prevention of cruelty to children or animals, no part of the net income of which inures to the benefit of any private stockholder or individual, to an amount not in excess of 15 per cent of your taxable net income as computed without deducting such contributions. Contributions to individuals are not deductible.



(SEE INSTRUCTIONS ON PAGE 2 UNDER CORRESPONDING HEADINGS)

DETAILS OF TAXABLE INCOME (INCLUDING INCOME OF WIFE (OR HUSBAND) AND DEPENDENT CHILDREN, IF NOT REPORTED ON SEPARATE RETURNS)

WRITE "NONE" IN EACH BLOCK IN WHICH YOU HAVE NO INCOME TO REPORT

Page 3

A. INCOME FROM SALARIES, WAGES, COMMISSIONS, BONUSES, DIRECTORS' FEES, AND PENSIONS, AND FROM PROFESSIONS.

1. By whom received.	2. Occupation or profession.	3. Name and address of employer or (if practicing a profession) office address.	4. Gross income.	5. Deductions, if any.
			$	$
		NET INCOME FROM SALARIES, ETC. (total column 4 minus total column 5)	$	$ $

Explanation of deductions:

B. INCOME FROM BUSINESS (INCLUDING FARMING).

Kind of business ... Business address ...

GROSS SALES and income from business services ... $

COST OF GOODS SOLD:

Labor ... $

Materials and supplies ...

Merchandise bought for sale ...

Other costs ...

PLUS inventories at beginning of year ...

TOTAL ... $

LESS inventories at end of year ...

NET COST OF GOODS SOLD ... $

OTHER BUSINESS DEDUCTIONS:

Salaries and wages not reported as "Labor" under "Cost of Goods Sold" ... $

Rent ...

Interest on business indebtedness ...

Taxes on business and business property ...

Repairs, wear and tear, and property losses (To be explained in table at bottom of page.)

Bad debts arising from sales (see instructions) ...

Other expenses (specify) ...

TOTAL OTHER BUSINESS DEDUCTIONS ... $

NET COST OF GOODS SOLD PLUS TOTAL OTHER BUSINESS DEDUCTIONS ... $

NET INCOME FROM BUSINESS (INCLUDING FARMING) ... $

Explanations:

C. PROFITS FROM SALE OF REAL ESTATE, STOCKS, BONDS, AND OTHER PROPERTY.

1. Kind of property.	2. Year acquired.	3. Name and address of purchaser or broker.	4. Sale price.	5. Original cost or market value March 1, 1913.	6. Cost of subsequent improvements, if any.	7. Depreciation previously allowed.
			$	$	$	$
		TOTALS	$	$	$	$

NET PROFIT FROM SALES (total of columns 4 and 7 minus total of columns 5 and 6) ... $

Explanations:

D. INCOME FROM RENTS AND ROYALTIES.

1. Kind of property.	2. Name and address of tenant or lessee.	3. Amount of rent and royalties.	4. Repairs, wear and tear, and property losses.	5. Interest.	6. Taxes.	7. Other expenses.
		$	$	$	$	$
	TOTALS	$	$	$	$	$

NET INCOME FROM RENTS AND ROYALTIES (total of column 3 minus total of columns 4, 5, 6, and 7) ... $

Explanations:

E. INTEREST ON BONDS AND OTHER OBLIGATIONS OF THE UNITED STATES ISSUED SINCE SEPTEMBER 1, 1917.

1. If not received directly, state name and address of partnership or fiduciary through whom received.	2. Amount of bonds or certificates.	3. Interest received on amount in excess of $5,000.	4. Indebtedness incurred for purchase of bonds or certificates.	5. Interest paid on proportionate part of such indebtedness.	6. Excess of interest paid, if any.	7. Excess of interest received, if any.
	$	$	$	$	$	$
TOTALS (Include total of column 7 (if any) in total net income on page 4. Enter total of column 6 (if any) under J, "Other deductions," on page 4.)		$		$	$	$

F. DIVIDENDS ON STOCK OF CORPORATIONS ORGANIZED OR OPERATING IN THE UNITED STATES AND SUBJECT TO INCOME TAX.

1. If not received directly state name of partnership or fiduciary through whom received.	2. Accumulated in 1913.	3. Accumulated in 1914.	4. Accumulated in 1915.	5. Accumulated in 1916.	6. Accumulated in 1917.
	$	$	$	$	$
TOTALS (include total of column 6 only in total net income on page 4)	$	$	$	$	$

EXPLANATION OF REPAIRS, WEAR AND TEAR (DEPRECIATION), AND LOSSES OF BUSINESS OR RENTAL PROPERTY, AND DEPLETION OF MINES, ETC.

1. Refer to "A," "B," or "D" above.	2. Kind of property. (If buildings, state also material of which constructed.)	3. Year acquired.	4. Cost of buildings or other property.	5. Repairs not covered by claims for wear and tear or losses.	Wear and tear (depreciation) and depletion charged off. 6. Rate.	7. Amount previous years.	8. Amount this year.	Losses not covered by insurance. 9. Cause of loss.	10. Amount of loss.
			$	$		$	$		$

Demographic History

Page 4

DETAILS OF TAXABLE INCOME (Concluded)

(SEE INSTRUCTIONS ON PAGE 2 UNDER CORRESPONDING HEADINGS)

TOTAL NET INCOME FROM SOURCES A, B, C, D, E, AND F, REPORTED ON PAGE 3 . . . $

G. INTEREST ON TAX-FREE-COVENANT BONDS (on which one normal tax of 2 per cent was withheld at source).

	1. Gross income.	2. Deductions, if any.	
	$	$	

NET INTEREST ON TAX-FREE-COVENANT BONDS (total column 1 minus total column 2) . . . $ $ $

H. OTHER INCOME (including income from partnerships and fiduciaries, except that reported under E, F, and G).

	1. Gross income.	2. Deductions, if any.	
Interest on bonds and other obligations of domestic and resident corporations (except as entered under G)	$	$	$
Interest on bonds of foreign countries and corporations and dividends on stock of foreign corporations			
Interest on notes, bank deposits, mortgages (except of corporations), and all other interest			

I. TOTAL NET INCOME FROM ALL SOURCES . . . $

J. GENERAL DEDUCTIONS NOT REPORTED ON PAGE 3 OR ABOVE (EXCEPT CONTRIBUTIONS—SEE N BELOW).

Interest on personal indebtedness	$	
Taxes on dwelling and personal property, and other taxes not reported above (see instructions on page 2)		
Other deductions, except contributions (explain)		
TOTAL GENERAL DEDUCTIONS, EXCEPT CONTRIBUTIONS		$

K. TOTAL NET INCOME (WITHOUT DEDUCTING EXCESS PROFITS TAXES OR CONTRIBUTIONS) . . . $

L. LESS EXCESS PROFITS TAXES, IF ANY, FOR 1917 (see instructions on page 1 under "Excess profits taxes") . . .

M. TOTAL NET INCOME (WITHOUT DEDUCTING CONTRIBUTIONS) (K minus L) . . . $

N. CONTRIBUTIONS TO CHARITABLE ORGANIZATIONS, ETC. (Enter below name and address of each organization and amount paid to each.)

$	$	
TOTAL (not over 15 per cent of item M)		$

O. TOTAL NET INCOME ON WHICH INCOME TAX IS TO BE COMPUTED (M minus N) . . . $

CAUTION

Read all instructions.

Answer all questions.

If necessary, ask your Collector of Internal Revenue for assistance.

Form 1040 (Revised January, 1918)—UNITED STATES INTERNAL REVENUE

INDIVIDUAL INCOME TAX RETURN FOR CALENDAR YEAR 1917

(Write plainly. Give name in full.)

Made by (or for) .....

Home address ..... (Street and number or rural route.) (Post office and State.)

(IF NAME AND ADDRESS ARE FILLED IN AND EITHER IS INCORRECT, PLEASE CORRECT IT.)

(Do not write in this space.)
RECEIVED .....

LIST

Month	Page	Line

Audited by .....

1. Did you make a return for 1916? ..... 2. If so, what address did you give on the return? ..... 3. To what Collector's office was it sent? ..... (Give district or city and State.)

4. Were you on December 31, 1917, married and living with wife (or husband)? ..... 5. If not, were you head of a family as defined in instructions on page 1 under "Personal Exemption"? ..... 6. How many dependent children under 18 (or mentally or physically incapacitated for self-support) had you on December 31, 1917? .....

7. If head of a family without dependent children, what was the relationship of those dependent upon you? ..... 8. Did your wife (or husband) or dependent children derive income from sources independent of your own? ..... 9. If so, is such income included in this return? .....

10. If not, was such income from a separate estate? ..... 11. If a separate return has been made by (or for) wife (or husband) or dependent child, give full name and address entered at head of that return .....

12. If income of $800 or more received by wife (or husband) or dependent child is included in this return, give full name of each such person, and also address if different from that given at the head of this return .....

13. What address other than those already entered on this return did you give to employers or other persons, firms, or corporations who paid you $800 or more income during 1917? .....

14. Is this return made from books kept on other than a cash basis? ..... 15. If so, were such books audited by a public accountant? ..... 16. By whom? ..... 17. Is this return based on that accountant's report? .....

18	Total net income on which income tax is to be computed (item O)	$	28	Normal tax of 2 per cent on amount of item 25	$
19	Less: Excess of interest received on obligations of United States issued since Sept. 1, 1917 (item E, total of column 7)		29	Additional normal tax of 2 per cent on amount of item 27	
20	Dividends (item F, total of column 6)		30	Total normal tax	
21	Personal exemption (see instruction 3, page 1)		31	Less tax withheld on tax-free-covenant bonds (2 per cent of net total of item G)	
22	Total of items 19, 20, and 21	$	32	Balance of normal tax due	$
23	Balance (item 18 minus item 22)	$	33	Surtax (see table on page 1)	
24	Add excess of interest paid on indebtedness incurred for purchase of obligations of United States issued since Sept. 1, 1917 (item E, total of column 6)		34	Excess profits tax at rate of 8 per cent (see instruction 7, page 1)	
25	Amount subject to normal tax of 2 per cent under act Oct. 3, 1917	$	35	Excess profits tax on income from business with invested capital, as computed on excess profits tax return (Form 1101)	
26	Less additional exemption	2 000 00	36	Total of items 32, 33, 34, and 35	$
27	Amount subject to normal tax of 2 per cent under act Sept. 8, 1916	$	37	Additional assessments and penalties (if any)	$

I swear (or affirm) that this return, including the accompanying schedules (if any), to the best of my knowledge and belief, is a true and complete statement of all taxable gains, profits, and income received by ..... (Enter "me" or name of person for whom return is made.) during the year 1917, and that ..... (Enter "I am," "he is," or "she is.") entitled to all deductions and exemptions entered or claimed herein.

(If return is made by an agent, the reason therefor must be stated on the line.)

Sworn to and subscribed before me this ..... day of ..... 1918.

..... (Signature of individual or agent.)

..... (Signature.) ..... (Title.) ..... (Address of agent.)

Appendix 3. Form 1040, *Individual Income Tax Return* (1942)

FORM 1040
Treasury Department
Internal Revenue Service

UNITED STATES
INDIVIDUAL INCOME TAX RETURN

Page 1
1942

OPTIONAL FORM 1040A MAY BE FILED INSTEAD OF THIS FORM IF GROSS INCOME IS REPORTED ON THE CASH BASIS FOR THE CALENDAR YEAR, IS NOT MORE THAN $3,000, AND CONSISTS *WHOLLY* OF SALARY, WAGES, OTHER COMPENSATION FOR PERSONAL SERVICES, DIVIDENDS, INTEREST OR ANNUITIES.

FOR CALENDAR YEAR 1942
or fiscal year beginning _____, 1942, and ending _____, 1943

PRINT NAME AND ADDRESS PLAINLY. (See Instruction C)

(Name) (Use given names of both husband and wife, if this is a joint return)

(Street and number, or rural route)

(Post office) (County) (State)

(Occupation) (Social Security number, if any)

(Name and address of employer)

(If more than one employer, attach statement showing name and address and amount received from each)

(Do not use these spaces)
File Code
Serial No.
District
(Cashier's Stamp)

Cash—Check—M. O.
First Payment
$

Item and Instruction No.	INCOME	Amount	Deductible Expenses (Attach itemized statement)	
1.	Salaries and other compensation for personal services, $		$	$
2.	Dividends			
3.	Interest on bank deposits, notes, etc.		Less amortizable bond premium	
4.	Interest on corporation bonds, etc.	$	$	
5.	Interest on Government obligations, etc.:			
	(*a*) From line (*h*), Schedule A	$	$	
	(*b*) From line (*i*), Schedule A	$	$	
6.	Rents and royalties. (From Schedule B)			
7.	Annuities			

ITEMS 8, 9, AND 10, BELOW (AND PAGES 3 AND 4) NEED NOT BE CONSIDERED UNLESS YOU HAVE INCOME (OR LOSSES) IN ADDITION TO ITEMS ABOVE.

8.	(*a*) Net gain (or loss) from sale or exchange of capital assets. (From Schedule F)	
	(*b*) Net gain (or loss) from sale or exchange of property other than capital assets. (From Schedule G)	
9.	Net profit (or loss) from business or profession. (From Schedule H)	
	(State total receipts, from line 1, Schedule H, $_____)	
10.	Income (or loss) from partnerships; fiduciary income; and other income. (From Schedule I)	
11.	Total income in items 1 to 10	$

DEDUCTIONS

12.	Contributions paid. (Explain in Schedule C)	$
13.	Interest. (Explain in Schedule C)	
14.	Taxes. (Explain in Schedule C)	
15.	Losses from fire, storm, shipwreck, or other casualty, or theft. (Explain in Schedule C)	
16.	Bad debts. (Explain in Schedule C)	
17.	Other deductions authorized by law. (Explain in Schedule C)	
18.	Total deductions in items 12 to 17	
19.	Net income (item 11 minus item 18)	$

COMPUTATION OF TAX

20.	Net income (item 19 above)	$		
21.	Less: Personal exemption. (From Schedule D-1)	$		
22.	Credit for dependents. (From Schedule D-2)			
23.	Balance (surtax net income)	$		
24.	Less: Item 5 (*a*) above	$		
25.	Earned income credit. (From Schedule E-1 or E-2)			
26.	Balance subject to normal tax	$		
27.	Normal tax (6% of item 26)		$	
28.	Surtax on item 23. (See Instruction 28)			
29.	Total (item 27 plus item 28)		$	
30.	Total tax (Item 29 or line 16, Schedule F)		$	
31.	Less: Income tax paid at source	$		
32.	Income tax paid to a foreign country or U. S. possession. (Attach Form 1116)			
33.	Balance of tax (Item 30 minus items 31 and 32)		$	

I/we declare, under the penalties of perjury, that this return (including any accompanying schedules and statements) has been examined by me/us, and to the best of my/our knowledge and belief is a true, correct, and complete return, made in good faith, for the taxable year stated, pursuant to the Internal Revenue Code and the regulations issued under authority thereof.

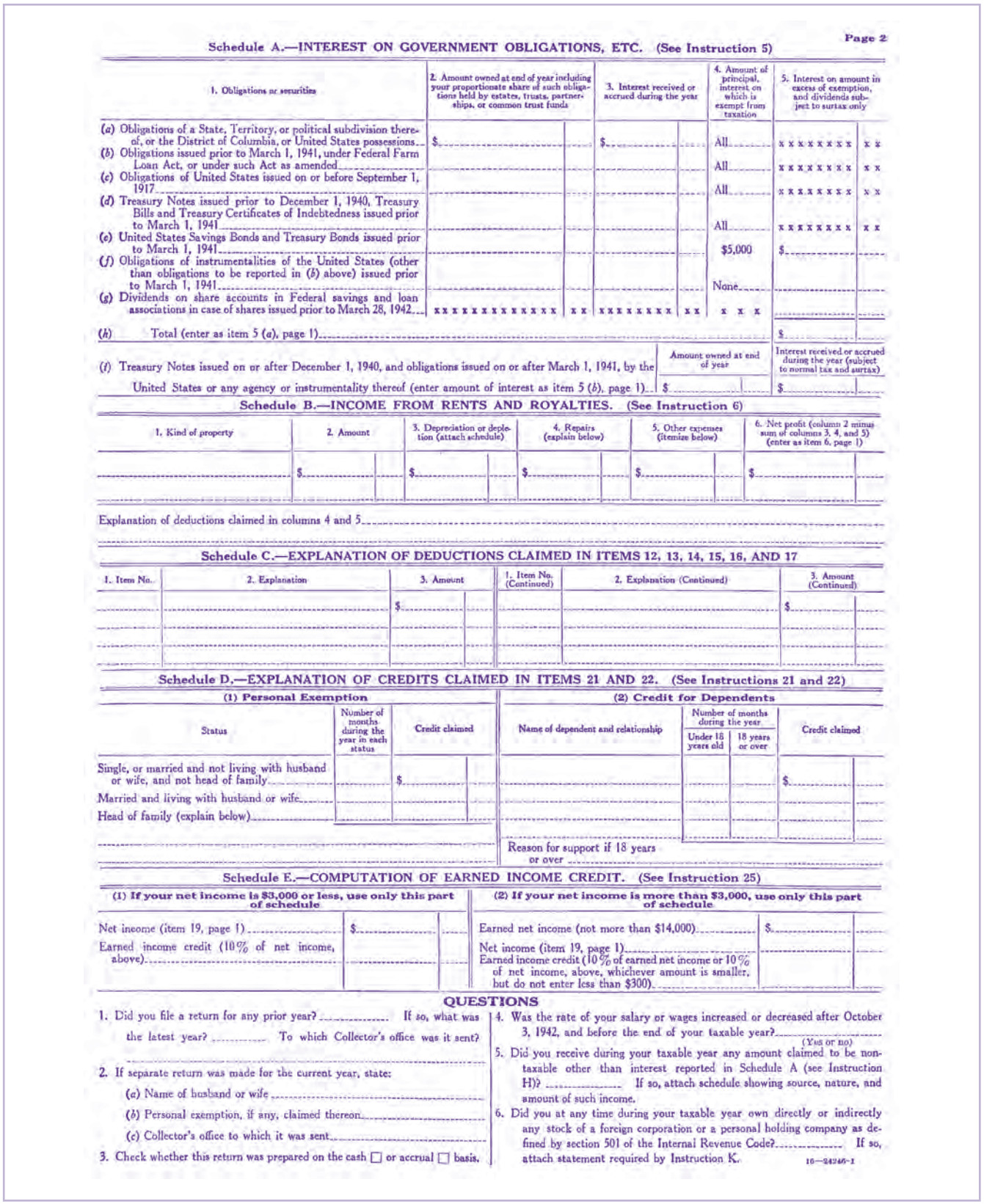
(Signature of person (other than taxpayer or agent) preparing return) (Date)

(Name of firm or employer, if any)

(Signature of taxpayer) (Date)

(If this is a joint return (not made by agent), it must be signed by both husband and wife)
A return made by an agent must be accompanied by power of attorney. (See Instruction F)

16—24240-1



Page 2

Schedule A.—INTEREST ON GOVERNMENT OBLIGATIONS, ETC. (See Instruction 5)

1. Obligations or securities	2. Amount owned at end of year including your proportionate share of such obligations held by estates, trusts, partnerships, or common trust funds	3. Interest received or accrued during the year	4. Amount of principal, interest on which is exempt from taxation	5. Interest on amount in excess of exemption, and dividends subject to surtax only
(a) Obligations of a State, Territory, or political subdivision thereof, or the District of Columbia, or United States possessions	$	$	All	xxxxxxxx
(b) Obligations issued prior to March 1, 1941, under Federal Farm Loan Act, or under such Act as amended			All	xxxxxxxx
(c) Obligations of United States issued on or before September 1, 1917			All	xxxxxxxx
(d) Treasury Notes issued prior to December 1, 1940, Treasury Bills and Treasury Certificates of Indebtedness issued prior to March 1, 1941			All	xxxxxxxx
(e) United States Savings Bonds and Treasury Bonds issued prior to March 1, 1941			$5,000	$
(f) Obligations of instrumentalities of the United States (other than obligations to be reported in (b) above) issued prior to March 1, 1941			None	
(g) Dividends on share accounts in Federal savings and loan associations in case of shares issued prior to March 28, 1942	xxxxxxxxxxxx	xxxxxxxx	xxx	
(h) Total (enter as item 5 (a), page 1)				$

	Amount owned at end of year	Interest received or accrued during the year (subject to normal tax and surtax)
(i) Treasury Notes issued on or after December 1, 1940, and obligations issued on or after March 1, 1941, by the United States or any agency or instrumentality thereof (enter amount of interest as item 5 (b), page 1)	$	$

Schedule B.—INCOME FROM RENTS AND ROYALTIES. (See Instruction 6)

1. Kind of property	2. Amount	3. Depreciation or depletion (attach schedule)	4. Repairs (explain below)	5. Other expenses (itemize below)	6. Net profit (column 2 minus sum of columns 3, 4, and 5) (enter as item 6, page 1)
	$	$	$	$	$

Explanation of deductions claimed in columns 4 and 5

Schedule C.—EXPLANATION OF DEDUCTIONS CLAIMED IN ITEMS 12, 13, 14, 15, 16, AND 17

1. Item No.	2. Explanation	3. Amount	1. Item No. (Continued)	2. Explanation (Continued)	3. Amount (Continued)
		$			$

Schedule D.—EXPLANATION OF CREDITS CLAIMED IN ITEMS 21 AND 22. (See Instructions 21 and 22)

(1) Personal Exemption

Status	Number of months during the year in each status	Credit claimed
Single, or married and not living with husband or wife, and not head of family		$
Married and living with husband or wife		
Head of family (explain below)		

(2) Credit for Dependents

Name of dependent and relationship	Number of months during the year: Under 18 years old	Number of months during the year: 18 years or over	Credit claimed
			$

Reason for support if 18 years or over

Schedule E.—COMPUTATION OF EARNED INCOME CREDIT. (See Instruction 25)

(1) If your net income is $3,000 or less, use only this part of schedule

Net income (item 19, page 1)	$
Earned income credit (10% of net income, above)	

(2) If your net income is more than $3,000, use only this part of schedule

Earned net income (not more than $14,000)	$
Net income (item 19, page 1)	
Earned income credit (10% of earned net income or 10% of net income, above, whichever amount is smaller, but do not enter less than $300)	

QUESTIONS

1. Did you file a return for any prior year? ..... If so, what was the latest year? ..... To which Collector's office was it sent?
2. If separate return was made for the current year, state:
   (a) Name of husband or wife .....
   (b) Personal exemption, if any, claimed thereon .....
   (c) Collector's office to which it was sent .....
3. Check whether this return was prepared on the cash ☐ or accrual ☐ basis.
4. Was the rate of your salary or wages increased or decreased after October 3, 1942, and before the end of your taxable year? ..... (Yes or no)
5. Did you receive during your taxable year any amount claimed to be nontaxable other than interest reported in Schedule A (see Instruction H)? ..... If so, attach schedule showing source, nature, and amount of such income.
6. Did you at any time during your taxable year own directly or indirectly any stock of a foreign corporation or a personal holding company as defined by section 501 of the Internal Revenue Code? ..... If so, attach statement required by Instruction K.

16—24246-1

DETACH PAGES 3 AND 4 IF NOT USED

Page 3

Schedule F.—GAINS AND LOSSES FROM SALES OR EXCHANGES OF CAPITAL ASSETS. (See Instruction 8)

1. Kind of property (if necessary, attach statement of descriptive details not shown below)	2. Date acquired (Mo. Day Year)	3. Date sold (Mo. Day Year)	4. Gross sales price (contract price)	5. Cost or other basis	6. Expense of sale and cost of improvements subsequent to acquisition or March 1, 1913	7. Depreciation allowed (or allowable) since acquisition or March 1, 1913 (explain in Schedule J)	8. Gain or loss (column 4 plus column 7 minus the sum of columns 5 and 6)	Gain or loss to be taken into account: 9. Percentage	10. Amount
SHORT-TERM CAPITAL GAINS AND LOSSES—ASSETS HELD NOT MORE THAN 6 MONTHS									
			$	$	$	$	$	100	$
								100	
								100	
								100	
Total net short-term capital gain or loss (enter in line 1, column 3, of summary below)									$
LONG-TERM CAPITAL GAINS AND LOSSES—ASSETS HELD FOR MORE THAN 6 MONTHS									
			$	$	$	$	$	50	
								50	
								50	
								50	
Total net long-term capital gain or loss (enter in line 2, column 3, of summary below)									$

SUMMARY OF CAPITAL GAINS AND LOSSES

1. Classification	2. Net short-term capital loss of preceding taxable year (not in excess of net income for such year), but only to extent of net short-term capital gain of current year	3. Net gain or loss to be taken into account from column 10, above: (a) Gain	3. (b) Loss	4. Net gain or loss to be taken into account from partnerships and common trust funds: (a) Gain	4. (b) Loss	5. Total net gain or loss taken into account in columns 2, 3, and 4 of this summary: (a) Gain	5. (b) Loss
1. Total net short-term capital gain or loss	$	$	$	$	$	$	$
2. Total net long-term capital gain or loss		$	$	$	$	$	$
3. Net gain in column 5, lines 1 and 2. (Enter as item 8 (a), page 1)						$	xxxxxxxx
4. Net loss in column 5, lines 1 and 2. (The amount to be entered as item 8 (a), page 1, is (1) this item or (2) net income, computed without regard to capital gains or losses, or (3) $1,000, whichever is smallest)						xxxxxxxx	$

COMPUTATION OF ALTERNATIVE TAX

Use only if you had an excess of net long-term *capital gain* over net short-term *capital loss*, and item 23, page 1, exceeds $18,000

1. Net income (item 19, page 1)	$	10. Normal tax (6% of line 9)	$
2. Excess of net long-term capital gain over net short-term capital loss (line 2, column 5 (a), minus line 1, column 5 (b), of summary above)		11. Surtax on line 6. (See Instruction 28)	
3. Ordinary net income (line 1 minus line 2)	$	12. Partial tax (line 10 plus line 11)	$
4. Less: Personal exemption. (From Schedule D-1)	$	13. 50% of line 2	
5. Credit for dependents. (From Schedule D-2)		14. Alternative tax (line 12 plus line 13)	$
6. Balance (surtax net income)	$	15. Total normal tax and surtax (item 29, page 1)	$
7. Less: Item 5 (a), page 1	$	16. Tax liability (line 14 or line 15, whichever is the lesser). (Enter as item 30, page 1)	$
8. Earned income credit. (From Schedule E-1 or E-2)			
9. Balance subject to normal tax	$		

Schedule G.—GAINS AND LOSSES FROM SALES OR EXCHANGES OF PROPERTY OTHER THAN CAPITAL ASSETS (See Instruction 8)

1. Kind of property	2. Date acquired	3. Gross sales price (contract price)	4. Cost or other basis	5. Expense of sale and cost of improvements subsequent to acquisition or March 1, 1913	6. Depreciation allowed (or allowable) since acquisition or March 1, 1913 (explain in Schedule J)	7. Gain or loss (column 3 plus column 6 minus the sum of columns 4 and 5)
		$	$	$	$	$
Total net gain (or loss) (enter as item 8 (b), page 1)						$

State the family, fiduciary, or business relationship to you, if any, of purchaser of any of the items on this page

If any of such items were acquired by you other than by purchase, explain fully how acquired

16—24246-1

Schedule H.—PROFIT (OR LOSS) FROM BUSINESS OR PROFESSION. (See Instruction 9)

(State (1) nature of business _____; (2) number of places of business _____; (3) business name and address if different from name and address on page 1 _____)

1. Total receipts _____ $ _____

COST OF GOODS SOLD

(To be used where inventories are an income-determining factor)

2. Inventory at beginning of year	$	
3. Merchandise bought for sale		
4. Labor		
5. Material and supplies		
6. Other costs (itemize below)		
7. Total of lines 2 to 6	$	
8. Less inventory at end of year		
9. Net cost of goods sold (line 7 minus line 8)	$	
10. Gross profit (line 1 minus line 9)	$	

OTHER BUSINESS DEDUCTIONS

11. Salaries and wages not included as "Labor" (do not deduct compensation for yourself)	$	
12. Interest on business indebtedness		
13. Taxes on business and business property		
14. Losses (explain below)		
15. Bad debts arising from sales or services		
16. Depreciation, obsolescence, and depletion (explain in Schedule J)		
17. Rent, repairs, and other expenses (itemize below or on separate sheet)		
18. Amortization of emergency facilities (attach statement)		
19. Total of lines 11 to 18	$	
20. Total of lines 9 and 19	$	
21. Net profit (or loss) (line 1 minus line 20) (enter as item 9, page 1)	$	

If the production, manufacture, purchase, or sale of merchandise is an income-producing factor, inventories are required. Enter "C," or "C or M," on lines 2 and 8 to indicate whether inventories are valued at cost, or cost or market, whichever is lower.

Explanation of deductions claimed in lines 6, 14, and 17 _____

Did you at any time after October 3, 1942, and before the end of your taxable year have in your employ more than eight individuals? _____ (Yes or No)

If answer is "Yes," have you in this return taken a deduction for any amount of wages or salaries representing an increase or decrease in rate after October 3, 1942? _____ (Yes or No) If answer to second question is "Yes," attach a statement explaining all such increases or decreases. If any of such increases or decreases required the prior approval of the National War Labor Board or the Commissioner of Internal Revenue as stated in Instruction 9, attach also a copy of the authorization for each of such increases or decreases.

Schedule I.—INCOME FROM PARTNERSHIPS, FIDUCIARIES, AND OTHER SOURCES

INCOME (OR LOSS) FROM PARTNERSHIPS, SYNDICATES, ETC. (SEE INSTRUCTION 10 (a)) (FURNISH NAMES AND ADDRESSES)		
	$	
		$
INCOME FROM FIDUCIARIES (FURNISH NAMES AND ADDRESSES)		
	$	
INCOME FROM OTHER SOURCES (STATE NATURE)		
	$	
Total amounts in Schedule I. (Enter as item 10, page 1)		$

Schedule J.—EXPLANATION OF DEDUCTION FOR DEPRECIATION CLAIMED IN SCHEDULES F, G, AND H

1. Kind of property (If buildings, state material of which constructed)	2. Date acquired	3. Cost or other basis (Do not include land or other nondepreciable property)	4. Assets fully depreciated in use at end of year	5. Depreciation allowed (or allowable) in prior years	6. Remaining cost or other basis to be recovered	7. Estimated life used in accumulating depreciation	8. Estimated remaining life from beginning of year	9. Depreciation allowable this year
		$	$	$	$			$

☆ U. S. GOVERNMENT PRINTING OFFICE : 1942 16—24265-1

Appendix 4. Form 1040A, *Optional Individual Income Tax Return* (1942)

FORM 1040 A
TREASURY DEPARTMENT
INTERNAL REVENUE SERVICE

OPTIONAL
UNITED STATES
INDIVIDUAL INCOME TAX RETURN

CALENDAR YEAR 1942

THIS RETURN MAY BE FILED INSTEAD OF FORM 1040 BY CITIZENS (OR RESIDENT ALIENS) REPORTING ON THE CASH BASIS IF GROSS INCOME IS NOT MORE THAN $3,000 AND IS ONLY FROM SALARY, WAGES, DIVIDENDS, INTEREST, AND ANNUITIES

Do not write in these spaces
Serial No.
Amount Paid, $
(Cashier's Stamp)

PRINT NAME AND HOME OR RESIDENTIAL ADDRESS PLAINLY BELOW

(Name) (Use given names of both husband and wife, if this is a joint return)

(Street and number, or rural route)

(Post office) (County) (State)

Occupation _____ Social Security number, if any _____

Name and address of employer _____

(If you had more than one employer, attach statement showing name and address and amount received from each)

Cash—Check—M. O.

DEPENDENTS ON JULY 1, 1942

List persons (other than husband or wife) *deriving their chief support from you* if they are under 18 years of age or if they are mentally or physically incapable of self-support

NAME OF DEPENDENT	RELATIONSHIP	IF 18 YEARS OF AGE OR OVER, GIVE REASON FOR LISTING

*GROSS INCOME LESS ALLOWANCE FOR DEPENDENTS

1. Salary, wages, and compensation for personal services	$	
2. Dividends, interest, and annuities		
3. Total	$	
4. Less: $385 for each dependent (If you are the head of a family (see definition under item 6 on other side) *only because of dependent(s) listed above*, $385 for each listed dependent *except one.*)		
5. INCOME SUBJECT TO TAX	$	

TAX

6. Tax on item 5 (from Column A, B, or C of table on other side)	$	

I/we declare, under the penalties of perjury, that this return has been examined by me/us, and, to the best of my/our knowledge and belief, is a true, correct, and complete return, made in good faith, for the taxable year stated, pursuant to the Internal Revenue Code and regulations issued under authority thereof; and that I/we had no income from sources other than stated hereon.

_____, 1943. (Date)

_____ (Signature)

_____ (Signature)
(If this return includes gross income of both husband and wife, it must be signed by both.)

Filing requirement.—An income tax return must be filed by single persons having a gross income (item 3 above) of $500 or more and married persons having a gross income either separately or combined of $1,200 or more.

**Military and naval personnel.*—Members of the military or naval forces of the United States below the grade of commissioned officer on December 31, 1942, should not include in gross income the first $250 if single on such date, or the first $300 if married or head of a family on such date, received as compensation for active service.

Returns of husband and wife.—Husband and wife may use this form as a joint return if they were living together on July 1, 1942, and if their combined gross income for the calendar year is not more than $3,000. A separate return may be made on this form if the gross income for the calendar year of the one filing the return is not more than $3,000, except that in the case of a husband and wife living together at any time during the calendar year separate returns may not be made on this form unless each elects to use this form.

Allowance for dependents.—Allowance of $385 for each dependent is applicable when this form is used. Where Form 1040 is used, the allowance for each dependent is $350.

Amended returns.—If a qualified taxpayer elects to use this form, amended return may not be made on Form 1040.

Filing of returns and payment of tax.—The return must be filed with the Collector of Internal Revenue for your district on or before March 15, 1943. The tax may be paid in equal quarterly installments commencing March 15, 1943. Pay tax, if any, to the Collector and if payment is made by check or money order, make payable to "Collector of Internal Revenue."

16—31231-1

INDICATE YOUR STATUS ON JULY 1, 1942, BY PLACING CHECK MARK (✓) IN THE APPLICABLE BLOCK (☐) BELOW

1. Single (and not head of family) on July 1, 1942 ☐

2. Married and not living with husband or wife (and not head of family) on July 1, 1942 ☐

IF YOU CHECKED No. 1 OR No. 2 ABOVE, FIND YOUR TAX IN COLUMN A

3. Married and living with husband or wife on July 1, 1942, but each filing separate returns on this form ☐

IF YOU CHECKED No. 3 ABOVE, FIND YOUR TAX IN COLUMN B

4. Married and living with husband or wife on July 1, 1942, and spouse had no gross income for the entire year ☐

5. Married and living with husband or wife on July 1, 1942, and this return includes gross income of both husband and wife for the entire year ☐

6. Head of family (a single person or married person not living with husband or wife who exercises family control and supports closely connected dependent relative(s) in one household) on July 1, 1942 ☐
(State number of such dependent relatives _____)

IF YOU CHECKED No. 4, 5, OR 6 ABOVE, FIND YOUR TAX IN COLUMN C

IF Income subject to tax (item 5 on other side) is		COLUMN A	COLUMN B	COLUMN C	IF Income subject to tax (item 5 on other side) is		COLUMN A	COLUMN B	COLUMN C	IF Income subject to tax (item 5 on other side) is		COLUMN A	COLUMN B	COLUMN C
Over	But not over	Your tax is	Your tax is	Your tax is	Over	But not over	Your tax is	Your tax is	Your tax is	Over	But not over	Your tax is	Your tax is	Your tax is
$0	$525	$0	$0	$0	$1,350	$1,375	$141	$122	$10	$2,175	$2,200	$283	$264	$150
525	550	1	0	0	1,375	1,400	145	126	14	2,200	2,225	288	269	155
550	575	4	0	0	1,400	1,425	149	130	17	2,225	2,250	292	273	159
575	600	7	0	0	1,425	1,450	154	135	21	2,250	2,275	296	277	163
600	625	11	0	0	1,450	1,475	158	139	25	2,275	2,300	301	282	168
625	650	15	0	0	1,475	1,500	162	143	29	2,300	2,325	305	286	172
650	675	20	3	0	1,500	1,525	167	148	34	2,325	2,350	309	290	176
675	700	24	6	0	1,525	1,550	171	152	38	2,350	2,375	314	295	181
700	725	28	9	0	1,550	1,575	175	156	42	2,375	2,400	318	299	185
725	750	33	14	0	1,575	1,600	180	161	47	2,400	2,425	322	303	189
750	775	37	18	0	1,600	1,625	184	165	51	2,425	2,450	327	308	194
775	800	41	22	0	1,625	1,650	188	169	55	2,450	2,475	331	312	198
800	825	46	27	0	1,650	1,675	193	174	60	2,475	2,500	335	316	202
825	850	50	31	0	1,675	1,700	197	178	64	2,500	2,525	340	321	207
850	875	54	35	0	1,700	1,725	201	182	68	2,525	2,550	344	325	211
875	900	59	40	0	1,725	1,750	206	187	73	2,550	2,575	348	329	215
900	925	63	44	0	1,750	1,775	210	191	77	2,575	2,600	353	334	220
925	950	67	48	0	1,775	1,800	214	195	81	2,600	2,625	357	338	224
950	975	71	52	0	1,800	1,825	218	199	85	2,625	2,650	361	342	228
975	1,000	76	57	0	1,825	1,850	223	204	90	2,650	2,675	366	347	233
1,000	1,025	80	61	0	1,850	1,875	227	208	94	2,675	2,700	371	351	237
1,025	1,050	84	65	0	1,875	1,900	231	212	98	2,700	2,725	376	355	241
1,050	1,075	89	70	0	1,900	1,925	236	217	103	2,725	2,750	381	359	245
1,075	1,100	93	74	0	1,925	1,950	240	221	107	2,750	2,775	386	364	250
1,100	1,125	97	78	0	1,950	1,975	244	225	111	2,775	2,800	391	369	254
1,125	1,150	102	83	0	1,975	2,000	249	230	116	2,800	2,825	396	374	258
1,150	1,175	106	87	0	2,000	2,025	253	234	120	2,825	2,850	401	379	263
1,175	1,200	110	91	0	2,025	2,050	257	238	124	2,850	2,875	406	384	267
1,200	1,225	115	96	0	2,050	2,075	262	243	129	2,875	2,900	411	389	271
1,225	1,250	119	100	0	2,075	2,100	266	247	133	2,900	2,925	416	394	276
1,250	1,275	123	104	0	2,100	2,125	270	251	137	2,925	2,950	421	399	280
1,275	1,300	128	109	1	2,125	2,150	275	256	142	2,950	2,975	426	404	284
1,300	1,325	132	113	4	2,150	2,175	279	260	146	2,975	3,000	431	409	289
1,325	1,350	136	117	7										

The income to be reported in this return is gross income (not including income which is wholly exempt from income tax) without any deductions. The taxes in the above table make allowance for personal exemption, earned income credit, and deductions aggregating 6 percent of gross income.

☆ U. S. GOVERNMENT PRINTING OFFICE : 1942 16—31231-1

Appendix 5. Form 1040EZ, *Income Tax Return for Single Filers with no Dependents* (1982)

Department of the Treasury—Internal Revenue Service

1982 **Form 1040EZ Income Tax Return for Single filers with no dependents** (0)

OMB No. 1545-0675

Instructions are on the back of this form.
Tax Table is in the 1040EZ and 1040A Tax Package.

Name and address

Use the IRS mailing label. If you don't have a label, print or type:

Name (first, initial, last) Social security number

Present home address

City, town or post office, State, and ZIP code

Presidential Election Campaign Fund
Check this box ☐ if you want $1 of your tax to go to this fund.

Figure your tax

	1 Wages, salaries, and tips. Attach your W-2 form(s).	1	.
	2 Interest income of $400 or less. If more than $400, you cannot use Form 1040EZ.	2	.
Attach Copy B of Forms W-2 here	**3** Add line 1 and line 2. This is your **adjusted gross income.**	3	.
	4 Allowable part of your charitable contributions. Complete the worksheet on page 18. Do not write more than $25.	4	.
	5 Subtract line 4 from line 3.	5	.
	6 Amount of your personal exemption.	6	1,000.00
	7 Subtract line 6 from line 5. This is your **taxable income.**	7	.
	8 Enter your Federal income tax withheld. This is shown on your W-2 form(s).	8	.
	9 Use the tax table on pages 26-31 to find the **tax** on your taxable income on line 7.	9	.

Refund or amount you owe

	10 If line 8 is larger than line 9, subtract line 9 from line 8. Enter the amount of your **refund.**	10	.
Attach tax payment here	**11** If line 9 is larger than line 8, subtract line 8 from line 9. Enter the **amount you owe.** Attach check or money order for the full amount payable to "Internal Revenue Service."	11	.

Sign your return

I have read this return. Under penalties of perjury, I declare that to the best of my knowledge and belief, the return is correct and complete.

Your signature Date

X

For **Privacy Act and Paperwork Reduction Act Notice,** see page 34.

1982 Instructions for Form 1040EZ

You can use this form if:	You cannot use this form if:
• Your filing status is single	• Your filing status is other than single
• You do not claim exemptions for being 65 or over, OR for being blind	• You claim exemptions for being 65 or over, OR for being blind
• You do not claim any dependents	• You claim any dependents
• Your taxable income is less than $50,000	• Your taxable income is $50,000 or more
• You had only wages, salaries, and tips and you had interest income of $400 or less	• You had income other than wages and interest income, OR you had interest of over $400 or any interest from an All-Savers Certificate
• You had no dividend income	• You had dividend income

If you can't use this form, you must use Form 1040A or 1040 instead. See pages 4 through 6. If you are uncertain about your filing status, dependents, or exemptions, read the step-by-step instructions for Form 1040A that begin on page 6.

Completing your return

Name and address
Use the mailing label from the back cover of the instruction booklet. Correct any errors right on the label. But don't place the label on your return until you have completed it. If you don't have a label, print or type the information in the spaces provided. If you don't have a social security number, see page 7.

Presidential election campaign fund
This fund was established by Congress to help pay campaign costs of candidates running for President. You may have one of your tax dollars go to this fund by checking the box.

Figure your tax
Line 1. Write on line 1 the total amount you received in wages, salaries, and tips from all employers.

Your employer should have reported your income on a 1982 wage statement, Form W-2. If you don't receive your W-2 form by February 15, contact your local IRS office. Attach W-2 form(s) to your return.

Line 2. Write on line 2 the total interest income you received from all sources, such as banks, savings and loans, credit unions, and other institutions with which you deposit money. You should receive an interest statement (usually Form 1099-INT) from each institution that paid you interest.

You cannot use Form 1040EZ if your total interest income is over $400 or you received interest income from an All-Savers Certificate.

Line 4. You can deduct 25% of what you gave to qualified charitable organizations in 1982. But if you gave $100 or more, you can't deduct more than $25. Complete the worksheet on page 18 to figure your deduction, and write the amount on line 4.

Line 6. Every taxpayer is entitled to one $1,000 personal exemption. If you are also entitled to additional exemptions for being 65 or over, for blindness, for your spouse, or for your dependent children or other dependents, you cannot use this form. You must use Form 1040A or Form 1040.

Line 8. Write the amount of Federal income tax withheld, as shown on your 1982 W-2 form(s). If you had two or more employers and had total wages of over $32,400, see page 19. If you want IRS to figure your tax for you, complete lines 1 through 8, sign, and date your return. If you want to figure your own tax, continue with these instructions.

Line 9. Use the amount on line 7 to find your tax in the tax table on pages 26-31. Be sure to use the column in the tax table for **single** taxpayers. Write the amount of tax on line 9.

Refund or amount you owe
Line 10. Compare line 8 with line 9. If line 8 is larger than line 9, you are entitled to a refund. Subtract line 9 from line 8, and write the result on line 10.

Line 11. If line 9 is larger than line 8, you owe more tax. Subtract line 8 from line 9, and write the result on line 11. Attach your check or money order for the full amount. Write your social security number and "1982 Form 1040EZ" on your payment.

Sign your return
You must sign and date your return. If you pay someone to prepare your return, that person must also sign it below the space for your signature and supply the other information required by IRS. See page 22.

Mailing your return

Your return is due by **April 15, 1983.** Use the addressed envelope that came with the instruction booklet. If you don't have an addressed envelope, see page 25 for the correct address.

☆ U.S. GOVERNMENT PRINTING OFFICE: 1982—O-363-286 13-2687299

National Taxpayer Advocate

Annual Report to Congress

2011 Annual Report to Congress

An Analysis of the IRS Examination Strategy: Suggestions to Maximize Compliance, Improve Credibility, and Respect Taxpayer Rights

An Analysis of the IRS Examination Strategy: Suggestions to Maximize Compliance, Improve Credibility, and Respect Taxpayer Rights[1]

[1] The principal author of this study is Karen Sheely, Systemic Advocacy Examination Technical Liaison.

EXECUTIVE SUMMARY

In the 2008 Annual Report to Congress, the National Taxpayer Advocate discussed concerns about the suitability of the IRS examination process, and questioned whether audit results reflect a correct determination of tax or a taxpayer's inability to navigate the system.[2] Instead of focusing on meeting taxpayer needs and increasing personal communication to determine the correct tax liability, the IRS increased its use of automated, streamlined examination processes and reduced personal contacts. In fiscal year (FY) 2010, 86 percent of individual audits were conducted by correspondence, and 42 percent concluded with no personal contact with the IRS whatsoever.[3] The examination process has become so removed that more than 25 percent of the EITC taxpayers surveyed for a TAS Research study were not even aware the IRS had audited their returns.[4]

The IRS is continuing to expand its automated examination, and examination-like procedures. It recently began to expand "audit coverage" using Accounts Management employees (instead of Examination employees) to "audit" cases previously considered "below tolerance" for Examination.[5] In addition, in FY 2010 the IRS made about 15 million contacts that many taxpayers may regard as examinations because they involve IRS attempts to match third-party income reporting to the return filed, or correct an error or omission.[6] The IRS has taken the position that these contacts do not constitute an examination because the IRS is not examining books or records but merely asking the taxpayer to explain a discrepancy.[7] By designating this contact as "not an examination," the IRS does not trigger a taxpayer's right to avoid unnecessary examinations and reserves the right to examine the books and records later.[8] The National Taxpayer Advocate is concerned that these new streamlined procedures bypass key taxpayer rights the IRS routinely provides to taxpayers subject to "real" examinations.

There is no doubt that the IRS needs automation to administer tax laws and tax-based social programs efficiently. However, instead of looking forward to identify new ways of doing business, the IRS examination strategy relies on outdated communication methods that do not meet the needs and preferences of taxpayers. The future of examination requires the IRS to use automation and technology in a way that benefits taxpayers. For example, the implementation of a virtual face-to-face audit appointment system could

2 National Taxpayer Advocate 2008 Annual Report to Congress 227-242.

3 For FY 2010, 86 percent of all individual tax return audits were correspondence audits and 42 percent concluded without personal contact. Automated Information Management System (AIMS) from the CDW FY 2010 (Dec. 2011).

4 National Taxpayer Advocate 2007 Annual Report to Congress vol. 2, 103.

5 IRS, Pre-Refund Program (PRP), *Executive Steering Committee Briefing* (July 25, 2011).

6 The IRS conducted 1,581,394 examinations of individuals, closed 4,336,000 "Automated Underreporter" contact cases, sent 8,445,374 math error notices, and made 793,132 Automated Substitute for Return (ASFR) assessments in FY 2010. IRS, Collection Activity Report NO-5000-139, *National Delinquent Return Activity Report* (2010) (ASFR data); IRS Data Book, *Table 14, Information Reporting Program* (FY 2010) (AUR data); IRS Data Book, Table 15, *Math Errors on Individual Income Tax Returns by Type of Error Calendar Year 2010* (FY 2010) (math error data); IRS Data Book, *Table 9a, Examination Coverage* (FY 2010) (examination data).

7 *See* Rev. Proc. 2005-32, § 4.03 2005-1 C.B. 1206.

8 IRC § 7605(b).

increase communications and provide prompt, personal auditor contacts that could ultimately reduce expensive downstream compliance costs such as repeat contacts, appeals, audit reconsiderations, and the assistance of the Taxpayer Advocate Service.

The purpose of this analysis is to look at the IRS examination strategy and identify ways to use the audit process to protect taxpayer rights, increase compliance, and preserve IRS credibility. This study indicates that a more effective examination strategy must include a greater emphasis on taxpayer communication and provide that every audit, or similar examination process, no matter the dollar amount involved, must instill and protect due process and taxpayer rights.

The National Taxpayer Advocate challenges the IRS to ensure that for every audit, or similar examination process, no matter the dollar amount involved, the IRS should:

1. In light of the information available in the 21st century, review and reassess the audit processes deemed "not an examination" and instead use the audit process to protect taxpayer rights, increase compliance, and preserve IRS credibility.
2. Provide a clear, concise, and understandable initial contact letter that places taxpayers on notice as to whether they are under audit and explains the rights associated with the process.
3. Whenever possible, verbally discuss the audit process and appeal rights with the taxpayer during the first interview to ensure that the taxpayer understands the process, what he or she needs to do, and his or her appeal rights.
4. Train all examiners in the tax law, not just IRS publications, so they are capable of and comfortable with discussing issues and the basis for determinations with taxpayers and practitioners.
5. Revisit the definition of "computer-generated letter," provide taxpayers with direct contact information for the assigned examiner, and permit taxpayers to contact and discuss the case with one examiner who will work that case to resolution.

Additionally, the National Taxpayer Advocate offers the following specific recommendations to the correspondence examination program to meet taxpayer needs and preferences and in doing so maximize compliance:

1. Conduct a comprehensive review of the work of correspondence examination and its staffing needs, today and in the future — and determine how to best incorporate virtual service delivery and other technologies such as a remote office audit to facilitate better interaction and service to taxpayers.
2. Whenever reasonable, use the term "audit" in place of "examination." Words like "review" or "exam" confuse taxpayers. "Audit" alerts the taxpayer to the importance of the IRS action.
3. Limit correspondence audits to returns with specific, clear-cut issues. Returns requiring income probes or issues that generally require voluminous records, such as

employee business records, are best handled by Tax Compliance Officers in an office or field setting.

4. Include in all correspondence involving determinations the name, telephone number, and unique identifying number of the IRS employee making the determination, as required by RRA 98.
5. Reinstate procedures under which, if they would benefit the taxpayer, one IRS employee is assigned to handle a case until it is resolved.
6. Test the ability to establish a telephone audit appointment, where an examiner can hold an initial interview, explain the examination process and appeal rights, discuss documentation, and define the next steps.
7. Redesign correspondence audit letters to increase comprehension, reduce redundant phone calls, and meet the requirements of the Plain Writing Act of 2010.
8. Improve training for Tax Examiners and provide them the technical guidance they need to be completely comfortable handling calls and inquiries.
9. Update the transfer request guidance to bring the regulation into conformity with the structure in place for more than a decade and describe situations where a request for a face-to-face audit is appropriate and will be considered.
10. Institute a technical review process to preserve the "presumption of correctness" of the Statutory Notice of Deficiency and resulting assessments. The review should focus on making sure the correct amount of tax is assessed against the correct taxpayer only after full consideration and discussion of any documentation submitted.

INTRODUCTION

The IRS examination process serves a critical role in tax administration.

The IRS is authorized by Congress to administer and supervise the execution and application of the nation's tax laws as detailed in the Internal Revenue Code (IRC).[9] As a matter of policy, the IRS Internal Revenue Manual (IRM) emphasizes that, "A tax system based on voluntary assessment would not be viable without enforcement programs to ensure compliance."[10] The IRS examination process helps ensure compliance by carrying out the authority granted in IRC § 7602(a)(1) to examine any books, papers, records, or other data that may be relevant to ascertain the correctness of any return.[11]

IRS examinations can leave a lasting impression — even on individuals who have never experienced an audit. IRS Oversight Board studies of taxpayer attitudes indicate that fear of an examination is a major influence to report taxes honestly. In 2010, 64 percent of taxpayers surveyed cited fear of an examination as a factor that influenced their voluntary

9 IRC §§ 7801 and 7803.

10 IRM 1.2.14.1.1 (Aug. 18, 1994).

11 IRC § 7602.

compliance. The impact on compliance is reflected by a smaller percentage (12 percent) of taxpayers believing it was acceptable to cheat on their income taxes in 2010 than in 2009 (13 percent).[12]

While the IRS accepts most federal income tax returns as filed, it audits a certain number each year to verify accuracy and enforce compliance. The IRS conducts each audit (also called an examination or exam) in one of three ways: (1) in the field; (2) in an office; or (3) by correspondence. In fiscal year 2010, the IRS conducted 1,735,083 audits of returns.[13] Also in FY 2010, the IRS made about 15 million contacts that many taxpayers may regard as examinations because they involve IRS attempts to match third-party income reporting to the return filed, or correct an error or omission.[14]

DISCUSSION

Some fear of an IRS audit may be warranted.

The prospect of an IRS audit can create anxiety for any taxpayer. Some argue there is nothing voluntary about our voluntary tax compliance system; it is only the fear of an audit that inspires the filing of returns and payment of taxes.[15] Some fear, or perhaps more appropriately trepidation, is justified because in an IRS audit the taxpayer generally bears the burden of proof.[16] That is, if the taxpayer does not rebut the IRS's determination, the court will assume the IRS is correct.

Previously, IRS Revenue Agents conducted audits with such a high level of professionalism, technical expertise, and oversight that IRS assessments generally deserved the

12 IRS Oversight Board, *Taxpayer Attitude Survey* 2 (Jan. 2011).

13 IRS Data Book, *Table 9a, Examination Coverage* (FY 2010).

14 The IRS conducted 1,581,394 examinations of individuals, closed 4,336,000 "Automated Underreporter" contact cases, sent 8,445,374 million math error notices, and made 793,132 Automated Substitute for Return (ASFR) assessments in FY 2010. IRS, Collection Activity Report NO-5000-139, *National Delinquent Return Activity Report* (2010) (ASFR data); IRS Data Book, *Table 14, Information Reporting Program* (FY 2010) (AUR data); IRS Data Book, Table 15, *Math Errors on Individual Income Tax Returns by Type of Error Calendar Year 2010* (FY 2010) (math error data); IRS Data Book, *Table 9a, Examination Coverage* (FY 2010) (examination data).

15 IRS Oversight Board studies of taxpayer attitudes showed that fear of an examination is a major factor influencing taxpayers to report taxes honestly. In 2010, 64 percent of taxpayers surveyed cited fear of an examination as a factor that influenced their voluntary compliance (up from 63 percent in 2009). IRS Oversight Board, *Taxpayer Attitude Survey* 5 (Jan. 2011).

16 Tax deficiency assessments determined by the IRS generally carry a presumption of correctness, and this presumption imposes upon the taxpayer the burden of proving that the assessment is erroneous. *See, e.g.*, *United States v. Janis*, 428 U.S. 433, 440 (1976). Exceptions exist to the presumption of correctness. For example, the IRS bears the burden of proof in fraud cases. Also, under IRC § 6201(d) if a taxpayer reasonably disputes an item of income reported on an information return by a third party and the taxpayer has fully "cooperated," the IRS has the burden of producing reasonable and probative information concerning such deficiency in addition to such information return. IRC § 6201(d) was enacted following the IRS's loss in *Portillo v. Comm'r*, 932 F. 2d 1128 (5th Cir. 1991) where the IRS relied on an information return from a third party (a customer of the taxpayer) to assert underreported income. Although the IRS established the taxpayer was a painter, engaged in painting during the period in question, the court held the proposed assessment was "arbitrary and erroneous" and not entitled to a presumption of correctness because the IRS failed to establish that the taxpayer received the unreported income after the taxpayer cooperated and raised reasonable concerns about the accuracy of the third-party reporting.

"presumption of correctness" granted by the courts.[17] Proposed assessments were based on detailed face-to-face interviews, a reconciliation of books and records, and thorough tax law research by accounting professionals. While taxpayers sometimes disagreed with the IRS's legal interpretations, the reliability of its accounting work was generally accepted. Unagreed cases were subject to significant internal review before the IRS would issue a Statutory Notice of Deficiency.[18] Before preparing the Statutory Notice, the Quality Review unit would contact the taxpayer or authorized representative to ensure that he or she understood the purpose and function of the notice.[19] Statutory Notices were not only reviewed by the Chief of Quality Review, but were inspected by IRS District Counsel and signed by the District Director.[20]

The IRS now relies on a centralized, automated correspondence examination process for the majority of individual audits.

The IRS now relies on centralized, automated procedures that inspire less confidence.[21] The IRS moved the bulk of its examination work from local offices conducting face-to-face audits to campus correspondence examination units.[22] Most individual audits are now conducted by correspondence using an automated batch system.[23] Instead of an interview and review of books and records by a Revenue Agent, Tax Examiners (and even some Accounts Management employees), process examinations with limited taxpayer contact and review only selected documents.[24] These employees rely upon IRS forms and publications for guidance rather than the IRC. Audit reconsiderations, previously considered a rarity, are now common.[25] The Statutory Notice of Deficiency, once a closely reviewed legal document issued only after all administrative remedies were exhausted, is now automated, signed electronically without review, and casually referred to as a "SNOD."

---

17 The justification given by courts for why the IRS's notice of deficiency is presumed correct include: (1) the government's need for the swift collection of revenues; (2) the inequality of information in the possession of the IRS relative to the taxpayer; and (3) to encourage taxpayers to keep records. *See, e.g.*, *Zuhone v. Comm'r*, 883 F.2d 1317, 1326 (7th Cir. 1989); *Carson v. United States*, 560 F.2d 693, 696 (5th Cir. 1977); *Portillo v. Comm'r*, 932 F.2d 1128, 1133 (5th Cir. 1991). As a general rule, a court will not "look behind" a notice of deficiency by examining the IRS's evidence, motives, or administrative policies or procedures. *Id.*

18 A Statutory Notice of Deficiency is required by IRC § 6212. It provides the taxpayer with the right to petition the Tax Court if he or she disagrees with the proposed deficiency. Taxpayers have 90 days (150 days if they are outside the United States) from the date of the notice to petition the Tax Court. IRC § 6213(a). The 90-day period cannot be extended and the Tax Court will not accept any late filed petitions.

19 IRM 4419, *Handbook for Quality Review, Section 242* (Dec. 22, 1981 Revision from IRS Archives).

20 IRM 4460, *Notices of Deficiency* (Aug. 5, 1981 Revision from IRS Archives).

21 For a detailed discussion of the legal, demographics, and administrative factors that included the IRS's drive to automation, *see From Tax Collector to Fiscal Automaton: Demographic History of Federal Income Tax Administration, 1913-2011*, *supra*.

22 During fiscal year (FY) 2010, more than 82 percent of the examinations of individuals were performed by correspondence. Treasury Inspector General for Tax Administration (TIGTA), Ref. No. 2011-30-071, *Trends in Compliance Activities Through Fiscal Year 2010* 11 (July 18, 2011).

23 Batch processing, now called Automated Correspondence Exam (ACE), is an IRS-developed, multifunctional software application that fully automates the initiation, processing, and closing of correspondence examination cases. Using the ACE, Correspondence Exam processes cases with minimal to no Tax Examiner involvement until a taxpayer reply is received. IRM 4.19.20.1 (Jan. 1, 2011).

24 Revenue Agents make tax determinations on field audits, Tax Examiners make determinations on Correspondence Examinations and Automated Underreporter cases, and Accounts Management employees provide taxpayer assistance on the IRS toll-free line.

25 Taxpayers who disagree with the outcome of an audit may ask the IRS to reconsider the examiner's determination if they have information not previously considered. *See* IRC § 7605(b). Audit reconsideration cases have increased about 190 percent, from 163,567 in FY 2006 to 474,581 in FY 2009. IRS, ERIS SBD 721 SBD 721 Database (July 27 & 28, 2010).

Field audits and correspondence audits differ in many ways.

Procedures for field and office audits reinforce the IRM requirement that "examiners have the ongoing responsibility to ensure all taxpayer rights are protected and observed, whether these rights are specified by statute or policy."[26] Revenue Agents, who generally work on large cases where the taxpayer is represented by a tax professional familiar with the audit process, must fully explain appeal rights and provide their direct contact information in case there are any questions.[27] Conversely, Tax Examiners, who generally work with lower income individuals who are more likely to be unrepresented and unfamiliar with the tax administration process, mail the taxpayers a copy of Publication 1, *Your Rights as a Taxpayer*, and do not have a direct telephone number.[28] Tax Examiners work with low and middle income taxpayers who are less likely to be able to communicate effectively with the IRS and respond with relevant information that would enable the IRS to reach an accurate determination.

In Correspondence Examination, the IRS is less likely to ask questions that would yield an accurate determination. While all face-to-face audits include an analysis and examination of income to determine whether taxable income has been accurately reported, correspondence audits do not.[29] Correspondence examinations address one tax year only, while field auditors inspect and if necessary adjust prior and subsequent year returns.[30] Revenue Agents are required to consider "Badges of Fraud" and prepare a detailed analysis of case facts and circumstances before proposing a fraud penalty.[31] Tax Examiners, however, process returns pre-identified (often through automated screens and filters) as fraudulent and propose strict liability penalties without any conversation with the taxpayer. For example, when the IRS detects an error on a return, automated systems assess an accuracy-related penalty before communicating with the taxpayer to determine whether he or she had the requisite intent or a reasonable cause for the violation.[32]

The IRS is continuing to automate its examination procedures in ways that may reduce the accuracy of its determinations. It recently expanded "audit coverage" using Accounts Management employees to audit cases previously considered "below tolerance" for

26 IRM 4.10.1.6 (May 14, 1999).

27 IRM 4.10.1.6.3 (May 14, 1999).

28 IRM 4.19.20.1.1 (Jan. 1, 2008). The batch system used to create the initial contact letter creates a letter, which is printed by the National Print Site and includes Publication1, *Your Rights as a Taxpayer*, as a stuffer. The move to a Universal Call Routing system with no direct number was highlighted in IRS, W&I Compliance, *Compliance Chat* (Spring 2008).

29 IRM 4.10.4 (Aug. 9, 2011).

30 TIGTA, Ref. No. 2010-30-024, *Significant Tax Issues Are Often Not Addressed During Correspondence Audits of Sole Proprietors* 3-4 (Feb. 24, 2010).

31 Common factors used to make a determination of fraudulent intent are referred to as the "Badges of Fraud" by IRS Counsel and the courts. Although no single factor or badge will establish fraud, the existence of several indicators may constitute persuasive circumstantial evidence of fraudulent intent. IRM 25.1.2.3 (Jan. 1, 2003).

32 *See* National Taxpayer Advocate 2007 Annual Report to Congress 275 (*The Accuracy-Related Penalty in the Automated Underreporter Units*). For an in-depth analysis of the civil tax penalty regime, see National Taxpayer Advocate 2008 Annual Report to Congress vol. 2, 2 (*A Framework for Reforming the Penalty Regime*). We have recommended legislation to prevent the IRS from automatically assessing accuracy-related penalties without managerial review. *See* National Taxpayer Advocate 2008 Annual Report to Congress vol. 2, 18.

Examination.[33] Efforts to expand coverage and streamline cases come at the expense of both examination quality and taxpayer rights. In one proposal, the IRS would identify a discrepancy between information reported on the return and information reflected in third-party data and then send out letters disallowing a tax benefit.[34] The contact letters for these returns did not mention the word "audit" or discuss appeal rights, but they did include a "SNOD."[35] The IRS's internal plan stated that if a question arises, Accounts Management employees with no examination or tax law research experience would be available to assist — when not answering other calls on the toll-free line.[36] Although not explicitly stated, the plan reflects a disturbing view that a case below the tolerance level for the Examination process is also below the tolerance level for due process and rights. The National Taxpayer Advocate continues to insist that the IRS instill and protect due process and taxpayer rights in every work plan.

The IRS could use automation and technology to increase the public's confidence in the accuracy of its determinations while preserving taxpayer rights. For example, technology could help each taxpayer reach the employee working on his or her case and ensure that the IRS does not send correspondence to the wrong address. However, if the IRS continues to use automation in ways that do not inspire confidence in the accuracy of its determinations, those determinations may lose their presumption of correctness in court.[37]

The public could also lose confidence in the IRS. Increasing audit coverage at the expense of quality and taxpayer rights may actually reduce voluntary compliance.[38] For example, audits that do not detect underreporting could hurt compliance if they show taxpayers the limits of the IRS's ability to detect cheating. Enforcement activities and procedures that reduce trust in the government or the tax system could harm compliance. Unless the IRS reverses current trends and revises its future plans, its determinations could become a joke both in court and in the court of public opinion and voluntary compliance may suffer.

---

33 IRS, Pre-Refund Program (PRP), *Executive Steering Committee Briefing* (July 25, 2011). Audit coverage, or the number of audits conducted, takes into consideration various tolerances specified in the Law Enforcement Manual (LEM) where the resources needed to complete an audit do not justify (from a cost-basis only) the potential tax adjustments. These cases are deemed "below tolerance" for Examination.

34 IRS, *Overview of the Accelerated Refund Assurance Program (ARAP)*, Discussion Document (Oct. 16, 2011).

35 Draft Form 4800 C on file with author.

36 IRS, *Overview of the Accelerated Refund Assurance Program (ARAP)*, Discussion Document (Oct. 16, 2011).

37 For example, in one case the IRS's SNOD was "arbitrary and erroneous" and not entitled to a presumption of correctness because the IRS failed to establish that the taxpayer received the unreported income shown on a Form 1099, which the taxpayer disputed. *Portillo v. Comm'r*, 932 F. 2d 1128 (5th Cir. 1991). Because the IRS concluded that this case was "susceptible to wholesale application to the IRP program and all 1099s," it was concerned that the determinations issued as a result of its matching programs would not necessarily carry a presumption of correctness. LGM TL-100 (1994). Its fears materialized in 1996, when Congress enacted IRC § 6201(d), which provided a limited exception to the presumption of correctness. If a "cooperative" taxpayer asserts a reasonable dispute with respect to any item of income reported on an information return, under IRC § 6201(d) the IRS generally has the burden of producing other "reasonable and probative information" concerning the deficiency. Thus, under current law the "presumption of correctness" does not apply to a SNOD that increases the taxpayer's income based solely on information provided on information returns, provided the taxpayer has cooperated and raises a reasonable dispute.

38 For additional discussion of research in this area, see, *e.g.*, National Taxpayer Advocate 2007 Annual Report to Congress vol. 2, 138-150 (Marjorie E. Kornhauser, *Normative and Cognitive Aspects of Tax Compliance*) (surveying tax compliance literature); National Taxpayer Advocate 2010 Annual Report to Congress vol. 2, 71 (*Researching the Causes of Noncompliance: An Overview of Upcoming Studies*) (surveying literature and proposing research into the causes of noncompliance).

Different parts of the IRS conduct different types of examinations.

The IRS identifies returns for examination through various methods, including computer scoring and document matching programs. Once selected for examination, the type of return (individual, business, or tax-exempt), the size of the entity, and the nature of the inquiry usually determine which IRS operating division will conduct the audit.[39]

The Large Business & International Operating Division (LB&I) employs Revenue Agents who conduct audits at the taxpayer's place of business. Most LB&I taxpayers are high-asset corporations, whose returns involve large-dollar, complex issues requiring an extensive review of their books and records.[40] Similarly, Small Business/Self-Employed Operating Division (SB/SE) Revenue Agents conduct audits at the taxpayer's place of business. SB/SE field audits generally include smaller corporations, partnerships, and larger sole proprietorships.[41] SB/SE Tax Compliance Officers, in contrast, conduct audits in an office setting, where individual taxpayers typically bring records for inspection.[42]

The Wage and Investment Operating Division (W&I) and SB/SE employ Tax Examiners who conduct correspondence examinations from campus processing centers. These audits focus on a limited number of specific, clear-cut issues that would not normally require a full-scale field audit.[43]

The IRS has increased its use of correspondence examinations as a low-cost way to increase the "audit coverage ratio."

The IRS examination strategy is based on the conclusion that more audits (audit coverage) generally lead to more compliance. According to IRS estimates, the indirect effect of an examination on voluntary compliance is between six and 12 times the direct effect, *i.e., the amount of the adjustment.*[44] To expand audit coverage and theoretically increase the indirect effect of these audits, the IRS increasingly relies on an automated correspondence examination environment.[45] By using the Automated Correspondence Exam (ACE) system, the IRS has increased the individual tax returns audited to 1,581,394 (or one of every 90)

39 IRS Pub.1, *Your Rights as a Taxpayer* (Rev. May 2008); IRS Pub. 556, *Examination of Returns, Appeals Rights, and Claims for Refund*, 2-3 (Rev. May 2008); IRS Pub. 3498-A, *The Examination Process (Examinations by Mail)* (Dec. 2006).

40 IRM 4.46.1 (July 22, 2011).

41 IRM 4.10.2 (Aug. 2007); IRM 4.10.3 (Mar. 2003).

42 *Id*.

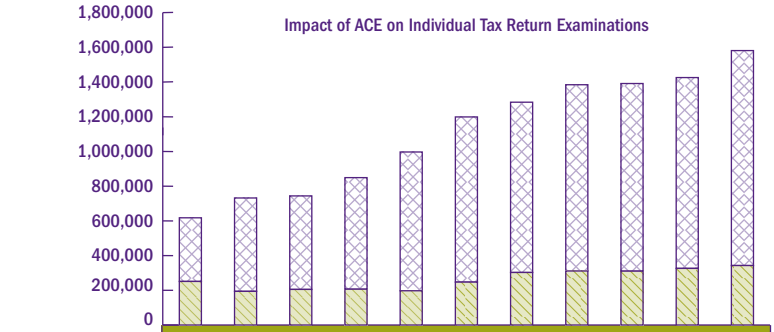
43 IRM 4.10.3.16 (Mar. 1, 2003).

44 *See* Alan H. Plumley, *The Impact of the IRS on Voluntary Tax Compliance: Preliminary Empirical Results*, Nat. Tax Assoc. 95th Annual Conf. on Taxation 8 (Nov. 2002), http://www.irs.gov/pub/irs-soi/irsvtc.pdf (11.7 times the proposed adjustment); Alan H. Plumley, Pub. 1916, *The Determinants of Individual Income Tax Compliance: Estimating the Impacts of Tax Policy, Enforcement, and IRS Responsiveness* 35-36 (Oct. 1996); Jeffrey A. Dubin, *Criminal Investigation Enforcement Activities and Taxpayer Noncompliance* 19 (May 2004), http://www.irs.gov/pub/irs-soi/04dubin.pdf (between six and seven times the proposed adjustment).

45 TIGTA, Ref. No. 2010-30-024, *Significant Tax Issues Are Often Not Addressed During Correspondence Audits of Sole Proprietors* 3 (Feb. 24, 2010).

in FY 2010.[46] In FY 2010, correspondence examinations accounted for 73 percent of all examinations and more than 82 percent of all individual exams.[47]

FIGURE 1, Impact of ACE on Individual Tax Return Examinations FY 2000-2010[48]



	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Correspondence	366,657	538,000	538,747	642,839	799,640	951,800	981,165	1,073,224	1,081,152	1,099,639	1,238,632
Face-to-Face	251,108	194,000	205,134	206,457	197,388	247,235	302,785	311,339	310,429	326,249	342,762

Correspondence examinations may not have a positive ripple effect on voluntary compliance.

The business decision to devote resources to correspondence examination instead of face-to-face audits is contrary to the recommendations of a recent Government Accountability Office (GAO) study.[49] The study suggests that increasing enforcement efforts by field agents would be among the most effective steps the IRS could take to address the tax gap, though by no means the only step needed. One study participant made the point that field compliance efforts generally have a ripple effect and may have a larger impact on compliance than the actual audits.[50]

The ripple effect of a correspondence examination, however, may be negligible.[51] A correspondence audit that does not detect unreported income may actually reduce voluntary compliance if taxpayers conclude and tell others that the IRS did not uncover cheating.[52] On the other hand, if the correspondence audit results in an incorrect assessment that

46 TIGTA, Ref. No. 2011-30-071, *Trends in Compliance Activities Through Fiscal Year 2010* 10-11 (July 18, 2011).

47 *Id.*

48 IRS Data Book, *Examination Coverage Table 10*, Fiscal Years 2000, and 2002 through 2005; TIGTA, Ref. No. 2002-30-184, *Management Advisory Report: Analysis of Trends in Compliance Activities* 4-5, (Sept. 2002) Through Fiscal Year 2001; IRS Data Book, *Examination Coverage Table 9*, Fiscal Years 2006–2007; IRS Data Book, *Examination Coverage Table 9a*, 2008–2010.

49 *See* GAO, GAO-08-703SP, *Highlights of the Joint Forum on Tax Compliance: Options for Improvement and Their Budgetary Potential* 7(June 20, 2008).

50 See *id*.

51 For an in-depth analysis of how the IRS Correspondence Examination Program does not promote voluntary compliance, see National Taxpayer Advocate 2008 Annual Report to Congress 158-167.

52 *See, e.g.*, Alan H. Plumley, Pub. 1916, The Determinants of Individual Income Tax Compliance: Estimating the Impacts of Tax Policy, Enforcement, and IRS Responsiveness 18 (Oct. 1996) (discussing this possibility).

requires the taxpayer to expend significant time and resources to correct, that taxpayer's experience may alienate others and encourage participation in the "cash" (*i.e.*, untrackable) economy.

The shift to automation can benefit the IRS examination strategy.

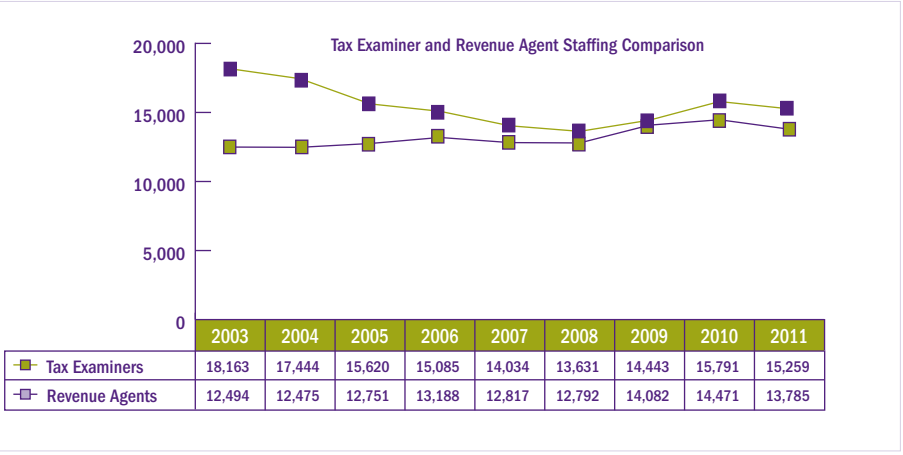
The IRS needs automation to administer tax laws and compliance-based programs such as Correspondence Examination efficiently. Automation can enhance speed and accuracy while promoting consistency. Automated processes that provide taxpayers with clear notices, ample response time, and appropriate assistance are used every day to handle everything from an erroneous cable bill to a traffic violation.

Automation also provides the IRS much-needed flexibility to meet customer demands. For example, the ability to shift work electronically from office to office has helped keep IRS offices experiencing a disaster up and running. Correspondence Examination moved in 2008 to a Universal Call Routing (UCR) system that directs incoming calls to the first available Tax Examiner and reduces waiting time.[53]

Automation created a notable shift in Examination personnel.

Revenue Agents, listed as the largest group of employees in the IRS in a 1991 hiring brochure, are now outnumbered by Tax Examiners.[54] From 18,000 in 1991, the number of Revenue Agents dropped to 11,886 by 2001 and remained at this level through FY 2010.[55] Conversely, the number of Tax Examiners increased to 15,259 in FY 2010.[56]

FIGURE 2, Tax Examiner/Revenue Agent Staffing Levels by FY



	2003	2004	2005	2006	2007	2008	2009	2010	2011
Tax Examiners	18,163	17,444	15,620	15,085	14,034	13,631	14,443	15,791	15,259
Revenue Agents	12,494	12,475	12,751	13,188	12,817	12,792	14,082	14,471	13,785

53 The move to a Universal Call Routing system with no direct number was highlighted in IRS, W&I Compliance, *Compliance Chat* (Spring 2008).

54 The brochure states, "Revenue Agents are the largest group of employees in the Service. In fact, with over 18,000 Revenue Agents, the IRS is the largest single employer of professional accountants in the world. Revenue Agents are professional accountants who examine and audit the books of individual and corporate taxpayers to determine correct federal tax liabilities." Recruitment brochure on file with author.

55 TIGTA, Ref. No. 2011-30-071, *Trends in Compliance Activities Through Fiscal Year 2010* 9 (July 18, 2011); TIGTA, Ref. No. 2002-30-184, *Management Advisory Report: Analysis of Trends in Compliance Activities Through Fiscal Year 2001* 13 (Sept. 2002).

56 Treasury Integrated Management Information System (TIMIS) on-roll data for the GS 592, Tax Examiner series as of Sept. 28, 2011.

In terms of production, the work of both Revenue Agents and Tax Examiners is impressive. In FY 2010, Tax Examiners processed 1,272,952 correspondence examinations resulting in tax assessments of $8,394,819,000.[57] In FY 2010, Revenue Agents closed 462,131 cases resulting in assessments of $36,415,664,000.[58]

Revenue Agents and Tax Examiners have different educational backgrounds and receive different training.

One notable difference between field and correspondence examination is the educational requirements for the employees conducting the audits. It takes a well-trained tax accounting professional to apply increasingly complex tax laws in a global market. As such, it is not surprising that the requirements for a Revenue Agent include a four-year degree along with 30 semester hours of accounting coursework.[59] Similarly, Tax Compliance Officers who handle office audits are usually business majors and others who possess six semester hours of accounting or can pass an accounting proficiency test.[60] Once hired, Revenue Agents and Tax Compliance Officers go through extensive technical classroom instruction interspersed with on-the-job training to develop interview and audit techniques.[61] What may be surprising is the work of the correspondence examination program, now the backbone of the IRS examination strategy, is completed by Tax Examiners, an entry-level position that requires a high school diploma or General Educational Development (GED) certificate.[62]

Revenue Agents and Tax Examiners have different expectations.

Current hiring brochures extol that as a Revenue Agent,

> "...you'll be a proactive decision-maker, working side-by-side with customers, businesses, CFOs, CEOs and the legal and financial communities. You'll use the latest in computers, telecommunications and data management systems. Interacting with taxpayers, businesses, tax-exempt organizations and more, you'll display a keen knowledge of changing tax laws and accounting practices, as well as various types of businesses and industries. Your work will be to educate, assist and counsel."[63]

57 IRS Data Book, *Examination Coverage Table 9a* (FY 2010).

58 *Id*.

59 *See* www.usajobs.gov for a complete list of requirements for a Revenue Agent, GS-512 series position.

60 *See* www.usajobs.gov for a complete list of requirements for a Tax Compliance Officer, GS-526 series position. *See also* http://jobs.irs.gov/midcareer/accounting-budget-finance.html#TaxComplianceOfficer.

61 IRS Publication 4149, *Careers at the IRS - Internal Revenue Agent* (Mar. 2007).

62 Many Tax Examiners begin their IRS careers at Grade 5, which requires a candidate to have 12 months of specialized experience at the next lower grade, a bachelors' degree or four years of education above high school in any field of study from an accredited college or university, or combination of education and experience equivalent to that described above. The Grade 4 Tax Examiner position, which can provide specialized experience at the next lowest grade level, requires a high school diploma or GED certificate. *See* www.usajobs.gov for a complete list of requirements for a Tax Examiner, GS-592 series position.

63 *See* http://jobs.irs.gov/midcareer/internal-revenue-agentel.html (last visited Dec. 16, 2011).

The duties described for a Tax Examiner are more rudimentary,

> "If you want to apply your accounting skills to a role that puts you directly in touch with numbers, you should be one of our Tax Examiners. This position reviews tax returns for accuracy and completeness, reviews and codes tax returns for computer processing, resolves errors, and corresponds with taxpayers to obtain any missing information."[64]

In practice, Revenue Agents are expected to focus on problem solving and assist taxpayers in solving any tax problems identified during an examination, even if the problems are not related to the examination.[65] Conversely, Tax Examiners are told to transfer taxpayers to other offices to deal with issues not related to the audits.[66] Guidance to Revenue Agents recognizes that "effective communication with taxpayers is a significant factor in conducting a quality examination and in minimizing taxpayer burden."[67] In focus groups held with Tax Examiners, employees reported that they are "...told to work the paper and get off the phone quickly."[68] Perhaps because of such guidance, Tax Examiners close 42 percent of their correspondence examinations without any personal taxpayer contact.[69]

The IRS does not fully train Tax Examiners on interview techniques or the tax law.

Tax Examiners receive technical training based on IRS publications, not the Code, regulations, or case law. Classroom training includes topics such as "Telephone Contacts", but does not cover telephone interview techniques. When managers are asked why Tax Examiners are hesitant to discuss cases on the phone, they often respond that the employees are afraid they will not know the answers to the questions.[70] Until the policy recently changed (at the insistence of the Taxpayer Advocate Service), seasoned Tax Examiners auditing employee business expenses were not properly trained on accountable versus non-accountable plans — a key concept in determining deductibility.[71]

To best utilize employees without a tax accounting background as tax accountants, the IRS creates "If – Then" guidance. For example, "If" a taxpayer has a birth certificate and full-year school record for his or her child, "Then" the child meets the relationship and residency requirements for the Earned Income Tax Credit (EITC). "If" a taxpayer has a birth certificate where the paternal information is blank and the child is too young to be in

64 *See* http://jobs.irs.gov/seasonal/tax-examiner.html (last visited Dec. 16, 2011).

65 IRM 4.10.1.5.1 (May 14, 1999).

66 IRM 4.19.19.3.4.2 (Aug. 5, 2011).

67 IRM 4.10.1.5.3 (May 14, 1999).

68 IRS, Phone Optimization Team, *Team Briefing* (June 29, 2009).

69 For FY 2010, 86 percent of all individual tax return audits were correspondence audits and 42 percent concluded without personal contact. AIMS from the CDW FY 2010 (Dec. 2011).

70 In employee focus groups, employees reported that they are "rushed" to the phones without proper training and receive calls on issues they are not training to work. IRS, Phone Optimization Team, *Team Briefing* (June 29, 2009).

71 Treas. Reg. § 1.62-2(c). *See also* National Taxpayer Advocate 2008 Annual Report to Congress, *Suitability of the Examination Process Recommendations* 242.

school or have a personal relationship with a pastor who could attest to residency, "Then" the taxpayer is simply out of luck. Alternative sources of documentation are neither offered, nor considered.[72]

The correspondence examination process discourages communications between the IRS and taxpayers.

IRS examinations may not be what taxpayers expect.

Humorist Dave Barry described an IRS audit this way: "All that happens is, you take your financial records to the IRS office and they put you into a tank filled with giant, stinging leeches. Many taxpayers are pleasantly surprised to find that they die within hours."[73] While some taxpayers may share this impression, the reality is that 86 percent of individual audits are conducted by correspondence, and 42 percent conclude with no personal contact with the IRS whatsoever.[74] The examination process has become so removed that more than 25 percent of the EITC taxpayers surveyed for a TAS Research study were not even aware the IRS had audited their returns.[75]

The correspondence examination process discourages telephone communications.

Since Correspondence Examination adopted the UCR system, which routes incoming calls to the first available Tax Examiner, the IRS has no longer provided taxpayers with the examiner's direct phone number. Prior to this change, the initial contact letter gave the taxpayer the general toll-free number for Correspondence Examination and listed the Operations Manager as the contact person. When the unit received correspondence, it updated the case and assigned it to a specific Tax Examiner. All future correspondence provided the taxpayer with contact information for the assigned employee, including his or her identifying number and direct extension on the toll-free line.

Under the new UCR system, the IRS does not provide a specific examiner name and extension, just the general toll-free number for the examination unit and the name of the Operations Manager.[76] As a result, no single employee is responsible and accountable for a case from receipt of correspondence until final determination, and taxpayers no longer have one specific point of contact most familiar with their cases.

When the IRS conducted research before making this substantial organizational change, it learned that taxpayers found it difficult to contact the assigned Tax Examiner and were frustrated by the wait times on toll-free lines.[77] Focus group interviews indicated that

72 IRM 4.19.14.5.8, *Filing Status* (Jan. 1, 2010), and IRM 4.19.14.5.9, *Child Tax Credit* (June 9, 2007), provide an example of the narrow "If – Then" guidance provided to Tax Examiners to disallow a filing status and a related child tax credit.

73 Jeffery L. Yablon, *As Certain as Death, Quotations About Taxes*, Tax Analysts (2010 Edition).

74 For FY 2010, 86 percent of all individual tax return audits were correspondence audits and 42.3 percent concluded without personal contact. AIMS from the CDW FY 2010 (Dec. 2011).

75 National Taxpayer Advocate 2007 Annual Report to Congress vol. 2, 103.

76 IRM 4.19.10.1.6.(6) (Jan. 1, 2011).

77 Pacific Consulting Group, *Compliance Center Examination (CC Exam) SB/SE National Report, January Through March 2008* (July 2008).

the ease of reaching a person outweighed the desire to speak to the person making the determination. Focus group participants agreed that they would not mind speaking to different people about their cases as long as the employees were "on the same page" and "knew what they were doing."[78] Accordingly, the IRS instituted call routing with the idea that this would be a better way to answer calls in a timely manner.

When taxpayers call, however, the employees who answer the phone are not all "on the same page." When the IRS receives correspondence, the information is scanned and loaded on the Correspondence Imaging System (CIS), which is then uploaded to Correspondence Examination Automation Support (CEAS).[79] Any authorized examination employee can access a taxpayer's case electronically and review the correspondence and substantiation. Tax examiners spend blocks of time working on correspondence or answering routed phone calls. Accordingly, the Tax Examiner who makes a determination on a case may not be the one the taxpayer reaches by phone.

Ideally, the IRS should document every case in a manner that allows anyone to review the file and determine why a particular decision was made, with all relevant conversations transcribed and details of determinations and decisions noted. The reality is that Tax Examiners update files between incoming calls, in what is referred to as "wrap time."[80] Conversation notes are supposed to be summarized while on a call with the taxpayer, not during wrap time.[81] However, when a taxpayer is on the line and a Tax Examiner knows additional callers are waiting, he or she is likely to take shortcuts and abbreviate notes. What might make perfect sense to the employee making the determination could be a mystery to the Tax Examiner answering a follow-up call. As such, taxpayers and practitioners now find they are not speaking to employees "on the same page"; nor are they satisfied with this new process. Taxpayers rightfully complain that they are frustrated about talking to Tax Examiners who do not have their files, having to resubmit paperwork, not having documentation acknowledged, having to repeat conversations, not receiving return calls, and not being able to get their cases resolved while on the phone.[82]

Taxpayers have trouble getting through to anyone at the correspondence examination unit by phone: What is so difficult about a telephone conversation?

The inability to reach someone by telephone to discuss a correspondence examination is a common taxpayer complaint reflected in customer satisfaction surveys.[83] However, once

78 *Id*.

79 IRM 4.19.21.2 (Jan. 1, 2011).

80 IRM 4.19.19.2 (Aug. 5, 2011).

81 See *Id.*, informing Tax Examiners that wrap time should not be used to document CEAS notes such as call summaries.

82 Phone Optimization Project (POP) Team Recommendations, *Solutions to Improve Taxpayer Satisfaction in Correspondence Examination Briefing Document* (June 21, 2010).

83 The IRS Restructuring and Review Act of 1998 (RRA '98) required the IRS to establish a "fair and equitable treatment of taxpayers" retention standard for all employees to provide assurance that employee performance is focused on providing quality service to taxpayers instead of achieving enforcement results. Pub. L. No. 105-206, § 1204(b), 112 Stat. 685, 722 (1998) (codified at IRC § 7804). To achieve assurance the RRA '98 required the IRS to develop taxpayer service surveys. *See id*. at § 1201 (codified at 5 U.S.C. §§ 9505(b) and 9508(a)(2)(A)).

taxpayers actually speak with Tax Examiners, they consistently rate the employees' courtesy and professionalism highly. A number of internal IRS teams, and most recently the cross-functional Correspondence Examination Taxpayer Satisfaction Improvement Initiative, have tried to figure out why it is so difficult for taxpayers to reach an examiner. Team research, analysis, and focus group interviews revealed that telephone access problems fall into three categories: repeat callers, hesitant employees, and organizational structure issues.[84] The initiative offered the following findings and solutions:

Repeat Callers — The lines are jammed with repeat callers.

It may be difficult to reach a Tax Examiner on the toll-free line because the system is overloaded. Telephone research determined that for calls received in the correspondence examination units:

- 62 percent of the callers are repeat callers;
- 13 percent phone more than eight times to resolve their issues;
- 28 percent of all repeat calls are from taxpayers wanting to know if the IRS received their correspondence; and
- 26 percent of repeat calls are questions about what to send or if their documentation was sufficient.[85]

To reduce calls, the team recommended the IRS create understandable, taxpayer-friendly, initial contact letters and acknowledge correspondence upon receipt. These suggestions were pursued by the Taxpayer Correspondence Taskgroup (TACT), now called Return Integrity and Correspondence Services (RICS), but never fully implemented.

Hesitant Employees — Employees are afraid of difficult questions.

Managers told the team some employees were hesitant to return calls because they were afraid they would be asked a question they could not answer. This seemed especially prevalent in Employee Business Expense (EBE) audits where an employee would not only need to know what is and is not deductible, but what would be considered an ordinary and necessary expense for a wide variety of occupations.[86]

The team recommended and the IRS initiated an in-depth training course for Tax Examiners on EBE. The IRS also created an occupation-specific online tool to help identify which expenses are ordinary and necessary, and determine what expenses are deductible and why.[87]

84 POP Team Recommendations, *Solutions to Improve Taxpayer Satisfaction in Correspondence Examination Briefing Document* (June 21, 2010).

85 *Id*. at 6.

86 IRC § 162.

87 POP Team Recommendations, *Solutions to Improve Taxpayer Satisfaction in Correspondence Examination*, Briefing Document (June 21, 2010).

Organization Structure — Some employees believe that as Tax Examiners, they will not have to talk to taxpayers.

Some employees said they accepted Tax Examiner positions, at a lower pay grade than an Accounts Management employee, to "get off the phones." Despite numerous conversations with employees where IRS executives shared that they too speak with taxpayers on the phone, some employees remain reluctant to do so. When asked specifically why they did not see the phone as a useful tool, one employee insightfully said, "Well, it *is* called *correspondence* examination."[88]

The team recommended, and the IRS initiated, training for all Tax Examiners that focuses on using the phone to:

- Reduce callbacks;
- Expedite closing cases;
- Reduce audit reconsideration cases;
- Increase taxpayer satisfaction; and
- Increase employee satisfaction.

The IRS's failure to give taxpayers a single point of contact may violate the law.

The lack of direct contact and access may be more than frustrating: it may be illegal. To make the IRS more accessible, the IRS Restructuring and Review Act of 1998 (RRA 98) required the IRS to include in all manually-generated correspondence the name, telephone number, and unique identifying number of the employee the taxpayer may contact regarding the correspondence.[89] RRA 98 further instructed the IRS to develop procedures that, if practical for the IRS and beneficial to the taxpayer, would assign one employee to handle an issue from start to finish.[90] Current correspondence examination procedures do not meet this requirement.

In practice, the IRS sometimes avoids the requirement to include contact information on manually-generated correspondence, which the IRM defines as "correspondence issued as a result of an IRS employee exercising his/her judgment in working/resolving a specific taxpayer case or correspondence, or where the employee (Tax Examiner, Revenue Agent, Revenue Officer, etc.) is asking the taxpayer to provide additional case-related information."[91] The IRS relies on the literal definition of "manually-generated" to conclude that computer-generated correspondence is not subject to these requirements.[92]

88 Comment arose during employee focus groups held as part of the information gathering phase of the Examination Customer Satisfaction Improvement Initiative.

89 Pub. L. No. 105-206, § 3705(a), 112 Stat. 685, 777 (1998) (codified at IRC § 7801).

90 *Id*.

91 IRM 21.3.3.4.17.2 (2) (Oct. 25, 2007).

92 IRM 4.19.10.1.6 specifies that letters mailed on cases in the W&I corporate inventory (that is, letters included in the inventory of letters that are system-generated) will include the W&I corporate toll free number, "tax examiner" as person to contact and site specific identification number.

For example, a Tax Examiner may find that after a review of documentation, the IRS needs additional substantiation to resolve the issue. In this instance, the employee has exercised judgment and is asking for additional case-related information, which seems to meet the definition of manually-generated correspondence. However, because the employee will issue a Letter 565, *Acknowledgement and Request for Additional Information*, through an automated system, the IRS considers this a computer-generated letter and does not include any identifying information for the employee making the determination. The National Taxpayer Advocate does not agree that an employee's use of machines to generate letters should exclude IRS correspondence from the legal requirements applicable to manually-generated correspondence. The fact that an employee uses an automated correspondence system to generate documents does not negate the fact that the correspondence is issued as a result of an IRS employee exercising judgment and making a decision on a specific case. The IRS interpretation of this requirement means that in the 21st century, with the extensive use of electronic word-processing, almost no taxpayer will be provided the protection of direct contact information for an IRS employee working the taxpayer's case, and no IRS employees will be accountable. This situation subverts both the requirements and the intent of RRA 98.

IRS letters often fail to reach taxpayers who are undergoing a correspondence examination.

The IRS sends over 200 million pieces of mail to taxpayers each year, including refunds, notices, and other official correspondence.[93] A relatively large volume of this mail never reaches the taxpayers. Although the IRS does not itself track how much mail is returned as "undeliverable as addressed," a TIGTA audit estimated that during FY 2009, approximately 19.3 million pieces of mail, or ten percent of the total, were returned to the IRS at an estimated cost of $57.9 million.[94] When an undeliverable piece of mail is the first letter sent to a taxpayer under correspondence audit, he or she may experience a significant adverse impact. As noted above, correspondence examination cases have minimal to no Tax Examiner involvement until the taxpayer replies to the IRS's letters. If a taxpayer never receives the initial contact letter, the proposed tax could be assessed by default.

Even taxpayers who receive the IRS letters may not be able to understand or respond in writing.

The IRS conducts most (60 percent) EITC audits by correspondence before issuing refunds and paying the credit.[95] Almost 70 percent of these taxpayers do not respond to the audit

93 IRS, Wage and Investment (W&I) Division, CARE/M&P Mail Management Project Office, Distribution Media and Publications; *Correspondence Production Services (CPS) Volume History*; and National Print Site Data (National Print Sites) Warehouse, *available at* http://nps.web.irs.gov/print%20warehouse/CPS%20FY-09-Site-Summ%20(2).xls (last visited July 6, 2010).

94 TIGTA, Ref. No. 2010-40-055, *Current Practices Are Preventing a Reduction in the Volume of Undelivered Mail* 1 (May 14, 2010). *See also* 2010 National Taxpayer Advocate Annual Report to Congress 221-234.

95 TIGTA, Ref. No.2011-40-023, *Reduction Targets and Strategies Have Not Been Established to Reduce the Billions of Dollars in Improper Earned Income Tax Payments Each Year* 29 (Feb. 7, 2011).

inquiry letters from the IRS,[96] which then denies the EITC. A 2004 TAS Research study of EITC audit reconsideration cases found that in cases originally closed as "no response," approximately 43 percent of the taxpayers had some or all of their EITC restored. They received on average about 96 percent of what they originally claimed on their returns.[97]

Taxpayers who actually receive an initial contact letter have trouble understanding it and struggle to prepare a response that meets the needs of the IRS. Even a taxpayer with expert writing skills might find it difficult to put into a letter the fluid living arrangements parents make on a sometimes daily basis over the residency of their children.[98] A simple telephone call would be so much easier.

IRS letters also confuse wise and savvy taxpayers. The SB/SE operating division sometimes works cases that involve neither small business (SB) nor self-employed (SE) taxpayers. A surprising number of taxpayers respond to SB/SE customer surveys with comments such as:

> "I do not understand why the audit by small business/self-employed was used since I do not own a small business and I am not self-employed. This audit should have been handled by another department of the IRS."
>
> "First off I wanted to comment that we are not a small business or self-employed. We won a prize that we had to pay taxes on that created this whole problem."
>
> "Once again, I do not know why you are sending this to me. I am NOT self-employed or have a small business. Whenever I received any correspondence from the IRS I would call to ask why they sent it and no one knew why — nobody had a clue." [99]

Within the general U.S. population, the use of correspondence is declining, but telephone contact, face-to-face visual streaming, and Internet access via cell phones are on the rise. More than 83 percent of American adults own a cell phone.[100] Forty-four percent of African-Americans and Latinos are smartphone users and have high rates of usage across a wide range of mobile applications.[101] While it used to be difficult to reach taxpayers at home, cell phones now seem to be everywhere. Even with this ready access, the number of

96 IRS AIMS FY 2010 (Oct. 2011) (ranging from 63 to 73 percent).

97 *See* National Taxpayer Advocate 2004 Annual Report to Congress vol. 2, 9 (*EITC Reconsideration Study*).

98 *See* Most Serious Problem: *Expansion of Math Error Authority and Lack of Notice Clarity Create Unnecessary Burden and Jeopardize Taxpayer Rights*, *supra*.

99 Pacific Consulting Group, *Compliance Center Examination (CC Exam) SB/SE National Report, Verbatim Comments, January Through March 2008* (July 2008).

100 Pew Research Center Publications, *Americans and Their Cell Phones* (Aug 15, 2011).

101 Pew Research Center Publication, *35% of American Adults Own a Smartphone* (July 11, 2011).

return calls from Tax Examiners is low.[102] Thus, the IRS is not using technology to increase taxpayer contact and obtain both taxpayer engagement and more accurate audit results.

In some cases, the IRS does not even tell taxpayers they are being audited because it does not want to trigger the taxpayer's right to avoid unnecessary or repetitive examinations.

As previously noted, taxpayers who receive exam notices often do not realize they are under audit.[103] This seems odd until we consider language in a recently proposed initial contact letter for a pilot project involving credits which the IRS believed to be "very likely" incorrect:

> *"While we were reviewing your tax return for [XXXX], we found certain items that we have questions about as explained in this letter. Therefore, we are proposing a change that will increase the tax and/or decrease the credits shown on your tax return. We based this change on information reported to us by employers, banks, or other payers under your name and social security number."*

The Taxpayer Advocate Service suggested adding some version of the following language:

> *"We are auditing your [XXXX] return. You claimed credits that appear unallowable. We're proposing to deny these credits and increase your tax. If you don't agree, you need to respond now."*

Our suggestion meets the requirements of the Plain Writing Act of 2010 and informs the taxpayer in no uncertain words that they are under audit.[104] "Review" or "exam" may confuse taxpayers,[105] but "audit" is always clear. This clarity is critical, both because taxpayers will be far more likely to pay attention to the letter and respond if they realize they are under audit, and because audits trigger certain rights. For example, under IRC § 7605(b) taxpayers have a right to not be subject to unnecessary, repetitive examinations, and if examined, to be subject to only one inspection of their books of account. To invoke these rights, taxpayers need to be placed on notice that they are under audit. The IRS contends these rights will not be abridged because the taxpayers in the pilot test will most likely not be subject to future audits. This is poor reasoning and poor tax administration. Taxpayer rights should not be hidden or ignored simply because they may not be needed.

The IRS has taken the position that an attempt to resolve a discrepancy between the taxpayer's return and data available from a third party does not constitute an examination because the IRS is not examining books or records but merely asking the taxpayer to explain

102 An FY 2008 analysis of voice mail versus outbound calls revealed 39 percent of voice mail messages were not returned within 24 hours. *See* IRS, Phone Optimization Team, *Team Briefing* (June 29, 2009).

103 *See* National Taxpayer Advocate 2004 Annual Report to Congress vol. 2 (*EITC Audit Reconsideration Study*).

104 The Plain Writing Act of 2010 requires federal agencies to use plain writing in nearly every document newly created or revised. Pub. L. No. 111-274, 124 Stat. 2861 (codified at 5 U.S.C. § 301).

105 Pacific Consulting Group Focus Group Interviews, conducted at fieldwork, Chicago, IL (Sept. 4, 2008).

a discrepancy.[106] The IRS does not want to call such contact an audit because it does not want to trigger the taxpayer's right to avoid unnecessary examinations.[107] Accordingly, it reserves the right to examine the books and records later without violating IRC § 7605(b). It is interesting to note that while the IRS does not consider these contacts an examination, it mails the CP2000 notice to explain discrepancies along with Publication 3498-A, *The Examination Process (Examinations by Mail)*. While the IRS may not consider this an examination, it is easy to understand why a taxpayer would.

The IRS has frequently expanded the list of audit-like checks that it will not consider to be an audit for purposes of IRC § 7605(b).[108] Decade by decade, the IRS adds to the list. For example, a Revenue Procedure indicates that looking at a tax return, such as those times when a Revenue Agent may inspect a prior or subsequent year return, is not considered an examination of the books and records. This guidance also states that a contact to verify a discrepancy between the taxpayer's return and an information return, or between a tax return and information otherwise in the IRS's possession, is not considered an examination. The IRS has broadly construed the application to the Automated Underreporter program, which matches income information filed with the IRS to individual filings. The AUR program is under expansion and will now reconcile business income to merchant card reporting. Any resolution would most likely require the IRS to review books and records, yet this currently falls under the IRS category of "not an examination." Simply by using this naming convention, the IRS could subject business taxpayers to repeated examinations of the books and records for one tax year.

The IRS sometimes sends confusing "combo" letters.

In an effort to streamline examination processes, the IRS has a tendency to revert to the use of combination or "combo" letters, which can also confuse taxpayers. Combo letters merge two distinct audit letters: (1) the initial contact letter and (2) the 30-day letter that includes the preliminary audit report and describes the taxpayer's appeal rights. The National Taxpayer Advocate has consistently expressed concern about their use.[109] Combo

106 *See* Rev. Proc. 2005-32, § 4.03 2005-1 C.B. 1206.

107 IRC § 7605(b).

108 For example, the 1959 version of this revenue procedure provided the IRS would generally not reopen a case "unless there has been substantial error, both in amount and in relation to the total tax liability, or there is evidence of fraud, malfeasance, collusion, concealment or the misrepresentation of a material fact." *See* Rev. Proc. 59-25, 1959-2 C.B. 938, *superseded by* Rev. Proc. 63-9, 1963-1 C.B. 488, *superseded by* Rev. Proc. 63-9, 1963-1 C.B. 488, *superseded by* Rev. Proc. 64-40, 964-2 C.B. 971, *superseded* by Rev. Proc. 68-28, 1968-2 C.B. 912, *superseded by* Rev. Proc. 68-28, 1968-2 C.B. 912, *superseded by* Rev. Proc. 72-40, 1972-2 C.B. 819, *superseded by* Rev. Proc. 72-40, 1972-2 C.B. 819, *superseded by* Rev. Proc. 74-5, 1974-1 C.B. 416, *superseded by* Rev. Proc. 74-5, 1974-1 C.B. 416, *superseded by* Rev. Proc. 81-35, 1981-2 C.B. 588, *superseded by* Rev. Proc. 81-35, 1981-2 C.B. 588, *superseded by* Rev. Proc. 83-19, 1983-1 C.B. 677, *superseded by* Rev. Proc. 83-19, 1983-1 C.B. 677, *superseded by* Rev. Proc. 85-13, 1985-1 C.B. 514, *superseded by* Rev. Proc. 94-68, 1994-2 C.B. 803, *superseded by* Rev. Proc. 94-68, 1994-2 C.B. 803, *superseded by* Rev. Proc. 2005-32, 2005-1 C.B. 1206.

109 Concerns about the use of the combination letter in Examination were raised in the National Taxpayer Advocate 2001 Annual Report to Congress 20-22, National Taxpayer Advocate 2002 Annual Report to Congress 55-63, National Taxpayer Advocate 2003 Annual Report to Congress 87-98, National Taxpayer Advocate 2004 Annual Report to Congress 163-180, National Taxpayer Advocate 2005 Annual Report to Congress 95-122, National Taxpayer Advocate 2006 Annual Report to Congress 289-310, National Taxpayer Advocate 2007 Annual Report to Congress 222-241, and National Taxpayer Advocate 2008 Annual Report to Congress 227-259.

letters are confusing because taxpayers do not know whether to respond to the exam and risk forfeiting their appeal rights, file an appeal and risk annoying the examiner, or both.

In recent years, the IRS has acknowledged these concerns, initially ending the use of combo letters in EITC audits and more recently discontinuing their use in other areas. However, current proposals to expand compliance coverage seemingly turn back the clock and reinstate the letters. For example, the IRS is testing an Automated Questionable Refund program where a Letter 4800C, which is essentially a truncated version of a combo letter, is issued with a report and followed by a SNOD.

Correspondence examinations are ineffective in many situations — one size does not fit all.

We are not alone in our concerns about the correspondence examination process. The GAO questioned the suitability and volume of correspondence examinations in a 1999 study that found more than half of taxpayers audited by correspondence did not respond to the IRS's letters.[110] When asked why, the IRS indicated it had not studied the issue but speculated taxpayers may be overwhelmed or intimidated by the letters and may not be comfortable with responding; some may not understand the letters or know how to respond; and others may know they owe additional tax but hope their non-responsiveness discourages the IRS from trying to collect. More recently, TIGTA commented on the disparity between correspondence audits and field audits in the area of income probes — an important tool in the battle to close the tax gap.[111]

There are times when a transfer from a correspondence audit to a local office is absolutely necessary to meet the needs of the taxpayer and the demands of the situation. For example, visually impaired taxpayers may require an office audit so readers can accompany them. In some situations, the books and records may be too voluminous, or, like trucking logs, a size difficult to copy for correspondence audit. What seems to be a reasonable request by a taxpayer for accommodation is seldom granted.[112]

110 GAO, GAO/GGD-99-48, *IRS Audits—Weaknesses in Selecting and Conducting Correspondence Audits* 3 (Mar. 1999).

111 TIGTA, Ref. No.: 2010-30-024, *Significant Tax Issues Are Often Not Addressed During Correspondence Audits of Sole Proprietors* (Feb. 24, 2010).

112 Taxpayer Advocacy Panel, *Correspondence Examination Briefing* (Feb. 24. 2011).

In Publication 3498-A, *The Examination Process, Examinations by Mail,* Frequently Asked Question #2 on page 4 asks:

> *Can I request a face-to-face interview?*
>
> Yes, but usually we are able to resolve most cases by telephone or correspondence. Face-to-face conferences are reserved for complex issues or substantial volumes of documentation. To discuss whether a face-to-face conference might be best for you, call the contact number provided on your most recent letter.

When a taxpayer calls the IRS to request a transfer, the IRM directs the Tax Examiner to ask for the request in writing,[113] and if one is made, to phone the taxpayer or representative and assure them that the issue can be resolved at the campus.[114] The result is essentially an automatic denial of the transfer request, which makes one wonder why the IRS burdened the taxpayer to make the request in writing in the first place. In the case of voluminous books and records, the IRM now includes provisions for Tax Examiners to sample receipts.[115] This technique is seldom used in correspondence examination. It would be difficult for even the most experienced examiners to sample receipts when they have no sense of the entirety of the books and records available.

When it comes to transfer requests, the cards are stacked in favor of the IRS. The IRC states that the time and place of an examination may be fixed by the Secretary and reasonable under the circumstances.[116] The regulations introduce the concept of considering, on a case-by-case basis, written requests by taxpayers to change the audit location established by the IRS.[117] These regulations, last updated in 1993, still reference the now-extinct district structure and do not mention correspondence audit or when a transfer would be appropriate. The volumes of work in Correspondence Examination have the impact of rendering transfer relief useless. Because the regulation specifically states that the IRS need not transfer an audit to an office that lacks the resources to conduct it, the IRS can almost always plead the case for inadequate resources.[118] The office examination unit only has 1,400 Tax Compliance Officers nationwide, and they already have a full caseload.[119] While the IRS clearly cannot accommodate every transfer request, it should update its guidelines to describe situations where a request is appropriate and will be considered.

The time has come to incorporate technology into the examination process.

The IRS has deployed numerous technological advances to further workforce efficiency and development. Employees use laptops and wireless services to work remotely and keep

113 IRM 4.19.19.6 (Aug. 5, 2011).

114 IRM 4.19.13.14 (Jan. 1, 2010) instructs employees to "Telephone POA or taxpayer to provide assurance that the issue can be resolved at the Campus."

115 IRM 4.19.13.14 (Jan. 1, 2010).

116 IRC § 7605(a).

117 Treas. Reg. § 301.7605-1.

118 Treas. Reg. § 301.7605-1(e)(B)(5).

119 TIGTA, Ref. No. 2011-30-071, *Trends in Compliance Activities Through Fiscal Year 2010* 8-9 (July 18, 2011).

up with assignments. Secured email and encryption software programs facilitate quick transfers of sensitive data. Travel vouchers, previously completed on paper with stacks of stapled receipts, are now finalized online with documentation that is either scanned or uploaded by fax and immediately available for review — oftentimes by remote managers. Training once held face-to-face is now conducted via Interactive Video Teleconferences (IVTs). Office Communicator systems provide the ability to share desktops, review documents, and work collaboratively across the country. These advances, once rare but now common to IRS employees, remain unavailable our customers — the taxpayers. Instead, the IRS continues to rely on outdated modes of communication. Correspondence, which is not always received by the taxpayer nor acknowledged by the IRS, remains the foundation of its examination process. Landline conversations are preferred to cell phones due to security concerns. Perhaps the most outdated convention is the notion that a fax cover-sheet with a disclosure statement telling the reader that the communication is private and confidential will be heeded.

There is no doubt that the IRS needs automation to administer tax laws and tax-based social programs efficiently. The volume, use, and availability of information reporting forced the IRS to use automation to process this data. A viable future for examination requires the IRS to use automation and technology in a positive way for taxpayers. Indeed, the IRS should provide the same accommodations to taxpayers as employees. Consider the possibilities:

- The IRS could employ a virtual service delivery system to keep work in campus locations, but conduct the equivalent of an office audit through live-stream video conferencing. Video cameras available on most computers and many smartphones would permit face-to-face contact with Powers of Attorney (POAs) and taxpayers from their offices and homes. The U.S. Tax Court's Electronic Courtroom already uses similar technology.[120]
- Taxpayers could submit digital documents electronically to ensure receipt and provide instant confirmation. Similar technology is already in place in the GovTrip system that federal employees use to arrange and account for travel.
- Reports could be shared and viewed together online to discuss adjustments and seek agreement. Current computer systems such as Office Communicator already provide for document sharing and collaboration.
- For cases requiring elevation to Appeals for resolution, the electronic file, complete with all digital documentation, could be transferred with the push of a button to an available Appeals Officer with the expertise to settle the dispute, eliminating months of delay in transferring a paper file.

The same technical expertise and communication skill expected of a Revenue Agent in the field would be required for a successful auditor in a Virtual Delivery Service environment.

120 http://www.ustaxcourt.gov/electronic_courtroom/electronic_courtroom_guidelines.pdf.

The use of highly skilled, trained technicians would mitigate the problems identified that arise from poorly trained employees. Instead of dumbing down correspondence examination, the IRS should be staffing-up with higher graded positions. The IRS should be planning for a technological expansion to the public now, including all of the staffing and training implications.

RECOMMENDATIONS

The National Taxpayer Advocate acknowledges that the examination of returns is an important compliance tool and offers the following suggestions for the IRS examination strategy to maximize compliance, improve credibility, and respect taxpayer rights.

Instill and Protect Taxpayer Rights in the Examination Strategy

The National Taxpayer Advocate challenges the IRS to ensure that for every audit, or similar examination process, no matter the dollar amount involved, the IRS should:

1. In light of the information available in the 21st century, review and reassess the audit processes deemed "not an examination" and instead use the audit process to protect taxpayer rights, increase compliance, and preserve IRS credibility.
2. Provide a clear, concise, and understandable initial contact letter that places taxpayers on notice as to whether they are under audit and explains the rights associated with the process.
3. Whenever possible, verbally discuss the audit process and appeal rights with the taxpayer during the first interview to ensure that the taxpayer understands the process, what he or she needs to do, and his or her appeal rights.
4. Train all examiners in the tax law, not just IRS publications, so they are capable of and comfortable with discussing issues and the basis for determinations with taxpayers and practitioners.
5. Revisit the definition of "computer-generated letter," provide taxpayers with direct contact information for the assigned examiner, and permit taxpayers to contact and discuss the case with one examiner who will work that case to resolution.

Update the Correspondence Examination Program to meet taxpayer needs and preferences and in doing so maximize compliance.

To meet taxpayer needs and preferences, and in doing so maximize compliance, the IRS should consider the following recommendations:

1. Conduct a comprehensive review of the work of correspondence examination and its staffing needs, today and in the future — and determine how to best incorporate virtual service delivery and other technologies such as a remote office audit to facilitate better interaction and service to taxpayers.

2. Whenever reasonable, use the term "audit" in place of "examination." Words like "review" or "exam" confuse taxpayers. "Audit" alerts the taxpayer to the importance of the IRS action.
3. Limit correspondence audits to returns with specific, clear-cut issues. Returns requiring income probes or issues that generally require voluminous records, such as employee business records, are best handled by Tax Compliance Officers in an office or field setting.
4. Include in all correspondence involving determinations the name, telephone number, and unique identifying number of the IRS employee making the determination as required by RRA 98.
5. Reinstate procedures under which, if they would benefit the taxpayer, one IRS employee is assigned to handle a case until it is resolved.
6. Test the ability to establish a telephone audit appointment, where an examiner can hold an initial interview, explain the examination process and appeal rights, discuss documentation, and define the next steps.
7. Redesign correspondence audit letters to increase comprehension, reduce redundant phone calls, and meet the requirements of the Plain Writing Act of 2010.
8. Improve training for Tax Examiners and provide them the technical guidance they need to be completely comfortable handling calls and inquiries.
9. Update the transfer request guidance to bring the regulation into conformity with the structure in place for more than a decade and describe situations where a request for a face-to-face audit is appropriate and will be considered.
10. Institute a technical review process to preserve the "presumption of correctness" of the Statutory Notice of Deficiency and resulting assessments. The review should focus on making sure the correct amount of tax is assessed against the correct taxpayer only after full consideration and discussion of any documentation submitted.

National Taxpayer Advocate

Annual Report to Congress

2011 Annual Report to Congress

Estimating the Impact of Liens on Taxpayer Compliance Behavior and Income

Estimating the Impact of Liens on Taxpayer Compliance Behavior and Income[1]

[1] The principal authors of this study are Terry Ashley, Tom Beers, and Jeff Wilson, TAS Research and Analysis.

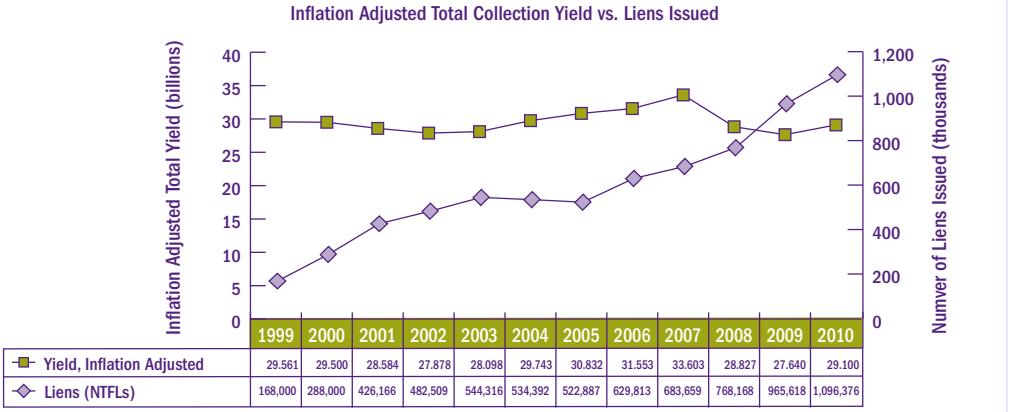
EXECUTIVE SUMMARY

Introduction

The Notice of Federal Tax Lien (NFTL) is a legal tool the IRS uses to facilitate the collection of unpaid tax debts. The IRS must file an NFTL in the appropriate location, such as a county register of deeds, to put third parties on notice and establish the priority of the government's interest in a taxpayer's property against subsequent purchasers, secured creditors, and junior lien holders.[2]

As shown in the chart below, while NFTL filings fell to an all-time low after the enactment of the Revenue and Reconciliation Act of 1998, they have since increased, and have risen precipitously since 2005. In fact, the 2011 volume of 1,042,230 filings is about six times the number for 1999.[3]

FIGURE 1, Inflation Adjusted Total Collection Yield vs. Liens Issued



Despite the 2011 "fresh start" initiative to help financially struggling taxpayers, the IRS continues to file most NFTLs based on a threshold amount of liability rather than considering taxpayers' individual circumstances and financial situations.[4] The National Taxpayer Advocate is concerned that the IRS's use of the NFTL may be harming taxpayers, especially those with economic hardships, while not significantly enhancing the IRS's ability to collect delinquent liabilities.[5] The National Taxpayer Advocate therefore requested that Taxpayer

2 IRC § 6323(f); Treas. Reg. § 301.6323(f)-1; IRM 5.12.2.8 (Oct. 30, 2009).

3 IRS, *IRS Data Books, Table 16, Delinquent Collection Activities, 1999-2010*; IRS, IRS, Collection Activity Report NO-5000-23, *Collection Workload Indicators* (Oct. 30, 2011). The inflation-adjusted totals reflect the yearly total collection yields adjusted to 2010 dollars using the U.S. Consumer Price Index-All Urban 2010, U.S. Bureau of Labor Statistics.

4 IRS, Media Relations Office, *IRS Announces New Effort to Help Struggling Taxpayers Get a Fresh Start; Major Changes to Lien Process*, IR-2011-20 (Feb. 24, 2011).

5 *See* Most Serious Problem:Changes to Lien Filing Practices Are Needed to Improve Future Compliance, Increase Revenue Collection, and Minimize Economic Harm, *supra*..

Advocate Service (TAS) Research & Analysis investigate the impact of NFTLs on the compliance behavior of delinquent taxpayers.

Methodology

To study the impact of the NFTL on compliance behavior, TAS Research analyzed a cohort of delinquent individual tax return filers (*i.e.*, those who file Forms 1040, *U.S. Individual Income Tax Return*) who incurred unpaid individual tax liabilities in 2002 and had no such liabilities at the beginning of that year. We identified the subgroup of these taxpayers against whom IRS filed liens between 2002 and 2004, as well as a comparable subgroup against whom the IRS did not file liens.[6] We compared the payment and filing compliance behavior of these two groups from inception of the liability through 2010, and examined the impact that lien filings had on taxpayers' incomes during this period.

Findings

Our research shows that lien filing was associated with negative outcomes for payment compliance behavior on the taxpayers' initial liabilities, negative filing compliance behavior, and negative impacts on the amount of income earned by taxpayers in years after the NFTL. Lien filing did have a positive effect on taxpayer payment compliance behavior on liabilities subsequent to their original ones.

Specifically, we found that in 2005 (our first study end point) taxpayers with liens were about 6.4 percent less likely to reduce their initial liabilities than comparable non-lien taxpayers, and that through 2008, at least four years after the liens were filed, taxpayers with liens were still over five percent less likely to reduce their initial liabilities. In addition, lien taxpayers were less likely to file required returns, with the increased likelihood of non-filing ranging between about one and three percent during the full study period (through 2010). Also, lien taxpayers were less likely to have an increase in their total positive incomes (TPI),[7] with the increased likelihood of negative outcomes starting at about 7.9 percent and gradually declining to about 5.2 percent by the end of the full study period. It should be noted that we did not adjust dollars for inflation. Therefore, the nominal decreases taxpayers experienced in TPI at the end of the study period (*i.e.*, 2010) relative to their 2002 TPI are greater in real terms than equivalent nominal losses experienced earlier in the period.

The positive effect for lien filing on future payment compliance started at about 5.6 percent and gradually declined to about 1.2 percent by the end of the study period (2010). It is unknown if the lien filing actually improves subsequent payment compliance or if the lien filing is merely reducing the likelihood that a taxpayer will report subsequent liabilities, since the lien filing also shows a negative effect on subsequent filing compliance.

6 As discussed in the body of the report, TAS Research used a technique known as "propensity scoring" to identify a group of non-lien taxpayers comparable to the lien taxpayers in the study with respect to the characteristics the IRS uses to make lien filing determinations.

7 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.

In general, the results for our models show that as the time increased, the impact associated with lien filing tended to decline.

Next Steps

The outcome measures discussed above may be interrelated. For example, declines in TPI may affect taxpayers' ability to pay down their tax liabilities. Conversely, lien filing may motivate taxpayers to stay current with new liabilities. More generally, existing tax liabilities may motivate both lien and non-lien taxpayers to become non-filers to avoid incurring additional liabilities, but may impact lien taxpayers more because they have larger liabilities or less ability to pay due to decreased TPI. These are all possible areas for future research.

TAS will conduct additional research in 2012 to investigate when NFTLs are likely to be most effective. Possible areas of future research, in addition to those mentioned above, include the impact of lien filing on taxpayers in currently not collectible (CNC) status, and whether removal of these taxpayers from our study cohort would significantly improve compliance outcome measures for the remaining lien taxpayers. We may also investigate whether lien filing is more effective for taxpayers who have significant assets. Finally, we may build on previous research and further explore the extent to which payments credited to lien taxpayers were attributable to sources other than the lien.[8]

Although our results show that IRS lien filing practices during the study period were generally not productive for either the IRS or taxpayers, we expect that lien filing can be an effective collection tool when the IRS makes filing determinations after careful consideration of each taxpayer's individual circumstances and financial situation.

8 In prior research, TAS found that most payments for lien taxpayers were attributable to sources other than the lien, such as refund offsets. *See* National Taxpayer Advocate 2009 Annual Report to Congress vol. 2, 1-18 (*The IRS's Use of Notices of Federal Tax Lien*).

INTRODUCTION

In fiscal year (FY) 2011, the IRS issued 1,042,230 liens.[9] Despite the "fresh start" initiative announced early in 2011 and intended to help struggling taxpayers, the IRS continues to file most Notices of Federal Tax Lien (NFTL) based on a threshold amount of liability.[10] Given the widespread use of this collection tool, it is important for the IRS to understand taxpayers' individual circumstances and financial situations prior to filing the NFTL. The National Taxpayer Advocate is concerned that the IRS's use of the NFTL may be harming taxpayers, especially those with economic hardships, while not significantly enhancing collection of delinquent liabilities. The National Taxpayer Advocate requested that TAS Research & Analysis investigate the impact of NFTLs on the compliance behavior of delinquent taxpayers to help the IRS better understand the effectiveness of NFTLs.

TAS Research analyzed a cohort of delinquent individual tax return filers (those who file Forms 1040, *U.S. Individual Income Tax Return*), who incurred unpaid tax liabilities in 2002 and had no such liabilities at the beginning of 2002. We identified the subgroup of these taxpayers against whom IRS filed liens between 2002 and 2004, as well as a comparable subgroup against whom the IRS did not file liens. We compared the payment and filing compliance behavior of these two groups from inception of the liability through 2010 and examined the impact that lien filing had on taxpayers' incomes during this time. We will discuss in detail how we selected these two groups for analysis in the methodology section.

BACKGROUND

A federal tax lien (FTL) arises when the IRS assesses a tax liability, sends the taxpayer notice and demand for payment, and the taxpayer does not fully pay the debt within ten days.[11] An FTL is effective as of the date of assessment and attaches to all of the taxpayer's property and rights to property, whether real or personal, including those acquired by the taxpayer after that date.[12] This lien continues against the taxpayer's property until the liability has been fully paid or is legally unenforceable.[13] To put third parties on notice and establish the priority of the government's interest in a taxpayer's property against subsequent purchasers, secured creditors, and junior lien holders, the IRS must file an NFTL in the appropriate location, such as a county register of deeds.[14]

9 IRS, Collection Activity Report NO-5000-23, *Collection Workload Indicators* (Oct. 30, 2011).

10 IRS, Media Relations Office, *IRS Announces New Effort to Help Struggling Taxpayers Get a Fresh Start; Major Changes to Lien Process*, IR-2011-20 (Feb. 24, 2011).

11 Internal Revenue Code (IRC) §§ 6321 and 6322. IRC § 6201 authorizes the IRS to assess all taxes owed. IRC § 6303 provides that within 60 days of the assessment the IRS must provide notice and demand for payment to any taxpayer liable for an unpaid tax.

12 *See* IRC § 6321; Internal Revenue Manual (IRM) 5.12.2.2 (Oct. 30, 2009).

13 IRC § 6322.

14 IRC § 6323(f); Treas. Reg. § 301.6323(f)-1; IRM 5.12.2.8 (Oct. 30, 2009).

A lien filing determination is required for all unpaid assessed delinquencies.[15] The IRS Internal Revenue Manual (IRM) specifies various criteria for lien filings depending on the nature of the delinquency. The IRS is even supposed to file an NFTL on most accounts reported as currently not collectible (CNC) if the unpaid balance is at least $10,000.[16] Streamlined installment agreements (IAs) do not usually require an NFTL filing.[17]

The IRS files nearly half of its NFTLs through the Automated Collection System (ACS), and files many of these without any significant employee review of the cases.[18] The National Taxpayer Advocate does not believe the IRS should be precluded from filing NFTLs, but rather that it should use this powerful collection tool judiciously as warranted by the circumstances of the delinquency.[19]

While NFTL filings fell to an all-time low after the enactment of the Revenue and Reconciliation Act of 1998, they have since increased, and have risen precipitously since 2005. In fact, the 2011 volume of 1,042,230 filings is about six times the number for 1999. The following figure shows the volume of IRS lien filings, and the total dollars collected since 1999.

15 IRM 5.12.2.4 (Mar. 28, 2011).

16 IRM 5.12.2.4.1 (Mar. 28, 2011). The lien filing threshold was increased to $10,000 as part of the IRS's "fresh start" initiative. *See Adjustments to IRS Lien Policies, available at* http://www.irs.gov/businesses/small/article/0,,id=239095,00.html (last visited Dec. 9, 2011).

17 IRM 5.14.5 (Mar. 11, 2011). Lien filing is not required for taxpayers entering into a streamlined installment agreement, but a lien may be filed at the discretion of the revenue officer. Following are current IA criteria:

Streamlined installment agreements may be approved for taxpayers under the following circumstances:

a. The aggregate unpaid balance of assessments (the SUMRY balance) is $25,000 or less. The unpaid balance of assessments includes tax, assessed penalty and interest, and all other assessments on the tax modules. It does not include accrued penalty and interest.

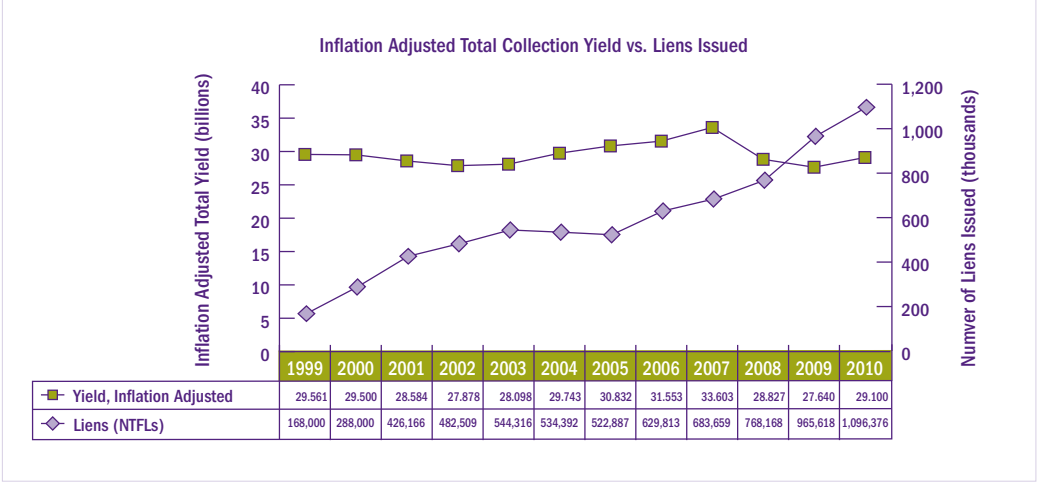
b. If pre-assessed taxes are included, the pre-assessed liability plus unpaid balance of assessments must be $25,000 or less.

c. The aggregate unpaid balance of assessments will be fully paid in 60 months, or the agreement will be fully paid prior to the CSED, whichever comes first.

18 IRS, Collection Activity Report NO-5000-C23, *Collection Workload Indicators* (Oct. 30, 2011). Of the 1,042,230 NFTLs filed in FY 2011, 45.6 percent were filed by the ACS. An analysis TAS conducted in FY 2011 showed that about 58 percent of ACS liens were filed systemically and without significant employee review. *See* National Taxpayer Advocate 2010 Annual Report to Congress vol. 2, 93 (Status Update: *Estimating the Impact of Liens on Taxpayer Compliance Behavior" an Ongoing Research Initiative*). On February 24, 2011, the IRS increased the threshold for systemically filing liens to $10,000 and raised it again to $25,000 on April 15, 2011. See IRS response to information request (Oct. 12, 2011). TAS will continue to monitor IRS lien filing volumes to determine the impact of these lien filing threshold changes.

19 For a detailed discussion of the National Taxpayer Advocate's concerns about IRS lien filing policies, see Changes to IRS Lien Filing Practices Are Needed to Improve Future Compliance, Increase Revenue Collection, and Minimize Economic Harm, *supra. See also* National Taxpayer Advocate 2010 Annual Report to Congress 302-310 (Status Update: *The IRS Has Been Slow to Address the Adverse Impact of Its Lien-Filing Policies on Taxpayers and Future Tax Compliance*).

FIGURE 2, Inflation-Adjusted Total Yield vs. Liens Issued[20]



As illustrated above, overall inflation-adjusted collection revenue has not kept pace with the increase in lien filings.[21] While other economic conditions certainly affect the total collection yield, the fact that increased lien filings do not necessarily increase collections makes the practice of filing an NFTL questionable in various situations.

OBJECTIVES

In this study, TAS Research sought to better understand the relationship between lien filings and delinquent taxpayer compliance behavior and the impact of lien filing on future taxpayer income. We explored four research questions:

1. Whether lien filing positively or negatively impacted taxpayers' payment behavior with respect to the original liabilities they incurred in 2002;
2. Whether lien filing positively or negatively impacted taxpayer payment compliance in subsequent periods;
3. Whether lien filing positively or negatively impacted taxpayer filing behavior in subsequent periods; and
4. Whether lien filing positively or negatively impacted taxpayer income in subsequent periods.

In a future study, we will conduct a sensitivity analysis to better understand when NFTLs are likely to be most effective as a collection tool. TAS does not envision that NFTLs are never effective, but rather that they may not be effective for certain taxpayers or in certain

20 IRS, *IRS Data Books, Table 16, Delinquent Collection Activities, 1999-2010*; IRS, Collection Activity Report NO-5000-23, *Collection Workload Indicators* (Oct. 30, 2011).

21 The inflation-adjusted totals reflect the yearly total collection yields adjusted to 2010 dollars using the U.S. Consumer Price Index-All Urban 2010, U.S. Bureau of Labor Statistics.

situations, such as for those with low incomes or few assets and those whose liabilities have been reported CNC.

METHODOLOGY

Our analysis employed a two-phase approach. Phase I involved a two-stage method of producing our cohort of comparable lien and non-lien taxpayers from the initial population of delinquent taxpayers. Phase II estimates the actual impact of the NFTL on taxpayer compliance behavior and income.

The first stage of Phase I estimates the probability that a taxpayer will have a tax lien filed against his or her delinquent liability. This stage is also described as generating "propensity scores" for the taxpayers. The propensity score represents the probability that the IRS will file a lien with respect to a taxpayer's tax liability and ranges in value between 0 and 1. We used a logistic regression equation to estimate the propensity scores.[22]

This estimation method addresses the selection bias inherent in the lien filing process, which exists because filings are not random events. Specifically, the IRS criteria that determine when tax lien filings should occur[23] introduce a selection bias that must be addressed, or the estimation of the tax lien's impact in the second phase (using a tax lien indicator) would produce biased results. To overcome this selection bias, we used propensity scores and a matching algorithm to generate matched pairs of lien taxpayers and non-lien taxpayers who are very similar with respect to the characteristics the IRS uses to make a lien filing determination. The result is a cohort of taxpayers that approximates a random sample of equivalent pairs of taxpayers.[24] This approach allows us to use a binary lien indicator (a variable with possible values of one or zero, where one indicates a tax lien has been filed against the taxpayer and zero indicates that a lien has not been filed) as an unbiased estimator of the lien effect in the second phase of our analysis. A more detailed discussion of both phases of the analysis follows.

Phase I Regression Analysis

In our first stage, we use regression to estimate the propensity score for each taxpayer (*i.e.*, the conditional probability of the taxpayer having a lien filed against him or her). We use a logistic regression where the dependent variable is a binary variable (one indicates a lien has been filed and zero indicates a lien has not been filed).[25] The independent variables are the covariates that capture the underlying conditions for tax lien filing, which are identified

22 The propensity score for this study is an estimate of the likelihood that the IRS will file a NFTL.

23 *See* IRM 5.12.1.13(2), IRM 5.12.2.8.1(4) & (5) and IRM 5.19.4.

24 Our cohort of lien taxpayers included about 93 percent of all taxpayers who acquired their individual income tax liabilities in 2002 and against whom the IRS filed liens between 2002 and 2004.

25 We actually model the dependent variable as a logit, which is the natural log of the odds derived from the dependent variable binary outcomes.

in the IRM.[26] Figures 3 and 4 report the lien filing criteria we identified in the IRS data and used to create our covariates. These criteria were in place at the time these delinquent taxpayers faced lien filing determinations (from 2002 to 2004).[27] The use of this information permits the model to more closely reflect IRS practices.

FIGURE 3, Criteria Captured in Model from IRM 5.12.1.13(2) & IRM 5.12.2.8(4) & (5)

ID	IRM Provision
1	The aggregate unpaid balance of assessment (UBA) is $5,000 or more.
2	If there is an UBA of any amount for an entity and the entity is not adhering to compliance requirements, such as federal tax deposits, return filings, etc.
3	An installment agreement does not meet streamlined, guaranteed, or in-business trust fund express criteria.
4	An open account with an aggregate UBA of $5,000 or more is being reported as currently not collectable.
5	The property is exempt by the Federal Bankruptcy Code or state insolvency proceeding.

Source: IRM 5.12.1.13(2) (July 31, 2001); IRM 5.12.2.8(4) & (5) (Mar. 1, 2004).

FIGURE 4, Criteria Captured in Model from IRM 5.19.4.5.2

ID	IRM Provision
1	Currently not collectible accounts, where aggregate assessed balance is at or above $5,000 and account is closed hardship (closing codes 24–32).
2	A lien has been filed and additional liabilities with aggregate assessed balance of $2,000 or more are received.
3	Consider lien filing in any situation where taxpayer has: ▪ Broken a promise. ▪ Been warned of possible lien filing. ▪ An aggregate assessed balance at or above $5,000. ▪ Employee believes filing the lien immediately will be helpful in collecting the balance due.

Source: IRM 5.19.4.5.2 (Aug. 30, 2001).

The model estimates the relationship between these criteria and the likelihood of lien filing to generate propensity scores. It generates a propensity score for each taxpayer based on the values the taxpayer has for each of these criteria. The higher the propensity score value, the greater the likelihood that the IRS will file an NFTL against the taxpayer under consideration. Figure 5 shows the independent variables included in the model.

26 Due to imitations in IRS data, we were not able to capture certain criteria for lien filings. See Appendix A for a more detailed discussion of how we implemented the IRS's lien filing criteria in the propensity scoring process.

27 In IRM 5.12, *Federal Tax Lien*, we used IRM 5.12.1.13(2) with a revision date of 7/31/2001 and IRM 5.12.2.8.1(4) & (5) with a revision date of 3/1/2004. In the Enforcement Action chapter, IRM 5.19.4, we found additional guidance on lien filing determinations. Because our analysis focuses on tax lien filings in 2002 to 2004, we used IRM 5.19.4.5.2(2)-(7) with a revision date of 8/30/2001.

FIGURE 5, Independent Variables for Propensity Scoring Model

Label	Variable Description
X1	An indicator of aggregate assessed tax greater than $5,000.
X2	An indicator of collection at risk.
X3	An indicator of taxpayer having CNC modules.
X4	An indicator of taxpayer having an installment agreement.
X5	An indicator of taxpayer having a defaulted installment agreement.
X6	An indicator of taxpayer having a bankruptcy filing.
X7	Log of taxpayer total module balance. This variable is not in the IRM criteria, but significantly affected the lien filing determination.
X8	An indicator of CNC status, hardship.

Source: TAS Research & Analysis, Lien Analysis.

The second stage uses the estimated propensity scores to create matched pairs of tax lien taxpayers with non-tax lien taxpayers. We used a propensity score matching technique known as the "nearest available neighbor" method.[28] The matched pairs allow the two groups (tax lien taxpayers and non-tax lien taxpayers) to be effectively identical over set covariates (observable characteristics pertaining to the IRS's lien filing determinations). This condition in the sample allows the estimate of the event (tax lien filing) effect to be less biased.

In the nearest available neighbor matching method, both lien and non-lien groups are randomly sorted. Then, the first lien unit is selected to find its closest non-lien unit match based on the absolute value of the difference between the propensity score of the selected lien unit and that of the non-lien unit under consideration. The closest non-lien unit is selected as a match. This procedure is repeated for all the lien units. This method matches lien and non-lien cases within a certain distance of the propensity score set by the user (.01 in our case).

Limitations

No lien or non-lien cases exist in the top ten percent of propensity scores and few lien or non-lien cases are in the next five percent of propensity scores. Therefore, this study does not pertain to those cases. We conducted two matches of lien cases against the population of non-lien cases to create more matches, so some non-lien cases were used twice and have a weight of two. About 93 percent of all lien cases (taxpayers against whom the IRS filed liens between 2002 and 2004) were matched.

Also, although we believe that we captured the important characteristics that drive lien filing determinations, due to data limitations some characteristics that may influence lien

28 We used a nearest-neighbor technique for matching the lien units and non-lien units that is called the "greedy" matching technique and was developed by Jon Kosanke and Erik Bergstralh.

filing behavior were not included in the propensity scoring process. See Appendix A for an in-depth discussion of how we implemented the IRS's lien filing practices in the process.

Phase II Regression Analysis

In Phase II we use logistic regression analysis to estimate the actual effect of the NFTL. As discussed above, we use the dataset that resulted from the Phase I propensity scoring and matching process. This dataset allows us to better estimate the impact of lien filing on the outcome variables of interest, because the dataset has been adjusted to address the selection bias inherent in the population of taxpayers against whom liens have been filed.

Following is a discussion of the regression models we used to estimate each of the outcome variables we explored.[29] Each model has a single outcome variable that represents the outcome we are interested in exploring (*e.g.*, taxpayer filing compliance or taxpayer payment compliance). The outcome variables are described below in the model discussions.

The independent variables included in the models capture all the factors that we believe significantly influence the model outcome variables. For example, to model the tax compliance behavior of delinquent taxpayers, the models include the factors that we believe may impact a taxpayer's compliance. The models have independent variables for taxpayer characteristics and indicators that reflect IRS collection activities associated with the taxpayer's liability. Individual taxpayer characteristics include marital status, number of exemptions, and an age category. Also, income information is included in several forms such as total positive income, average total positive income, presence of the earned income tax credit (EITC), and business or partnership income.

Since taxpayer compliance may be influenced by IRS audit and collection activities, the models include independent variables that capture whether the taxpayer has undergone an audit, as well as information about important collection-related activities, such as whether the taxpayer had an installment agreement (IA) or defaulted on an IA, whether the taxpayer was placed in CNC status, or whether the IRS levied on the taxpayer.

Additional independent variables include entity model balance at lien filing time and nonfiler status. See Figure 6 below for a description of all of the independent variables in the models and which are included in each model.

[29] The outcome variables are the dependent variables of our regression models.

FIGURE 6, Independent Variables for the Tax Compliance Models

Label	Variable Description	Current Payment	Future Payment	Future Filing	Future Income
X1	A vector of 11 Age Categories.	X	X	X	X
X2	The log of the taxpayer's entity module balance on the date of lien filing (or proxy).	X	X	X	X
X3	The log of the taxpayer's total positive income.	X	X	X	
X4	The log of the taxpayer's average total positive income.	X	X	X	
X5	An indicator that taxpayer filed for bankruptcy.	X	X	X	X
X6	An indicator that taxpayer has self-employment or sole proprietorship income.	X	X	X	X
X7	The number of exemptions claimed by the taxpayer.	X	X	X	X
X8	An indicator that taxpayer is married.	X	X	X	X
X9	An indicator that taxpayer claimed EITC.	X	X	X	
X10	An indicator that taxpayer has an installment agreement.	X	X	X	X
X11	An indicator that taxpayer did not timely file a required return.	X	X		X
X12	An indicator that taxpayer defaulted on an installment agreement.	X	X	X	X
X13	An indicator that taxpayer has a levy.	X	X	X	X
X14	An indicator that taxpayer has an offer in compromise status.	X	X	X	X
X15	An indicator that taxpayer defaulted on an offer in compromise.	X	X	X	X
X16	An indicator that taxpayer is in currently not collectible status.	X	X	X	X
X17	An indicator that taxpayer has had an audit.	X	X	X	X
X18	An indicator that taxpayer has no filing requirement.	X	X	X	X
X19	An indicator that taxpayer has a tax lien.	X	X	X	X

The lien variable is the critical independent variable in these models. The positive or negative sign on the estimated value for the lien variable shows whether lien filing had a positive or negative effect on the outcome variable being modeled. In Figure 7 (in the Findings section), we report on the sign of the lien variable and its marginal effect for each of our models. The marginal effect shows the impact lien filing had on the likelihood of the outcome we are modeling (*i.e.*, how much more or less likely lien taxpayers were to experience the outcome than non-lien taxpayers).

We use each regression model to estimate the lien effect on its outcome variable over six different timeframes: 2002–2005, 2002–2006, 2002–2007, 2002–2008, 2002–2009, and 2002–2010.

Current Payment Behavior

This model investigates the tax lien's impact on the probability of the taxpayer making sufficient payments during the study period to reduce the original liability incurred in 2002.

The dependent variable is a binary variable,[30] where one indicates a reduction has occurred in the balance due for the original liability during the period we are investigating (*i.e.*, the balance due is lower at the end of the study period). As mentioned above, we investigate six different study periods for this model and all the models that follow: 2002-2005, 2002-2006, 2002-2007, 2002-2008, 2002-2009, and 2002-2010.

Future Payment Behavior

This model investigates the impact of the lien on the probability of the taxpayer staying compliant with his payment of tax liabilities in all periods subsequent to 2002 (*i.e.*, after the original liability was incurred). Any new liabilities incurred subsequent to 2002 and still in existence at the end of the study period are included in the calculation. The dependent variable is a binary variable, where one indicates that any tax liabilities incurred subsequent to 2002 have been paid in full. If a balance remains for any of these liabilities at the end of the study period, the dependent variable will be zero.

Future Filing Behavior

This model investigates the tax lien's impact on the taxpayer's timely filing behavior during the study period. The dependent variable in this relationship is the timely tax filing indicator for future returns. This is a binary variable where one signifies that all required individual tax forms (*i.e.*, Forms 1040) for all years subsequent to 2002 included in the study period were filed timely. Zero signifies at least one return was not filed timely.

We determined whether a taxpayer did not timely file a required return based on the status code posted to the taxpayer's entity module on the IRS Individual Master File (IMF). The following status codes indicate that at some point during the study period the taxpayer had not filed a required return:

1. Module established; return not filed [status 0];
2. Return not posted; letter of inquiry mailed – Delinquency Status [status 2];
3. Taxpayer Delinquency Investigation (TDI) Status; occurs after 4th notice, [status 3]; or
4. Delinquent return not filed [status 6].

Future Income Outcome

This model investigates the impact of the lien on the taxpayer's future income. The dependent variable in this relationship is the change in income as measured by the change in the taxpayer's total positive income between the beginning and the end of the study period.[31]

30 We actually model the dependent variable in all of our models as a logit, which is the natural log of the odds derived from the dependent variable binary outcomes.

31 TPI is calculated by summing the positive values from the following income fields from a taxpayer's individual 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.

The dependent variable is a binary variable, where one indicates that the taxpayer's total positive income increased.

FINDINGS

Our model results show that taxpayers with liens filed against them were less likely than comparable taxpayers without liens to be compliant on their 2002 liabilities. They were also less likely to timely file required returns and generate greater total positive income after 2002. Lien filing did have a positive effect on payment compliance subsequent to 2002. It is unknown if the lien filing actually improves subsequent payment compliance or if the lien filing is merely reducing the likelihood that a taxpayer will report subsequent liabilities, since the lien filing also shows a negative effect on subsequent filing compliance.

The results for the signs and the marginal effects of the lien indicator variable are illustrated in Figure 7 below. The marginal effect of the lien indicator shows the increased probability that taxpayers with liens will experience the outcome we are modeling when compared to non-lien taxpayers. For example, in the case of the future filing model, a positive marginal effect would show how much more likely taxpayers with liens were to file all required returns than non-lien taxpayers, and a negative marginal effect would show how much less likely lien taxpayers were to file required returns. As shown in Figure 7, lien filing was a significant factor that had negative marginal effects for most outcome variables and most periods we analyzed.

FIGURE 7, Signs and Marginal Effects of Lien Indicator Variables

Models[A]	2002-2005	2002-2006	2002-2007	2002-2008	2002-2009	2002-2010	Average
Current Payment	-6.36%	-6.00%	-5.99%	-5.21%	-4.78%	-4.54%	-5.48%
Future Payment	5.58%	4.69%	3.70%	2.77%	2.18%	1.23%	3.36%
Future Filing	-0.87%	-1.51%	-2.12%	-2.48%	-2.83%	-2.78%	-2.10%
Future Income	-7.89%	-7.61%	-6.70%	-6.38%	-5.78%	-5.16%	-6.59%

A All models, except the future payment model, produced coefficients for the lien indicator that were negative and significant. The lien coefficients for the future payment model were positive and significant.
Source: TAS Research, Lien Analysis 2011

We found that in 2005 (our first study end point) taxpayers with liens were about 6.4 percent less likely to reduce their initial liabilities than comparable non-lien taxpayers, and that through 2008, at least four years after the liens were filed, taxpayers with liens were still over five percent less likely to reduce their initial liabilities. In addition, lien taxpayers were less likely to file required returns, with the increased likelihood of non-filing ranging between about one and three percent during the full study period (*i.e.,* through 2010). Also, lien taxpayers were less likely to have an increase in their TPI, with the increased likelihood of negative outcomes starting at about 7.9 percent and gradually declining to about 5.2 percent by the end of the full study period. It should be noted that we did not adjust dollars for inflation. Therefore, the nominal decreases taxpayers experienced in TPI at the

end of the study period (*i.e.*, 2010) relative to their 2002 TPI are greater in real terms than equivalent nominal losses experienced earlier in the study period.

The positive effect for lien filing on future payment compliance started at about 5.6 percent and gradually declined to about 1.2 percent by the end of the study period (2010). It is unknown if the lien filing actually improves subsequent payment compliance or if the lien filing is merely reducing the likelihood that a taxpayer will report subsequent liabilities, since the lien filing also shows a negative effect on subsequent filing compliance.

In summary, lien filings for this group of delinquent taxpayers were associated with negative outcomes for current payment activities, future tax filing activities, and future total positive income. Lien filing had a positive effect on future payment activities. The size of the negative impact associated with lien filing ranged from about one percent to about eight percent for the outcome variables we analyzed. In general, our results show that as the time increased, the impact associated with lien filing tended to decline.

CONCLUSIONS

In this study, TAS Research analyzed the impact of lien filing on comparable groups of lien and non-lien taxpayers who acquired individual income tax liabilities in 2002 and who had no such liabilities at the beginning of 2002. Our cohort of lien taxpayers included about 93 percent of all taxpayers who acquired new individual income tax liabilities in 2002 and against whom the IRS filed liens between 2002 and 2004. The results of our research show that lien filing was associated with negative outcomes for current payment activities, future tax filing activities, and future total positive income. Lien filing had a positive effect on future payment activities.

These outcome measures may be interrelated. For example, declines in TPI may affect taxpayers' ability to pay down their tax liabilities. Conversely, lien filing may motivate taxpayers to stay current with new liabilities. More generally, existing tax liabilities may motivate both lien and non-lien taxpayers to become non-filers to avoid incurring additional liabilities, but may impact lien taxpayers more because they have larger liabilities or less ability to pay due to decreased TPI. These are all possible areas for future research.

TAS will perform more research in 2012 to investigate when NFTLs are likely to be most effective as a collection tool. Possible areas for future research, in addition to those mentioned above, include the impact of lien filing on taxpayers in CNC status, and whether removal of these taxpayers from our study cohort would significantly improve compliance outcome measures for the remaining lien taxpayers. We may also investigate whether lien filing is more effective for taxpayers who have significant assets. Finally, we may build on previous research and further explore the extent to which payments credited to lien

taxpayers were attributable to sources other than the lien.[32] We will invite the IRS to collaborate with TAS on this research.

Although our results show that IRS lien filing practices during the study period were generally not productive for either the IRS or taxpayers, we expect that lien filing can be an effective collection tool when filing determinations are made after a careful analysis of each taxpayer's individual circumstances and financial situation.

32 In prior research, TAS found that most payments for lien taxpayers were attributable to sources other than the lien, such as refund offsets. *See* National Taxpayer Advocate 2009 Annual Report to Congress vol. 2, 1-18 (*The IRS's Use of Notices of Federal Tax Lien*).

APPENDIX A: IRM LIEN FILING REQUIREMENTS

Our analysis focuses on tax lien filings from 2002 through 2004. Consequently, we used IRM 5.12.1.13(2) with a revision date of 7/31/2001 and IRM 5.12.2.8.1(4) & (5) with a revision date of 3/1/2004.[33] These IRM sections cover IRS lien filing requirements. The criteria covered in IRM 5.12.1.13(2), revision date 7/31/2001, provide the following situations for tax lien filing:[34]

- The aggregate unpaid balance of assessment is $5,000 or more. [file an NFTL]
- An IA is $25,000 or more. [file an NFTL]
- An open account with an aggregate unpaid balance of assessment (UBA) of $5,000 or more is being reported as CNC. [file an NFTL]
- A case involving both assessed and preassessed periods will be reported CNC. [The filing of an NFTL may be held up to include both periods on the NFTL.]
- The property is exempt by the Federal Bankruptcy Code or state insolvency proceeding. [file an NFTL]
- The party on which a levy is to be served is likely to file a priority claim under IRC § 6323(a) or (c). [file an NFTL even though there is no mandatory NFTL filing requirement prior to service of the notice of levy on wage, salaries, etc.]

The criteria covered in IRM 5.12.2.8.1(4) & (5), revision date March 1, 2004, provide the following situations for filing a tax lien:[35]

- The aggregate UBA is $5,000 or more. [file an NFTL]
- An installment agreement does not meet streamlined, guaranteed, or in-business trust fund express criteria. [file an NFTL]
- There are additional assessments of $5,000 or more. [file an NFTL]
- An open account with an aggregate UBA of $5,000 or more is being reported as currently not collectible. [file an NFTL]
- A case involving both assessed and unassessed periods will be reported CNC. [file an NFTL]
- The property is exempt by the Federal Bankruptcy Code or state insolvency proceeding. [file an NFTL]
- The taxpayer resides outside the U.S. and has known assets. [file an NFTL]

We looked at these criteria as the starting point regarding the filing of an NFTL. As we built the model for measuring the propensity for filing, we used these criteria as the

33 The next revision to IRM 5.12.2.4.1 occurred May 20, 2005.

34 IRM 5.12.1.13(2) (July 31, 2001).

35 IRM 5.12.2.8.1(4) & (5) (Mar. 1, 2004).

benchmark for building our variables from the data. Additional information for building our variables also came from the IRM Enforcement Action chapter.

The Enforcement Action chapter, IRM 5.19.4, provides additional guidance on the lien filing determination. Again, because our analysis focuses on filings in 2002 to 2004, we used IRM 5.19.4.5.2(2)-(7) with a revision date of 8/30/2001.[36] IRM 5.19.4.5.2(2)-(7) states that liens should be filed in these six situations, some of which overlap with IRM 5.12.2:[37]

- Installment agreement: file a lien when both of the following conditions exist:
  - Aggregate assessed balance is at or above $5,000.
  - A Collection Information Statement (CIS) is required.
- Currently not collectible: file a lien when both of the following conditions exist:
  - Aggregate assessed balance is at or above $5,000.
  - Account is being closed under hardship provisions.
- R7 cases: these are older accounts with an aggregate assessed balance at or above $5,000 that are reassigned for follow-up to a systemically issued ACS Letter 39.
- File an NFTL if collection is at risk, such as:
  - A creditor plans to seize the taxpayer's assets or the taxpayer is preparing to sell them.
  - The taxpayer is about to file bankruptcy.
- If a lien has been filed and additional liabilities with an aggregate assessed balance of $2,000 or more are received, file an additional lien only if it significantly enhances the collectability of the account.
- The employee may consider lien filing in any situation where a taxpayer has:
  - Broken a promise;
  - Been warned of possible lien filing;
  - An aggregate assessed balance at or above $5,000; and
  - The employee believes filing the lien immediately will be helpful in collecting the balance due.

The Enforcement Action guidance on tax lien filing appears to expand on the conditions for lien filing to allow Collection staff some discretion in filing the lien. We used this information to further enhance our understanding of IRS lien filing practices. We limited our modeling of filing determinations to information that could be captured on the criteria described above. Data limitations prevented us from capturing all of these situations for filing an NFTL.

36 The next revision to IRM 5.19.4 occurred August 1, 2005.

37 IRM 5.19.4.5.2(2)-(7) (Aug. 30, 2001).

Comparison of IRM NFTL Filing Criteria and Our NFTL Model

Data availability limited the IRM 5.12 section criteria that could be captured as covariates in our tax lien filing model. Figure 8 shows the criteria that were captured.

FIGURE 8, Variables Matched to IRM 5.12, Federal Tax Liens

ID	IRS IRM 5.12	In Model	Description of Variable in Model
1	Aggregate UBA is $5,000 or more. [Appears for IRM 5.12.1.13 & IRM 5.12.2.8.1]	Yes	Indicator of aggregate assessed balance equal to or greater than $5,000.
2	Installment agreement is $25,000 or more. [Appears for IRM 5.12.1.13] Installment agreement does not meet streamlined, guaranteed, or in-business trust fund express criteria. [Appears for IRM 5.12.2.8.1]	Yes	Indicator of taxpayer having an installment agreement.
3	There are additional assessments of $5,000 or more. [Appears for IRM 5.12.2.8.1]	No	Included in item 1.
4	An open account with an aggregate UBA of $5,000 or more is being reported as currently not collectible. [Appears for IRM 5.12.1.13 & IRM 5.12.2.8.1]	Yes	Indicator of taxpayer having CNC modules and aggregate assessed balance equal to or greater than $5,000.
5	A case involving both assessed and unassessed periods will be reported as currently not collectable. [Appears for IRM 5.12.1.13 & IRM 5.12.2.8.1]	No	NA
6	The property is exempt by the Federal Bankruptcy Code or state insolvency proceeding. [Appears for IRM 5.12.1.13 & IRM 5.12.2.8.1]	Yes	Indicator of taxpayer having a bankruptcy filing.
7	The party on which a levy is to be served is likely to file a priority claim under IRC 6323(a) or (c). [Appears for IRM 5.12.1.13]	No	NA
8	Taxpayer resides outside U.S. and has known assets. [Appears for IRM 5.12.2.8.1]	No	NA

Source: IRM 5.12.; NA=Not Available.

We augmented the variable list for our analysis with information from the Enforcement Action section, IRM 5.19.4.5.2 (2)-(7). This area of the IRM expanded the lien filing criteria to allow Collection staff to exercise judgment when making lien filing determinations. Due to data limitations, we were unable to model some of these criteria. Figure 9 shows the criteria that were captured.

FIGURE 9, Variables Matched to IRM 5.19.4.5.2

ID	IRS IRM 5.19.4.5.2	In Model	Description of Variable in Model
1	Installment Agreement, where aggregate assessed balance is at or above $5,000 and Collection Information Statement (CIS) is required.	No	Captured in prior variables.
2	CNC, where aggregate assessed balance is at or above $5,000 and account is closed hardship (closing codes 24 through 32).	Yes	Indicator of hardship, TC530 with closing codes 24 to 32.
3	R7 cases, older accounts where aggregate assessed balance is at or above $5,000.	No	NA
4	Collection is at risk, where creditor plans to seize the taxpayer's assets or the taxpayer is about to file bankruptcy.	No	NA
5	A lien has been filed and additional liabilities with aggregate assessed balance of $2,000 or more are received.	Yes	Indicator that taxpayer is a repeater, *i.e.*, taxpayer incurred another balance due.
6	Consider lien filing in any situation where taxpayer has: ▪ Broken a promise. ▪ Been warned of possible lien filing. ▪ An aggregate assessed balance is at or above $5,000. ▪ Employee believes filing the lien immediately will be helpful in collecting the balance due.	Yes	· Indicator of default of installment agreement. · Indicator of taxpayer noncompliance with a filing requirement.

Source: IRM 5.19.4.5.2; NA=Not Available.

We also allowed for the possible influence of the size of the liability on lien filing behavior by including a variable for the total module balance due.

This page intentionally left blank.

National Taxpayer Advocate

Annual Report to Congress

2011 Annual Report to Congress

Math Errors Committed on Individual Tax Returns: A Review of Math Errors Issued for Claimed Dependents

Math Errors Committed on Individual Tax Returns: A Review of Math Errors Issued for Claimed Dependents

FIGURES

TABLES

EXECUTIVE SUMMARY

Introduction

Math error authority allows the IRS to correct some types of errors on returns and send notices to taxpayers explaining the changes. It requires taxpayers who do not agree with the correction to respond within a specified time and request an abatement of tax.[1] However, if the taxpayer fails to request abatement timely, the IRS may collect the additional tax.[2]

The IRS processed 141 million individual tax returns in 2010, many of which contained errors in computations or lacked information necessary to process the return.[3] Using its math error authority to correct these errors during processing, the IRS issued more than 11.8 million math errors, some resulting in smaller refunds than the taxpayers originally claimed.[4] The number of math errors flagged by the IRS has increased over time. In fact, from 2005–2010, the number of math errors has increased by more than 150 percent or by about seven million errors.[5] These errors tend to rise substantially in years following significant tax law changes.

Hundreds of thousands of taxpayers receive math error notices for failure to provide a correct Taxpayer Identification Number (TIN) for a dependent, but a significant number subsequently prove to the IRS that they properly claimed the exemptions and associated tax credits. Once the taxpayer has proven that he or she properly claimed the credit, the IRS is obligated by law to reverse its math error corrections and issue any resulting refunds to the taxpayers.

Findings

TAS studied a statistically valid sample of tax year 2009 accounts in which the IRS reversed its math error adjustments related to dependent TINs.[6] The research identified all individual accounts that had received any one of the three standard math error notices related to incorrect or missing dependent TINs affecting the dependency exemption and related

1 Internal Revenue Code (IRC) § 6213(b)(2)(A). The ability of a taxpayer to protest a math error assessment, even without substantiating explanation, is addressed in Internal Revenue Manual (IRM) 21.5.4.4.4 (Oct. 1, 2010) and IRM 21.5.4.4.5 (Sept. 9, 2010).

2 IRC §§ 6213(g)(2)(A) through 6213(g)(2)(E). At this point, the assessment cannot be appealed in the U.S. Tax Court.

3 IRS, Fiscal Year (FY) 2010 Data Book, 2010 Table 2, *Number of Returns filed by Type of Return, Fiscal Years 2009 & 2010*.

4 IMF Math Error Report (Dec. 24, 2010) 11,858,691 math errors for returns processed in 2010.

5 IMF Math Error Reports (Dec. 2005, Dec. 2010, and Nov. 5, 2011). This figure compares full year 2005 counts to 2010. If considering the most current year data, math errors increased by about 60 percent between 2005 and 2011 or by more than three million math errors.

6 TAS reviewed a random sample of 501 cases with the math error codes for missing or incorrect dependent TINs (Notice Codes 604, 605, and 743) and whose account included an action to reverse a previous disallowance. Ten cases were dropped from the sample because of incomplete data. After reviewing the data, we decided the information was not available to determine if the missing TIN information (Notice Code 604) could be resolved internally. After preliminary analyses, the 89 cases with this math error were dropped from the sample. This left us with a total sample size of 402, which is statistically valid at the 95 percent confidence level and a maximum margin of error of five percent.

non-refundable credits or the additional child tax credit, or the Earned Income Tax Credit (EITC).[7] Brief descriptions of the three math error notices are contained in Table 1:

TABLE 1, Description of Dependent TIN Math Error Notices

Notice Code	General Description[A]
604	We disallowed one or more exemptions due to a missing dependent TIN. This change may also affect related tax credits.
605	We disallowed one or more exemptions due to an incorrect TIN or name. This change may also affect related tax credits.
743	We disallowed EITC claimed on your return due to an incorrect or missing dependent TIN or name.

A. For a literal and complete description, see Appendix Table 14.

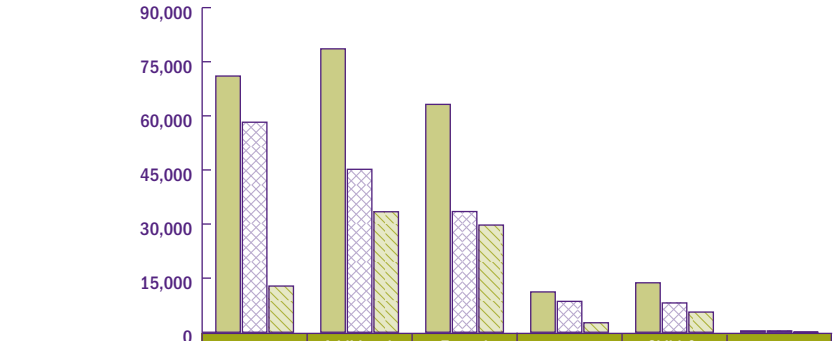
For tax year 2009, nearly 300,000 returns contained errors with dependent taxpayer identification numbers.[8] On average, one dependent TIN error was made per return, and the vast majority of these returns were filed on paper forms. More than half of these returns included a married filing joint filing status and another 28 percent used head of household status. About half of the returns were prepared by the taxpayer and the other half by paid preparers.

In the cases studied for tax year 2009, the IRS subsequently reversed at least part of its dependent TIN math errors on 55 percent of the returns with incorrect TINs. In other words, the IRS denied part of the taxpayer's claim when initially processing the return. However, when later contacted by the taxpayer, the IRS reinstated many credits originally claimed by the taxpayer. Figure 1 shows a breakdown of the type and number of credits claimed by those with incorrect dependent TIN math errors in tax year 2009 and details how many of the claims were allowed or disallowed by the IRS at the time the return was filed.

7 TAS analyzed data for returns with math error codes, or Taxpayer Notice Codes (TPNC), pertaining to missing or incorrect dependent TINs (math error codes 604, 605, or 743) for tax year 2009. Math error code 604 is issued for a missing TIN, while math error codes 605 and 743 are issued on returns where the TIN or name does not match SSA records. In some instances, math error code 743 may also be issued for a missing dependent TIN.

8 Prior to 2009, errors related to dependent TINs were the top errors, but in 2009 errors involving the Recovery Rebate became the most frequent. In 2010 and 2011, errors associated with the Making Work Pay Credit became the most common math errors.

FIGURE 1, The Number of Returns with Credits Claimed by Those with Incorrect Dependent TIN Math Errors for TY 2009 Shown by Allowed vs. Disallowed at Return Filing[9]



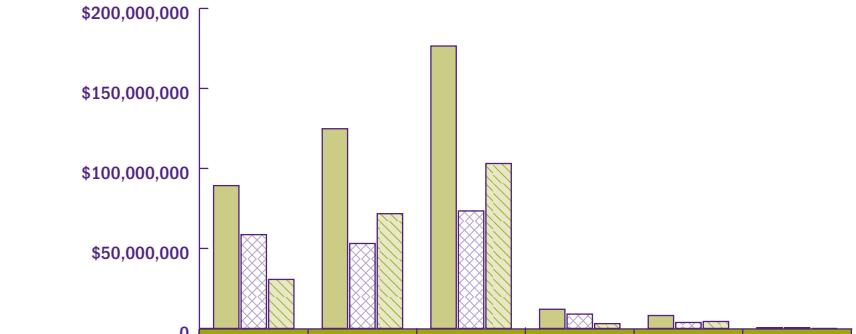
	Child Tax Credit	Additional Child Tax Credit	Earned Income Tax Credit	Education Credits	Child & Dependent Care Credit	Other Credits
Total Credits Claimed	71,035	78,579	63,177	11,179	13,708	375
Allowed	58,231	45,175	33,461	8,556	8,118	375
Disallowed	12,804	33,404	29,716	2,623	5,590	0

Source: Compliance Data Warehouse IRTF and IMF

Figure 2 shows a breakdown of the dollar amount of credits claimed by those with incorrect dependent TIN math errors for tax year 2009, shown by credit type and how many dollars claimed were initially allowed or disallowed by the IRS. The IRS disallowed over $200 million of credits claimed on returns with incorrect dependent TINs.

9 TAS analysis of TY 2009 data from Compliance Data Warehouse's (CDW) Individual Return Transaction File (IRTF) and Individual Master File (IMF) (Oct. 2011).

FIGURE 2, The Dollar Amount of Credits Claimed by Those with Incorrect Dependent TIN Math Errors for TY 2009 Shown by Allowed vs. Disallowed at Return Filing[10]



	Child Tax Credit	Additional Child Tax Credit	Earned Income Tax Credit	Education Credits	Child & Dependent Care Credit	Other Credits
Total Credits Claimed	$89,270,346	$124,814,896	$176,515,953	$11,984,291	$8,080,543	$487,149
Allowed	$58,632,896	$53,097,876	$73,427,295	$8,976,078	$3,730,777	$487,149
Disallowed	$30,637,450	$71,717,020	$103,088,658	$3,008,213	$4,349,766	$0

Source: Compliance Data Warehouse IRTF and IMF

Ultimately about 150,000 taxpayers had their refunds restored to them. On average, the IRS subsequently allowed nearly $2,000 per return after the initial disallowance, with a delay of nearly three months.[11] Table 2 below shows the details on the refund amounts allowed by the IRS after math error processing.

TABLE 2, Refunds Subsequently Allowed on Returns with Incorrect TINs for TY 2009

	TY 2009 Population	
Incorrect TIN Math Errors	**Per Return**	**Total**
$ refunded after adjustment	$1,982 (avg.) $1,560 (median)	$292,370,605
Weeks to issue refund for reversed ME	12 (avg.) 4 (median)	1,775,795
Interest paid related to reversed ME	$34 (avg.) $18 (median)	$2,336,019

The results of our sample review show that the IRS had the information necessary to resolve 56 percent of these 2009 dependent TIN math errors and could have avoided making a math error adjustment.[12] This would have significantly reduced taxpayer burden. Using readily available information to resolve TIN errors would have prevented math error

10 TAS analysis of TY 2009 data from CDW IRTF and IMF (Oct. 2011).

11 TAS analysis of TY 2009 data from CDW IRTF and IMF (Dec. 2010).

12 The IRS refers to math error notices as taxpayer notice codes. The sample results have a margin of error of plus or minus five percent at the 95 percent confidence level.

notices and delays in releasing nearly 75,000 refunds. Additionally, the IRS paid more than $2.3 million in interest for corrected math errors relating to incorrect dependent TINs for tax year 2009.

TAS's study also found that a portion of taxpayers who appear to have valid dependent TINs, never reply to the IRS math error notice, and are actually entitled to dependent related exemptions and credits which they never receive. TAS reviewed a sample of 105 cases that had a math error for missing or incorrect dependent TINs (notice codes 605 or 743) and had no refund issued. TAS found that 38 percent of these cases had either received a refund after TAS pulled its original sample or the adjustment was made but the refund was either offset or the balance due was reduced. However, 62 percent of the sample still had no adjustment.

TAS determined that the IRS could have corrected and allowed all of the dependent TINs in 41 percent of the cases that still had no adjustment, if the IRS had examined its own records. It could have corrected at least one of the dependent TINs in another 11 percent of these cases. These sample percentages translate into over 40,000 taxpayers who may not have received refunds they were entitled to.[13] Further, these 40,000 taxpayers lost at least $44 million related to disallowed dependent TINs, or an average of $1,274 per taxpayer.[14]

Recommendations

The National Taxpayer Advocate recommends that the IRS change its procedures to require that in cases of incorrect dependent TINs, employees conduct internal research to resolve these deficiencies before using math error authority to deny dependency exemptions and associated credits. The National Taxpayer Advocate further recommends that the IRS apply the methodology presented in this study to examine all math errors with significant volume and significant reversal rates to determine how it might expeditiously resolve such deficiencies rather than exercise its math error authority to deny taxpayer claims, thereby burdening taxpayers and creating IRS rework.

13 These sample results have a margin of error of plus or minus 12 percent at the 95 percent confidence level.

14 Taxpayers who were ultimately due a complete reversal for disallowed dependent TINs lost an average $1,274 or median $1,113 per taxpayer.

INTRODUCTION

Because of the extraordinarily large volume of tax returns the IRS receives each year (more than 141 million individual returns in 2010), efficient processing is vital to the IRS and taxpayers.[15] Congress first granted math error authority to the IRS in 1976 in response to the growing complexity of returns and to help the IRS streamline processing.[16] Math error authority allows the IRS to correct some types of errors on returns and send notices to taxpayers explaining the changes. It requires taxpayers who do not agree with the correction to respond within a specified time and request an abatement of tax.[17] However, if the taxpayer fails to request abatement timely, the IRS may collect the additional tax.[18]

Originally, math error authority applied only to calculation errors. Over time, Congress expanded the scope of math error authority to include other true math errors as well as some clerical errors (such as incorrectly entered dependent TINs) and other issues that are based more on "facts and circumstances." Recently, math error authority has been seen as a cost efficient method by which the IRS can stop erroneous credits from being allowed. Although internal data is frequently used by the IRS to make math error adjustments on credits and deductions for which it has the authority to do so, it does not use its own internal databases to fix errors on dependent TINs. This report demonstrates that the IRS has sufficient information to fix many dependent TIN transcription errors, saving the IRS time and money and saving taxpayers the burden of having to dispute the adjustment.

This study focuses on "math errors" that involve the requirement to provide a valid TIN for each dependent claimed on a return, and will investigate the impact on both taxpayers and the IRS. The IRS issues separate math error notices to advise the taxpayer of the disallowance of statutory credits[19] and the disallowance of the EITC.[20] These disallowances involve millions of dollars of tax credits to impacted taxpayers.[21] Nevertheless, these taxpayers are often entitled to the credits but do not receive their full refunds unless they contact the

15 IRS, FY 2010 Data Book, 2010 Table 2- *Number of Returns filed by Type of Return, Fiscal Years 2009 & 2010*. For a historical and demographic analysis of the growth and expansion of the United States taxpayer population, see *From Tax Collector to Fiscal Automation: Demographic History of Federal Income Tax Administration, 1913-2011, supra*.

16 Internal Revenue Code (IRC) § 6213(g)(2)(C) and Pub. L. No. 94-455, 90 Stat. 1520 (Oct. 4, 1976). For a detailed discussion of the history and issues pertaining to IRS math error authority, see *Expansion of Math Error Authority and Lack of Notice Clarity Create Unnecessary Burden and Jeopardizes Taxpayer Rights*, *supra*; *Mandate that IRS, in Conjunction with the National Taxpayer Advocate, Review Any Proposed Expanded Math Error Authority to Protect Taxpayer Rights*, *supra*; National Taxpayer Advocate 2003 Annual Report to Congress 113-121(Most Serious Problem: *Math Error Authority*); National Taxpayer Advocate 2002 Annual Report to Congress 185-197 (Legislative Recommendation: *Math Error Authority*).

17 IRC § 6213(b)(2)(A). The ability of a taxpayer to protest a math error assessment, even without substantiating explanation, is addressed in IRM 21.5.4.4.4 (Oct. 1, 2010) and IRM 21.5.4.4.5 (Sept. 9, 2010).

18 IRC §§ 6213(g)(2)(A) through 6213(g)(2)(E). At this point, the assessment cannot be appealed in the U.S. Tax Court.

19 As used in its internal databases, the IRS defines *statutory credits* as: foreign tax credits, credit for child and dependent care expenses, education credits, retirement savings contributions credit, child tax credit, residential energy credits, and other credits.

20 The Earned Income Tax Credit (EITC) is a refundable credit designed to provide an incentive to work and offset the burden of Social Security taxes for low income working families. IRC § 32.

21 TAS Research (Sept. 2011). TAS analysis of 2009 data from CDW IRTF and IMF (Dec. 2010). More than $37 million in statutory credits claimed and over $100 million EITC credits claimed were initially disallowed by IRS in 2009 because of dependent TIN issues (math errors 605 or 743). See Figure 6 for more information.

IRS. When the taxpayer provides corrected dependent information, the IRS releases the full refund but only after a delay of several more weeks. In addition to the burden imposed on taxpayers to contact the IRS and to wait weeks to receive their entire refunds, this subsequent reversal of math errors and processing new refunds costs the IRS additional monies.

Some significant findings from this study follow:

- In calendar year 2010, almost 300,000 taxpayers were issued over 340,000 dependent TIN math errors for tax year 2009. Another 150,000 dependent TIN math errors were issued for prior year returns not filed until 2010.
- Dependent TIN math errors continue to occur in high volumes and rank among the most frequent types of math errors.
- The IRS initially denied about $200 million in credits, which were ultimately restored to taxpayers after math error processing. Taxpayers affected by dependent TIN math errors had an average refund amount of nearly $2,000 delayed 12 weeks.
- Another 40,000 tax year 2009 taxpayers were denied at least $44 million in refunds because they either did not dispute the IRS disallowance of their dependent TIN or were unsuccessful in doing so, even though internal IRS information was available to correct the TIN.
- Dependent TIN math errors conservatively cost the IRS about $650,000 to issue the notice and over $2.3 million in back interest after the taxpayer corrects the TIN.

BACKGROUND

What Is a Math Error?

Math error authority enables the IRS to increase its tax return processing capacity by quickly resolving simple mathematical or clerical mistakes and summarily assessing the adjusted tax. If given authority under IRC § 6213(b) or (g), the IRS can make an assessment without issuing a statutory notice of deficiency (SNOD).[22] Once the IRS notifies taxpayers of a math error, they have 60 days to request abatement of the additional tax. If the taxpayer makes a timely request, but does not provide the necessary information to correct the account, the IRS will abate the assessment and follow formal deficiency procedures to reassess the tax (*i.e.*, send the taxpayer a SNOD, which provides the taxpayer the opportunity to petition the United States Tax Court).[23] However, if the taxpayer fails to request abatement timely, the tax is assessed and IRS may collect the additional tax.[24] At this point, the assessment cannot be appealed in the U.S. Tax Court.[25]

22 IRC § 6213(b)(2)(A).

23 IRC § 6213(b)(2)(A). The ability of a taxpayer to protest a math error assessment, even without substantiating explanation, is addressed in IRM 21.5.4.4.4 (Oct. 1, 2010) and IRM 21.5.4.4.5 (Sept. 9, 2010).

24 IRC §§ 6213(g)(2)(A) through 6213(g)(2)(E).

25 Tax Court is the only pre-payment judicial forum (*i.e.*, the taxpayer does not have to pay the liability to contest the assessment in Tax Court, unlike in Federal District Court or the Court of Federal Claims where the taxpayer has to pay the tax and then file for a refund claim).

How Do Math Errors Relate to TINs?

IRC § 151(e) states that for the IRS to allow a deduction for personal exemptions (including the taxpayer, spouse, and any dependents) a return must contain a taxpayer identification number.[26] IRC § 6213(g)(2) provides the IRS authority to correct math and clerical errors during processing, including calculation errors and entries that are inconsistent or exceed statutory limits. The definition of a math or clerical error includes the omission of a correct TIN.[27] The TIN may be considered incorrect or invalid generally if the number or last name is different from Social Security Administration records (or IRS records for taxpayers who use an Individual Taxpayer Identification Number (ITIN)). Thus, if a TIN for a personal exemption is not provided or is not accurate, the IRS may use math error authority to disallow the exemption, and any dependent-related credits, including the EITC, the Dependent Care Credit, or the Child Tax Credit.[28]

In applying this aspect of math error authority, the IRS directs its processing employees to perform different levels of research depending on the use of the TIN.[29] If the TIN is used for a primary taxpayer, employees are to research the return, its attachments and W-2s, and check the Integrated Data Retrieval System (IDRS) to identify the correct TIN. If they do not find a valid number, the employees send the taxpayer a "soft" notice requesting it.[30] If the number is for a secondary taxpayer (spouse), employees are to search the return, attachments, and W-2s, and perform limited IDRS research only if specific conditions are apparent, such as self-employment or an individual retirement account for the secondary taxpayer. If no valid TIN for the secondary taxpayer is found in these limited circumstances, employees also send the taxpayer a "soft" notice requesting it.[31] In both cases, the lack of a valid TIN prevents the IRS from processing the return further, and the IRS makes internal and external efforts to obtain the TIN.

However, if an incorrect TIN is used for a dependent, employees are instructed to search only the return and attachments for a correct number. If a correct TIN is not found, employees disallow the dependent exemption and associated credits. The IRS will continue processing the return and generate a math error notice advising the taxpayer a TIN error was made and how the correction of this error affected their account (*i.e.*, disallowance of the exemption and any related credits). Taxpayers may respond to these math error notices by phone, in person, or in writing with the correct TIN or name and have the dependent exemption and associated credits reinstated.

---

26 IRC § 151.

27 IRC 6213(g)(2).

28 IRC §§ 6213(g)(2)(F), (H), and (I).

29 IRM 3.12.3, *Error Resolution, Individual Tax Returns* (Jan. 1, 2011).

30 IRM 3.12.3.4.3.2(3) (Jan. 1, 2011). The soft notice is correspondence requesting the missing TIN. The IRS will suspend action for 40 days, using IDRS command code SSPDN, ERS Action Code 221. *See* IRM Exhibit 3.12.10-4 (Jan. 1, 2011).

31 IRM 3.12.3.4.3.4(3) (Jan. 1, 2011). *See also Error Resolution System (ERS) for Individual Master File Documents, Training Job Aid* 2532-701 (Rev. 10-2011).

This study focuses on math error codes related to an incorrect or missing TIN. The table below provides a brief description of each of these math error codes.

TABLE 3, Description of Dependent TIN Math Error Notices

Notice Code	General Description[A]
604	We disallowed one or more exemptions due to a missing dependent TIN. This change may also affect related tax credits.
605	We disallowed one or more exemptions due to an incorrect TIN or name. This change may also affect related tax credits.
743	We disallowed EITC claimed on your return due to an incorrect or missing dependent TIN or name.

A. For a literal and complete description, see Appendix Table 14.

METHODOLOGY

TAS analyzed data for returns with math error codes pertaining to missing or incorrect dependent TINs (Notice Codes 604, 605, and 743) for tax year 2009, typically returns filed in calendar year 2010.[32] The data were obtained from the IRS's Compliance Data Warehouse (CDW), Individual Returns Transaction File (IRTF), and Individual Master File (IMF). We limited the review to taxpayers whose current-year dependent claims were originally disallowed by the IRS, and were later reversed to allow at least part of the original claim. TAS also used a data collection instrument (DCI) to obtain specifics about the type of incorrect data reported by taxpayers and to determine if the IRS possessed internal data to resolve the error.

TAS reviewed a random sample of 501 cases with the math error codes for missing or incorrect dependent TINs (Notice Codes 604, 605, and 743) and whose account included an action to reverse a previous disallowance. Ten cases were dropped from the sample because of incomplete data. After reviewing the data, we decided the information was not available to determine if the missing TIN information (Notice Code 604) could be resolved internally. After preliminary analyses, the 89 cases with this math error were dropped from the sample.[33] This left us with a total sample size of 402, which is statistically valid at the 95 percent confidence level with a maximum margin of error of five percent.

Additionally, TAS pulled a sample of tax year 2009 cases whose dependent exemption claims were disallowed and where a full refund was not issued by August 2011 (cycle 32), essentially a control group, to see if IRS had the information available to fix the dependent TIN problem and allow the claim. This sample of 105 cases included only those that were charged math error codes 605 or 743 for missing or incorrect dependent TINs. This

32 Math error code 604 is issued for a missing TIN, while math error codes 605 and 743 are issued on returns where the TIN or name does not match SSA records. In some instances, math error code 743 may also be issued for a missing dependent TIN.

33 All cases involving math errors 605 and 743 were retained. Seven cases that contained both math error 604 and 743 are included because it was not clear whether the errors were related to a missing dependent TIN or a name mismatch.

supplemental sample is statistically valid at the 95 percent confidence level with a nine and one half percent maximum margin of error.[34]

TAS also analyzed data from the Electronic Online-Output Network System (EONS) IMF Error Code report (480-62-11). This report provides counts of math errors by error type and processing center on a calendar year basis. We analyzed data for calendar years (CY) 2005–2011 (as of November 5).

Limitations

Some data gathered on the DCI required reviewers to exercise judgment as to what type of error occurred and whether the IRS had internal data available to resolve the error. To minimize bias and different interpretations, reviewers were thoroughly briefed on the purpose of the data collection and given written guidelines on how to define the attributes. The number of individuals collecting data was kept to a minimum, and a subset of the data was reviewed for accuracy.

OBJECTIVES

The main objective of this study was to determine how many dependent TIN math errors could be corrected from internal IRS information. The study also sought out data on how many math errors involve dependent TINs and how dependent TIN math errors affect taxpayers and the IRS. Finally, the study attempts to determine how often and in what amounts the IRS reverses dependent TIN math errors. To understand how significant the problem of missing or incorrect dependent TINs may be, we have also compared them against math errors as a whole.

The research questions for this study follow:

- **How many math errors do taxpayers commit related to missing or incorrect dependent TINs?**
  - How many math errors for incorrect or missing dependent TINs does the IRS issue annually?
- **How do dependent TIN math errors compare with the entire math error population?**
  - How many and what types of math errors are committed annually?
  - How do incorrect dependent TIN issues rank when compared to other math errors?

[34] Later in the study, we look at a subset of this sample, which increases this margin of error to 12 percent for those with a late issued adjustment or refund. This margin of error is based on stratifying the sample by whether the account was adjusted in some manner or had a late issued refund as compared to accounts that did not have an adjustment.

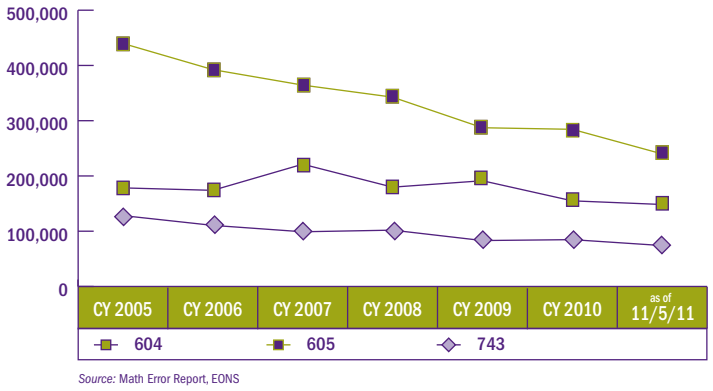
- **What are the characteristics of returns with incorrect dependent TIN math errors?**
  - What are some general traits of tax returns with incorrect dependent TINs?
  - What TIN type (SSN, ITIN, etc.) do primary taxpayers whose returns have math errors for incorrect or missing dependent TINs have?
  - How many dependent exemptions per return are initially claimed on returns with incorrect dependent TIN math errors?
  - Who prepares the returns that contain math errors for incorrect dependent TINs (self-prepared, paid preparer, etc.)?
  - What filing method was used to file returns with math errors for incorrect dependent TINs (paper vs. electronic)?
- **How much do dependent TIN math error reversals cost the IRS and taxpayers?**
  - What are the IRS costs related to reversed math errors?
  - What type of burden do taxpayers experience as a result of receiving these math error notices?
  - How many and what types of credits are claimed by taxpayers with incorrect TINs?
  - How many dollars per return are refunded to taxpayers after the IRS reverses the math error adjustments?
  - How long does the IRS take to issue refunds related to reversed math errors?
- **How many dependent TIN errors could be corrected from internal IRS information?**
  - How many math errors for incorrect or missing dependent TINs are later reversed?
  - What are the underlying reasons for math error adjustments for incorrect or missing dependent TINs? How many are due to an incorrect or missing TIN or for an incorrect or missing name?
  - How many returns are issued math errors for incorrect dependent TINs that are not reversed even though the taxpayer is actually eligible to claim the dependent?

FINDINGS

Math Errors Attributable to Dependent TINs Remain High.

For calendar year 2010, the IRS assessed about 341,000 math errors related to dependent TINs against nearly 300,000 taxpayers.[35] As demonstrated by the following figure, this volume has been relatively stable throughout the last several years, although the numbers are decreasing slightly as more taxpayers file electronic returns.[36]

FIGURE 3, Volume of Math Errors for Missing Dependent TIN (604), Incorrect Dependent TIN (605), and Incorrect Dependent TINs or Name Mismatch with EITC Claimed (743) for Calendar Years 2005–2011 (as of November 5, 2011)[37]



Source: Math Error Report, EONS

Note: From this point forward we exclude math error 604, missing dependent TIN, from our analyses (except where specifically stated) because there was insufficient information on file to determine if IRS could have resolved the issue internally.

35 Each year several thousand of these math error notices are also issued on prior tax year returns. The IRS data on the volume of math error codes issued is based on calendar year and includes current and prior year returns. The TAS study focuses on current year returns and taxpayers who received a reversal of the disallowed claim.

36 Electronic returns will generally reject if a dependent's TIN is listed incorrectly.

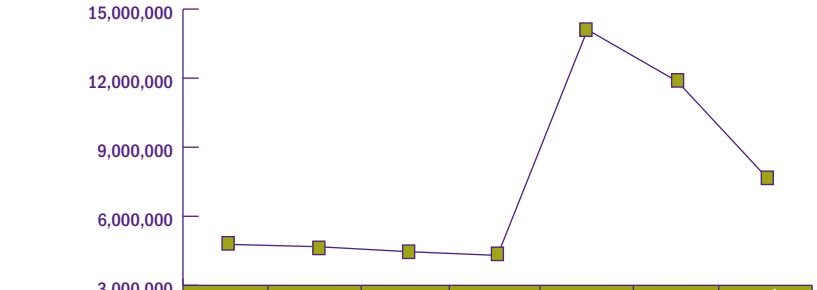
37 IRS, IMF Math Error Reports (Dec. 2005 through Dec. 2010, and Nov. 5, 2011). The totals include all individual tax return math error notices in each calendar year (could be current or prior year returns). Original figures for 2008 were overstated because a counter was not reset at the end of 2007. For this chart, 2008 figures were revised by subtracting 2007 figures from the reported 2008 figures.

Despite Overall Growth in Math Errors, Dependent TIN Math Errors Continue to Comprise a Significant Number of Math Errors.

Overall Growth in Math Errors

The overall number of math errors flagged by the IRS has increased over time. The IRS issued nearly 12 million math errors for individual tax returns processed in calendar year 2010 (primarily tax year 2009 returns). As shown in the chart below, the number of math errors has increased by more than 150 percent — or about seven million errors — from 2005–2010.[38]

FIGURE 4, Math Errors on Individual Tax Returns, Calendar Years 2005 – 2011 (as of November 5, 2011)[39]



	2005	2006	2007	2008	2009	2010	as of 11/5/11
Total Math Errors	4,780,137	4,678,443	4,463,717	4,300,022	14,102,490	11,858,691	7,661,072

Source: Math Error Report, EONS

Math errors tend to rise substantially in years following significant tax law changes. In 2008, the Recovery Rebate Credit and First-Time Homebuyer Credit first came into effect, and the IRS received expanded math error authority to administer claims.[40] Effective for TY 2009, the IRS received additional math error authority for the Making Work Pay Credit.[41] As shown in Figure 4, the most significant increases in math errors occurred after 2008. Table 12 in the Appendix (and accompanying Table 13) show that the most common

38 IMF Math Error Reports (Dec. 2005, Dec. 2010, and Nov. 5, 2011). This figure compares full year 2005 counts to 2010. If considering the most current year data, math errors increased by about 60 percent between 2005 and 2011, or by almost three million errors.

39 IRS, IMF Math Error Reports (Dec. 2005 through Dec. 2010, and Nov. 5, 2011). The totals include all individual tax return math errors in each calendar year. Original figures for 2008 were overstated because a counter was not reset at the end of 2007. For this chart, 2008 figures were revised by subtracting 2007 figures from the reported 2008 figures.

40 Economic Stimulus Act of 2008, Pub. L. No. 110-185, § 101, 122 Stat 613, 613-617 (2008); Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, § 3011, 122 Stat. 2654, 2888-2891. In 2009 the IRS received additional math error authority for the first-time homebuyer credit. Worker, Homeownership, and Business Assistance Act of 2009, Pub. L. No. 111-92, §§11, 12, 123 Stat. 2848, 2989-2992 (2009).

41 American Recovery and Reinvestment Act of 2009, PL 111-5, § 1001, 123 Stat. 115, 309-312 (2009).

math errors in 2009 - 2011 relate to the Recovery Rebate and the Making Work Pay Credit.[42] These changes — and their associated math errors — topped the list of most frequently committed math errors for the past three years.

Dependent TIN Math Errors Compared with Overall Math Errors

In the last five years, only 27 different math error codes (out of more than 400 available) have made the top 20 in terms of frequency, and 18 of those errors occurred over 100,000 times each per year. The top 20 math errors accounted for about 70 percent of all math error notice codes in the four years leading up to 2009. However, math errors spiked in 2009 –due to the Recovery Rebate and Making Work Pay Credit–to about three times as many as in each of the years from 2005–2007, with the top 20 accounting for about 90 percent of the total of all math errors.

The "clerical" incorrect dependent TIN math errors are the only ones in the top 20 that are not "calculation" math errors.[43] These errors disallow dependent(s) claimed on the return and any credits related to that dependent (*e.g.*, child tax credit, dependent care credit).

While the number of dependent TIN math errors has remained relatively consistent over the past few years, the increase of new types of math errors may have downplayed the ongoing significance of dependent TIN errors. Prior to 2009, errors related to dependent TINs were the top rated math errors, but their ranking dropped beginning in 2009. However math errors attributed to incorrect or missing dependent TINs have remained in the top 21 most frequent math errors since calendar year 2005, as shown in the following table.[44]

TABLE 4, Ranking Among Most Frequently Issued Math Errors by Year, by Math Error[45]

Notice Code	2005	2006	2007	2008	2009	2010	2011
Incorrect TIN 605	1	1	1	1	4	9	8
EITC with Incorrect or Missing TIN 743	9	12	13	14	17	20	21

Source: Math Error Report, EONS

42 The First-Time Home Buyers Credit, a credit available beginning in 2008 and ending September 30, 2010, was responsible for a sizable number of math errors (Notice Code 346); however, they are not captured in the IRS Math Error Report. IRC § 36. The Recovery Rebate Credit was a one-time benefit for taxpayers who did not receive a full economic stimulus payment the previous year and whose circumstances changed, making them eligible for some or all of the unpaid portion. IRC § 6428. The Making Work Pay Credit was a refundable credit of up to $400 for working individuals and up to $800 for married taxpayers filing joint returns, created by the American Recovery and Reinvestment Act of 2009. American Recovery and Reinvestment Act of 2009, PL 111-5, § 1001, 123 Stat. 115, 309-312 (2009); IRC § 36A.

43 These dependent TIN math errors include incorrect Social Security numbers, ITINs, or adoption taxpayer identification numbers (ATIN).

44 For a complete breakdown of the top 20 most frequently committed math errors for 2007 through 2011 and an explanation of the reason for the math error, see Tables 12 and 13 in the Appendix.

45 IRS, IMF Math Error Reports (Dec. 2005 through Dec. 2010, and Nov. 5, 2011). The totals include all individual tax return math error notices in each calendar year. Math Error 604, related to missing TINs, ranked anywhere from the fifth to the fifteenth most frequently committed math error for calendar years 2005 - 2011 (through Nov. 5, 2011).

While dependent TIN math errors may not currently be the top math errors, they continue to comprise a significant number of overall math errors. As seen in Table 5, dependent TIN math errors accounted for about six percent of math errors in 2011, nearing half a million math errors.[46] This percent is much lower than in previous years where it consistently comprised about 15 percent of math errors. The drop is primarily due to the dramatic increase in errors for new tax provisions such as those for the Recovery Rebate Credit and Making Work Pay Credit.[47] Thus, with the sunsetting of these credits, dependent TIN math errors will probably constitute a much greater percentage of math errors in future years.

TABLE 5, Overall Math Errors, by Year[48]

Year	Dependent TIN Errors					
	Missing TIN Math Error Notice Code 604	Incorrect TIN Math Error Notice Code 605	EITC Incorrect or Missing TIN Math Error Notice Code 743	Total # of Dependent TIN Math Errors	Total # of Overall Math Errors	Dependent TIN Math Errors as a % of Overall Math Errors
2005[49]	178,403	439,814	128,232	746,449	4,780,137	15.6%
2006[50]	173,967	392,447	110,552	676,966	4,678,443	14.5%
2007[51]	221,256	364,431	98,977	684,664	4,463,717	15.3%
2008[52]	176,719	342,617	101,913	621,249	4,300,022	14.4%
2009[53]	191,325	287,270	83,108	561,703	14,102,490	4.0%
2010[54]	154,958	284,397	84,724	524,079	11,858,691	4.4%
2011[55]	148,346	239,851	74,021	462,218	7,661,072	6.0%

Source: Math Error Report, EONS

Characteristics of Returns with Incorrect Dependent TIN Math Errors

It is helpful to understand some basic traits of returns with dependent TIN math errors. Table 6 compares returns with dependent TIN errors with those of all individual tax returns. Of the returns looked at for tax year 2009 with dependent TIN math errors, on average, one dependent TIN error was made per return. Returns with dependent TIN errors claim more than three times the number of dependents, on average, than individual tax returns overall.

46 This count includes all math errors committed on returns processed in 2011, both current and prior year.

47 A large number of math errors committed were related to the First-Time Home Buyers Credit (FTHBC), but those were not part of the report.

48 For purposes of calculating the number of dependent TIN math errors as a percentage of overall math errors, this table includes math error notice code 604.

49 IMF Math Error Report (Dec. 26, 2005).

50 IMF Math Error Report (Dec. 24, 2006).

51 IMF Math Error Report (Dec. 30, 2007).

52 IMF Math Error Report (Dec. 28, 2008).

53 IMF Math Error Report (Dec. 27, 2009).

54 IMF Math Error Report (Dec. 24, 2010).

55 IMF Math Error Report (Nov. 5, 2011).

TABLE 6, Characteristics of Returns with Incorrect or Missing Dependent TINs compared with All Individual Returns

	Math Error 605 or 743 Returns		All Individual Tax Returns
	Count or Percentage	Total Amount	Count or Percentage
Dependent Exemptions Claimed[56]	2.2 (avg) 2.0 (median)	324,503	0.7 (avg) 0.0 (median)
Preparer type for returns with incorrect TIN	50.5% (pd preparer) 49.3% (self prepare) 0.2% (IRS prepared)	74,246 (pd preparer) 72,902 (self prepare) 343 (IRS prepared)	59.4% (pd preparer) 40.5% (self prepare) 0.1% (IRS prepared)
Filing Method	4.5% (electronic) 95.5% (paper)	6,681 (electronic) 140,810 (paper)	78.9% (electronic) 28.1% (paper)
Filing Status	18.9% (single) 51.7% (MFJ) 1.3% (MFS) 28.1% (HOH) 0.0% (widow)	27,941 (single) 76,281 (MFJ) 1,874 (MFS) 41,396 (HOH) 0 (widow)	44.7% (single) 38.2% (MFJ) 2.0% (MFS) 15.0% (HOH) 0.1% (widow)

Source: Compliance Data Warehouse IRTF and IMF

Taxpayers' Filing Status and Their Method of Filing Returns

More than half of the returns with dependent TIN errors had a married filing joint filing status and another 28 percent used a head of household status. These numbers are significantly higher than the breakdown of filing status for all individual tax returns.

Half of the returns with dependent TIN errors were prepared by the taxpayer and the other half by paid preparers. These returns are only slightly more likely to be self-prepared than individual tax returns overall. Thus, TIN errors cannot be attributable only to taxpayers preparing their own returns.

The overwhelming majority of returns with dependent TIN errors — over 95 percent — were filed on paper forms. This contrasts with individual returns overall where almost 80 percent are filed electronically. This fact is not surprising as a tax return's TINs, including dependent TINs, are electronically reviewed by the IRS prior to the return being accepted. Returns with incorrect TINs are generally rejected until the TIN is corrected. Thus, electronic filing usually prevents dependent TIN errors.

ITIN Filers Are More Likely to Be Assigned a Missing TIN Math Error than SSN Filers.

ITIN filers, who are but a small part of the filing population, receive a large number of math error notices for missing or incorrect dependent TINs. As we noted from the sample, a large component — over 26 percent — of those with missing dependent TIN (code 604) errors reflect primary taxpayers filing with Individual Taxpayer Identification Numbers. ITINs are not nearly as prevalent in cases associated with an incorrect SSN, where less

56 *Dependent Exemptions Claimed* excludes the primary and secondary taxpayer exemptions. Exemptions for disability or age are included.

than 15 percent of the returns included a primary taxpayer ITIN. Although a primary taxpayer filing under an ITIN does not preclude having dependents with Social Security numbers, many alien dependents will not qualify for an SSN and will need to apply for the ITIN.[57] When an alien taxpayer has a tax return filing requirement, but he, his spouse, or his dependent is ineligible to obtain an SSN, the taxpayer must file a tax return, absent a TIN, attached to the W-7, *Application for Individual Taxpayer Identification Number (ITIN)*.[58] The processing of the tax return itself cannot commence until the processing of the ITIN application is concluded, at which time the IRS assigns the ITIN or rejects the application.[59]

Missing dependent TIN math errors are more common to ITIN filers than SSN filers. This is primarily because once the IRS rejects a dependent W-7 application (Form W-7, *Application for IRS Individual Taxpayer Identification Number*), it may send the return forward for processing without any TIN, and the processing unit will assign a missing dependent TIN math error code.[60] Although refund claim returns submitted with ITIN applications should be returned to taxpayers whose applications are rejected, balance due returns are not returned and are processed.[61] Once the IRS processes the return with the rejected ITIN application, it disallows the dependency exemption and associated credits with an assignment of math error 604 for a missing TIN.[62]

The EITC and Child Tax Credit Were More Likely to Be Claimed by Taxpayers with Incorrect TINs.

During initial processing, the IRS allowed some of the credits claimed on nearly 75 percent of the returns with incorrect dependent TINs. However the IRS only allowed 56 percent of the credit amount (dollars) claimed on these returns.[63] Often, some credits are allowed because only one of the dependents claimed on the return has an incorrect TIN. The IRS will still allow credits for any dependent with a correct TIN on the return. The EITC shows the highest disallowance rate of the credits reviewed, with the IRS disallowing almost half of the credits claimed and nearly 60 percent of the amount claimed. The IRS allowed almost 90 percent of statutory credits claimed, but less than 75 percent of the dollars claimed during return processing. The IRS also disallowed about 40 percent of the additional child tax credits and over half of the amounts claimed. See figures five and six for a detailed analysis of the allowance and disallowance of claimed credits by type and their dollar amounts.

57 IRC § 6109; Treas. Reg. § 301.6109-1(d)(3).

58 *See* National Taxpayer Advocate 2010 Annual Report to Congress 319.

59 *Id*.

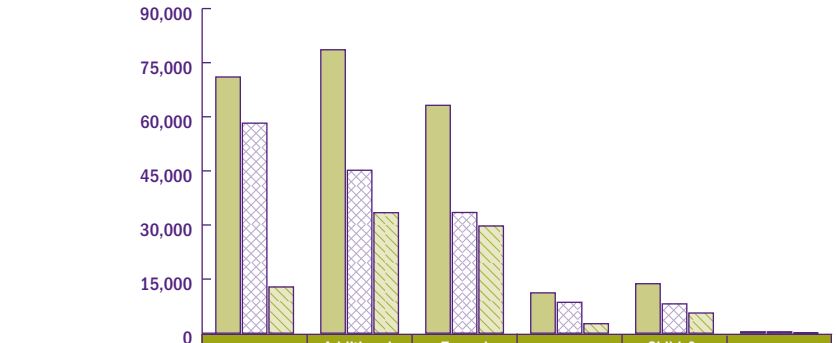
60 TAS Research (Sept. 2011). TAS analysis of 2009 data from CDW IRTF and IMF (Dec. 2010). For tax year 2009 Notice Code 604 (missing TIN), 47 percent or 36,000 of the notice assessments were resolved fully or partially.

61 IRM 3.21.263.6.1.32.4 (Jan. 1, 2011); IRM 3.21.263.7.2.4 (Jan. 1, 2011).

62 IRM 3.14.1.6.12.4.2 (Jan. 1, 2011). Math error inquiries for missing dependent TINs are worked under normal math error procedures. IRM 3.21.263.7.6 (Jan. 1, 2011). The taxpayer is given the explanation that "[f]or one or more of your dependents the SSN or ITIN was missing." This explanation is not adequate for the taxpayers whose ITIN applications for their dependents were rejected, because they had and continue to have no TIN to enter on the return.

63 Statutory credits are defined as: foreign tax credits, credit for child and dependent care expenses, education credits, retirement savings contributions credits, child tax credits, residential energy credits, and other credits. Some of the disallowances of credits may be due to other errors on the return.

FIGURE 5, The Number of Returns with Credits Claimed by Those with Incorrect Dependent TIN Math Errors for TY 2009 Shown by Allowed vs. Disallowed at Return Filing[64]

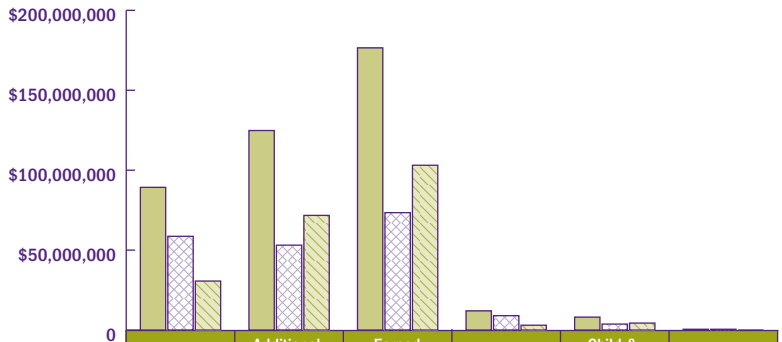


	Child Tax Credit	Additional Child Tax Credit	Earned Income Tax Credit	Education Credits	Child & Dependent Care Credit	Other Credits
Total Credits Claimed	71,035	78,579	63,177	11,179	13,708	375
Allowed	58,231	45,175	33,461	8,556	8,118	375
Disallowed	12,804	33,404	29,716	2,623	5,590	0

Source: Compliance Data Warehouse IRTF and IMF

Figure 6 shows a breakdown of the dollar amount of credits claimed by those with incorrect dependent TIN math errors for tax year 2009, shown by credit type and how many dollars claimed were initially allowed or disallowed by the IRS. The IRS disallowed over $200 million of credits claimed on returns with incorrect dependent TINs.

FIGURE 6, The Dollar Amount of Credits Claimed by Those with Incorrect Dependent TIN Math Errors for TY 2009 Shown by Allowed vs. Disallowed at Return Filing[65]



	Child Tax Credit	Additional Child Tax Credit	Earned Income Tax Credit	Education Credits	Child & Dependent Care Credit	Other Credits
Total Credits Claimed	$89,270,346	$124,814,896	$176,515,953	$11,984,291	$8,080,543	$487,149
Allowed	$58,632,896	$53,097,876	$73,427,295	$8,976,078	$3,730,777	$487,149
Disallowed	$30,637,450	$71,717,020	$103,088,658	$3,008,213	$4,349,766	$0

Source: Compliance Data Warehouse IRTF and IMF

64 TAS analysis of TY 2009 data from CDW IRTF and IMF (Oct. 2011).

65 *Id.*

Costs and Burden of Reversing Math Errors

In TAS's review of 341,000 math errors issued for TY 2009 disallowing dependency exemptions and tax credits tied to dependents, we found that over half (about 184,000) of these math errors had a reversal of at least part of the amount disallowed.[66] Given the number of dependent TIN math errors and the high rate of reversal, our study also considered the costs and burden associated with reversing these math errors, for both the IRS and taxpayers. We were unable to calculate a total cost, since cost information for all aspects of charging and reversing dependent TIN math errors was not available. However, we were able to calculate a conservative estimate based on figures published on the IRS's internal website in February 2006, and unchanged as late as January 2008. The estimate includes costs for review of the math error notices, files, and downstream toll-free customer service, but not the expenses for supplies, postage and printing.

Reversed Math Errors Are a Significant Burden and Cost to the IRS

TAS Research was able to quantify some of the costs associated with sending out dependent TIN math error notices. The following items cost the IRS about three million dollars on tax year 2009 returns filed during 2010:

- Math error notice preparation, excluding printing, and mailing;
- Preparation and issuance of a second refund and correction notice; and
- Interest paid on delayed refund.

Costs vary depending on the type of notice sent to the taxpayer, as seen in the table below:

TABLE 7, Math Error Notice Costs Per Thousand (February 2006)

Costs per 1,000 Math Error Notices, February 2006		
Notice	**Description**	**Cost per 1,000**
CP11	Math Error, Balance due of $5 or more	$3,186.84
CP12	Math Error, Overpayment of $1 or more	$1,827.98
CP21B	Math Error, Data Processing Adjustment, Overpayment of $1 or more	$ 539.38

Our estimate of about three million dollars is based on the costs cited above. We calculate that the IRS spent at least $500,000 sending initial letters related to math error notices for incorrect dependent TIN errors on the return for 2009 tax returns. A second notice for the reversal would cost at least $142,000 more. Additionally, the IRS paid more than $2.3 million in interest for corrected math errors relating to incorrect dependent TINs for tax year

[66] TAS Research (Sept. 2011). TAS analysis of TY 2009 data from CDW IRTF and IMF (Dec. 2010). For Notice Code 605 (incorrect TIN), 55 percent, or 114,000 were resolved fully or partially; and for Notice Code 743 (incorrect TIN for EITC), 61 percent, or 35,000 were resolved fully or partially. Although the IRS later reversed 47 percent of math errors with missing TIN data (Notice Code 604), the IRS does not have the information needed to fill in missing TINs. Consequently, the analysis was narrowed to include only returns with math error 605 or 743.

2009.[67] These estimates are very conservative, using cost figures that are at least five years old and excluding the expenses of supplies, postage, and printing.[68]

We were unable to quantify numerous additional processing costs the IRS incurs for sending out incorrect math error notices, which may later have to be reversed. They include:

- Error Resolution System (ERS)[69] action disallowing dependent exemption and related credits;
- Preparation and issuance of Form 1099-INT if more than $10 interest is paid on second refund.

These IRS processing actions involve considerable time and expense. The original return is "corrected" by return processing employees to disallow the dependent(s) and associated credits. This disallowance is followed, in most cases, by a refund for a reduced amount and a math error notice systemically issued describing the error of an incorrect dependent TIN. Customer service employees must handle a minimum of one taxpayer inquiry to verify the dependent TIN provided by the taxpayer, adjust the account again to reverse the math error "corrections," and arrange for a second refund or corrected balance due notice to be issued. Additionally, if the IRS does not issue the second refund within required processing timeframes, it must pay interest. If the interest amount is $10 or more, the IRS must also issue Form 1099-INT, *Interest Income*, for the year in which it was paid.

Reversed Math Errors are a Significant Burden and Cost to Taxpayers.

Sending out incorrect math error notices, which are later reversed, increases burden and costs for taxpayers, such as:

- Delayed processing (approximately two weeks, depending on the complexity of the errors);
- Decreased refund/increased balance due;
- Math error notice receipt/response (calls/walk-in to identify pertinent dependent, provide correct TIN);
- Delayed payment of full refund; and
- Reporting requirement for tax year in which interest (on delayed refunds) was received.

67 IRC § 6611(a) provides that interest must be paid by the government on overpayments at a rate set out in IRC § 6621.

68 TAS analysis of TY 2009 data from CDW IRTF and IMF (Nov. 2011). Notice Gatekeeper, Estimates include notice review, files, and downstream toll-free costs. Our estimates are based on an assumption that the CP 12 letter for overpayment was sent for all 264,175 different math errors because this was the most conservative approach. It is likely that a sizable portion of these letters were actually the CP11 instead. Assuming the CP21B letter was sent as a second notice to taxpayers, those could account for another $142,000 in expenses. When considering the expenses for missing dependent TIN (math error 604), the IRS likely spent a minimum of another $140,000 on first letters and $40,000 on second letters.

69 IRM 3.12.37.8.1 (Jan. 1, 2011). The Error Resolution System is a real-time computer system that corrects errors that are discovered during the Generalized Mainline Framework processing.

Dependent TIN math errors delay refunds and create burden for taxpayers by requiring them to contact the IRS to resolve the matter. Taxpayers may use various methods to provide information that will reinstate the dependent exemption and associated credits — phone, walk-in, correspondence, or referral of the matter to their practitioner. If a taxpayer has claimed more than one dependent, and has not identified the erroneous TIN through his or her own research, the taxpayer must first contact IRS to determine which TIN is inaccurate. It is not uncommon for these taxpayers to have to contact the IRS a second time after securing the correct TIN data for the appropriate dependent. If the account is adjusted for an additional refund that includes interest, these taxpayers have a new reporting requirement for the tax year in which the interest was received. Inevitably, some of these taxpayers have to contact the IRS again to find out why they received Form 1099-INT.

As mentioned, the dependent TIN math error explanations are so broadly written that it is difficult to identify which dependent TIN has an error. For example, the wording of Notice Code 605 for incorrect dependent TIN presumes the dependent TIN supplied by the taxpayer is correct, and the name of the dependent is incorrect. The analysis of our sample shows the error most common to Notice Code 605 accounts is a digit transcription mistake in the dependent TIN, not an error in the dependent's name.[70]

In addition to the time it takes taxpayers to resolve their math error, there are significant dollars at stake for taxpayers. The taxpayers' accounts we studied (Notice Codes 605 or 743) indicated claim amounts of over $400 million in statutory, additional child tax, and earned income tax credits. The IRS held over half of these funds pending math error resolution. Table 8 below shows the average and median credits originally claimed per return for the different types of credits. Those claiming the EITC and Additional Child Tax Credit (ACTC) were least likely to have their claims allowed both in numbers and amount claimed.

[70] For a detailed discussion on the lack of specificity in math errors and how that impacts taxpayers' ability to respond, see *Expansion of Math Error Authority and Lack of Notice Clarity Create Unnecessary Burden and Jeopardize Taxpayer Rights*, *supra*.

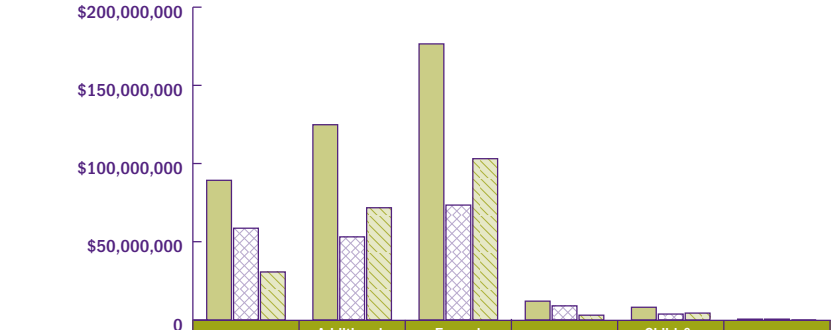
TABLE 8, Dollar Amounts of Credits Claimed on Returns with Incorrect Dependent TINs for TY 2009

	Total Returns with Credits Claimed	Total Dollars Claimed	Dollars Claimed Per Return
Child Tax Credit (CTC)	71,035	$89,270,346	$1,257 (avg.) $1,000 (median)
Additional Child Tax Credit (ACTC)	78,579	$124,814,896	$1,588 (avg.) $1,425 (median)
Earned Income Tax Credit (EITC)	63,177	$176,515,953	$2,794 (avg.) $2,946 (median)
Education Credit	11,179	$11,984,291	$1,072 (avg.) $1,015 (median)
Child & Dependent Care Credit	13,708	$8,080,543	$ 590 (avg.) $ 600 (median)
Other Credits	375	$487,149	$1,300 (avg.) $1,300 (median)

Source: Compliance Data Warehouse IRTF and IMF

Overall, the IRS allowed only $200 million of $400 million claimed on these original returns. Figure 7 below graphically displays the amount of credit claimed by taxpayers with incorrect TINs and the amounts originally allowed by the IRS. This data is displayed separately for the most common credits. The EITC and the additional child tax credit had the largest disallowances on both a percentage and amount basis. Over half of the amount of these credits was disallowed at about $103 million and $72 million, respectively. The child and dependent care credit also had over half of the amount claimed disallowed, but the amount was only about four million dollars.

FIGURE 7, The Dollar Amount of Credits Claimed by Those with Incorrect Dependent TIN Math Errors for TY 2009 Shown by Allowed vs. Disallowed at Return Filing[71]



	Child Tax Credit	Additional Child Tax Credit	Earned Income Tax Credit	Education Credits	Child & Dependent Care Credit	Other Credits
Total Credits Claimed	$89,270,346	$124,814,896	$176,515,953	$11,984,291	$8,080,543	$487,149
Allowed	$58,632,896	$53,097,876	$73,427,295	$8,976,078	$3,730,777	$487,149
Disallowed	$30,637,450	$71,717,020	$103,088,658	$3,008,213	$4,349,766	$0

Source: Compliance Data Warehouse IRTF and IMF

71 TAS analysis of TY 2009 data from CDW IRTF and IMF (Oct. 2011).

Ultimately about 150,000 taxpayers had their refunds restored to them. On average, the IRS subsequently allowed nearly $2,000 per return after the initial disallowance, with a delay of nearly three months.[72] See Table 9 below for details on the refund amounts allowed by the IRS after math error processing.

TABLE 9, Refunds Subsequently Allowed on Returns with Incorrect TINs for TY 2009

	TY 2009 Population	
Incorrect TIN Math Errors	**Per Return**	**Total**
$ refunded after adjustment	$1,982 (avg.) $1,560 (median)	$292,370,605
Weeks to issue refund for reversed ME	12 (avg.) 4 (median)	1,775,795
Interest paid related to reversed ME	$34 (avg.) $18 (median)	$2,336,019

Source: Compliance Data Warehouse IRTF and IMF

Research of Internal Records May Resolve Many Incorrect Dependent TINs.

Given the considerable cost and burden in charging and resolving dependent TIN math error notices, it would be in the best interest of the IRS and taxpayers to minimize them. IRS could readily adopt procedures for internal research of dependent TINs similar to those used for perfecting primary and secondary TINs.[73] For example, the IRS could use IDRS and its related systems to research prior year returns and taxpayer contact records for previous accurate reporting of a dependent TIN by the taxpayer.[74] By conducting such research upfront during return processing, IRS could eliminate a significant number of dependent TIN math error notices and their downstream impact on both the IRS and taxpayers. The following table shows the results of a TAS analysis of a sample of accounts in which the IRS abated its math error assessment. As shown below, the IRS had sufficient information to resolve over half of these TIN math errors instead of sending a math error notice.

72 TAS analysis of TY 2009 data from CDW IRTF and IMF (Dec. 2010).

73 IRM 3.12.3.4 (Rev. Jan. 1, 2011) allows research of the return and its attachments, and use of IDRS to locate an accurate TIN for the primary or secondary taxpayer.

74 IDRS Command Codes RTVUE and TRDBV record prior year return data, including the names and TINs used for dependents. Account Management Services (AMS) is a web-based resource which Customer Service employees use to record actions taken as a result of taxpayer inquiries, including the dependent TINs validated to resolve math error notices.

TABLE 10, TY 2009 Data Shows Opportunity for IRS to Resolve Incorrect Dependent TINs and Avoid Math Error Adjustments[75]

Sample Results Using Internal IRS Data	Incorrect Dependent TINs with credits other than EITC (605)	Incorrect Dependent TINs with EITC (743)	Total Incorrect Dependent TINs
Resolved All TINs Completely	51%	50%	50%
Resolved Some TINs	6%	5%	6%
Total Completely and Partially Resolved	57%	55%	56%

Source: Compliance Data Warehouse IRTF and IMF

Taxpayers with Valid Dependent TINs May Not Be Receiving Tax Credits to Which They Are Entitled

Still other taxpayers appear to have valid dependent TINs, but never reply to the IRS math error notice that has identified the TIN as incorrect. TAS Research sampled 105 cases that had a math error code 605 or 743 and had no refund issued. TAS found that 38 percent of these cases had either received a refund after TAS pulled its original sample or the adjustment was made but the refund was either offset or the balance due was reduced. However, 62 percent of the sample still had no adjustment.

TAS determined that the IRS could have corrected and allowed all of the dependent TINs in 41 percent of the cases that still had no adjustment, if the IRS had examined its own records. It could have corrected at least one of the dependent TINs in another 11 percent of these cases. These sample percentages translate into over 40,000 taxpayers who may not have received refunds they were entitled to.[76] Further, these 40,000 taxpayers lost at least $44 million related to disallowed dependent TINs, or an average of $1,274 per taxpayer.[77] These results indicate that many taxpayers are actually entitled to dependent related exemptions and credits that they never receive.

Taxpayers Who Keep the Same Filing Status from One Year to the Next Would be Good Candidates for Using Internal Research to Resolve Math Errors

Taxpayers whose filing status remained the same from one year to the next would be good candidates for the IRS to use internal research to resolve the math error since it is unlikely that entitlement to the dependency exemption would be in dispute in the subsequent year. The table below shows that the majority, 55–91 percent, of taxpayers who receive an incorrect dependent TIN math error notice keep the same filing status from year to year. For tax year 2009, taxpayers issued incorrect dependent TIN math errors were usually the primary taxpayers in 2008, and most of these taxpayers reported the same filing status.

75 TAS analysis of TY 2009 data from CDW IRTF and IMF (Oct. 2011). A sample of about 400 accounts in which the IRS abated its math error assessment showed that the IRS had internal data to resolve 56 percent of code 605 and 743 accounts. The column titled *Incorrect Dependent TINS, with credits other than EITC* reflects math error code 605 accounts; the column titled *Incorrect Dependent TINS with EITC* reflects math error code 743 accounts.

76 These sample results have a margin of error of plus or minus 12 percent at the 95 percent confidence level.

77 Taxpayers who were ultimately due a complete reversal for disallowed dependent TINs lost an average $1,274 or median $1,113 per taxpayer.

TABLE 11, TY 2008 & 2009 Filing Status for Taxpayers Receiving TY 2009 Math Errors Related to Incorrect or Missing Dependent TINs[78]

		Filing Status in TY 2009				
		Single	MFJ	MFS	HoH	Total
Filing Status in TY 2008	Single	**55.4%**	1.6%	0.0%	12.2%	32,983
	MFJ	3.3%	**91.3%**	20.0%	4.8%	122,745
	MFS	1.7%	1.5%	**60.0%**	0.8%	5,217
	HoH	39.6%	5.6%	20.0%	**82.2%**	78,386
	Total	41,368	128,770	3,416	65,777	239,331

Source: Compliance Data Warehouse IRTF and IMF

Taxpayers Were Sent Math Error Notices Because a TIN Was a Few Numbers Off

When looking at the sample of about 400 cases where incorrect TINs had been corrected and allowed by IRS, TAS's analysis suggests that at least 25 percent of the cases reviewed had a problem with the dependent TIN being a few digits off or having numbers transposed. Another ten percent of cases appeared to have surname discrepancy issues, some of which are repeated each year when surnames change due to divorce and remarriage. The IRS has the potential to resolve many of these issues using existing internal data.

CONCLUSION

Dependent TIN math errors continue to be a problem for the IRS and taxpayers and are costly and burdensome to resolve. The data analyzed in this study suggests that an opportunity exists for the IRS to correct many dependent TIN math errors without issuing a math error notice. This would prevent taxpayers who don't reply to math error notices, but are entitled to the credits, from losing the refund generated by such credits. In addition to preventing loss of refunds, such preemptive steps may reduce burden and costs for the taxpayer and IRS alike.

RECOMMENDATIONS

The National Taxpayer Advocate offers these recommendations:

1. The IRS should use internal data to correct dependent TIN errors whenever possible *(i.e.,* data from prior year returns and contacts with IRS similar to that done for primary and secondary TINs).
2. The IRS should study other high-volume math errors to try to determine why the errors are being made and change tax form instructions or processing to mitigate these errors.

78 Compliance Data Warehouse, IRTF (Oct. 2011). MFJ = married filing joint, MFS = married filing separate, HoH = head of household.

APPENDIX

TABLE 12, The 20 Most Frequently Committed Math Errors, 2007–2011 (through November 5, 2011)

	2007		2008		2009		2010		2011	
	Math Error Notice Code	Total as of 12/23/07	Math Error Notice Code	Total as of 12/28/08	Math Error Notice Code	Total as of 12/27/09	Math Error Notice Code	Total as of 12/24/10	Math Error Notice Code	Total as of 11/5/11
1	605	364,431	605	342,617	624	6,233,453	661	4,778,917	661	2,672,203
2	209	280,694	209	298,095	621	3,688,716	667	770,394	667	382,070
3	211	262,630	211	262,228	209	299,244	665	445,460	665	267,431
4	299	246,730	131	240,933	605	287,270	100	402,338	131	261,685
5	604	221,256	299	223,241	211	230,938	624	373,404	209	258,795
6	131	220,137	285	220,042	131	230,605	209	332,253	605	239,851
7	200	218,371	604	176,719	285	212,134	664	298,566	211	184,258
8	285	217,164	192	120,817	299	196,248	621	285,824	285	183,489
9	252	117,232	208	113,465	604	191,325	605	284,397	268	174,796
10	192	114,243	252	109,741	192	178,647	211	257,428	299	154,863
11	251	111,967	293	108,595	200	149,920	131	253,349	604	148,346
12	101	109,823	251	106,866	252	109,003	285	198,702	624	138,552
13	743	98,977	743	101,913	208	101,206	299	194,184	192	116,773
14	208	97,857	200	96,125	101	94,761	192	161,456	621	106,063
15	141	83,255	101	95,731	251	89,377	604	154,958	101	88,398
16	293	80,579	141	89,108	141	88,628	200	121,153	141	87,160
17	268	76,740	268	78,551	743	83,108	141	121,055	100	86,881
18	100	76,034	100	75,155	194	69,977	208	104,850	194	83,035
19	297	73,664	653	68,628	268	69,612	101	85,444	208	82,326
20	653	67,383	194	64,541	293	66,120	743	84,724	252	76,539

TABLE 13, Brief Description of the Most Frequently Committed Math Errors (Shown in Table 12), 2007–2011 (through November 5, 2011)

TPNC	General Description
100	Free-style explanation of miscellaneous errors
101	We [IRS] changed the filing status and recomputed the tax accordingly.
131	We changed the amount of taxable social security benefits.
141	We changed the amount of total income on your return.
192	We changed the standard deduction because you are age 65 or blind.
194	We changed the amount claimed as the standard deduction.
200	We changed the total exemption amount on your return.
208	We changed the taxable income because of a subtraction error.
209	We changed the amount of tax on your return because it was incorrect.
211	We changed the amount of tax on your return using the Schedule D rate.
251	We disallowed a child tax credit because the child exceeded the age limit.
252	We changed the amount claimed as child tax credit.
268	We changed the amount of self-employment tax due to an error.
285	We changed the amount claimed as Earned Income Credit (EIC).
293	We disallowed the EIC claimed since you were not age 25 to 64.
297	We changed the amount claimed as total payments due to an error.
299	We changed the refund or the amount you owed because of an error.
604	We disallowed one or more exemptions due to a missing dependent TIN. This change may also affect related tax credits.
605	We disallowed one or more exemptions due to an incorrect TIN or name. This change may also affect related tax credits.
621	We changed the amount of the recovery rebate credit you claimed.
624	We computed your recovery rebate credit for you.
653	We disallowed the EIC because you did not submit Form 8862.
661	We computed the Making Work Pay Credit for you.
664	We changed the amount you claimed as Making Work Pay Credit.
665	We changed the amount you claimed as Making Work Pay Credit.
667	We changed the amount you claimed as Making Work Pay Credit.
743	We disallowed EITC claimed on your return due to an incorrect or missing dependent TIN or name.

TABLE 14, Math Error Code Fill-Ins

The table below contains math error explanations that may print on a notice based on the Taxpayer Notice Code (TPNC) assigned to the account.

When a math error can be tied to a line on the return, a literal specific to that line and tax form prints. When the word 'Default' appears in the Tax Form column below, it indicates language used either for prior year returns or for current year returns when the error is not line-specific. 'NA' appearing in the 'Content' column indicates that the math error explanation is not applicable to that tax form.

Code	Tax Form	Literal Content
604	Default	Each dependent listed on your tax return must have a valid Social Security Number (SSN) or Individual Taxpayer Identification Number (ITIN). For one or more of your dependents the SSN or ITIN was missing. As a result, we didn't allow one or more of your exemptions. This change may affect your taxable income, tax, or any of the following credits: ▪ Credit for Child & Dependent Care Expenses ▪ Education Credits ▪ Child Tax Credit ▪ Additional Child Tax Credit If you, your spouse, or any of your dependents do not qualify for an SSN, you may obtain an Individual Taxpayer Identification Number (ITIN) issued by the Internal Revenue Service by filing Form W-7, Application for IRS Individual Taxpayer Identification Number. This number will allow you to file your return and to claim an exemption but you will be ineligible to claim the Earned Income Credit. You may call 1-800-829-3676 to get Form W-7 or download it from our website at www.irs.gov.
605	Default	Each dependent listed on your tax return must have a valid Social Security Number (SSN) or Individual Taxpayer Identification Number (ITIN). For one or more of your dependents the last name doesn't match our records or the records provided by the Social Security Administration. As a result, we didn't allow one or more of your exemptions. This change may affect your taxable income, tax, or any of the following credits: ▪ Credit for Child & Dependent Care Expenses ▪ Education Credits ▪ Child Tax Credit ▪ Additional Child Tax Credit If you, your spouse, or any of your dependents do not qualify for an SSN, you may obtain an Individual Taxpayer Identification Number (ITIN) issued by the Internal Revenue Service by filing Form W-7, Application for IRS Individual Taxpayer Identification Number. This number will allow you to file your return and to claim an exemption but you will be ineligible to claim the Earned Income Credit. You may call 1-800-829-3676 to get Form W-7 or download it from our website at www.irs.gov.

Table continued on next page

Code	Tax Form	Literal Content
743	1040	We didn't allow part or all of the amount claimed as Earned Income Credit (EIC) on Line 66a of your Form 1040. For one or more of the children listed on your Schedule EIC, Earned Income Credit: ▪ The Social Security Number is missing or ▪ The last name doesn't match our records or the records of the Social Security Administration. If you, your spouse, or any of your dependents do not qualify for an SSN, you may obtain an Individual Taxpayer Identification Number (ITIN) issued by the Internal Revenue Service by filing Form W-7, Application for IRS Individual Taxpayer Identification Number. This number will allow you to file your return and to claim an exemption but you will be ineligible to claim the Earned Income Credit. You may call 1-800-829-3676 to get Form W-7 or download it from our website at www.irs.gov.
	1040A	We didn't allow part or all of the amount claimed as Earned Income Credit (EIC) on Line 40a of your Form 1040A. For one or more of the children listed on your Schedule EIC, Earned Income Credit: ▪ The Social Security Number is missing or ▪ The last name doesn't match our records or the records of the Social Security Administration. If you, your spouse, or any of your dependents do not qualify for an SSN, you may obtain an Individual Taxpayer Identification Number (ITIN) issued by the Internal Revenue Service by filing Form W-7, Application for IRS Individual Taxpayer Identification Number. This number will allow you to file your return and to claim an exemption but you will be ineligible to claim the Earned Income Credit. You may call 1-800-829-3676 to get Form W-7 or download it from our website at www.irs.gov.
	1040EZ	NA
	Default	We didn't allow part or all of the amount claimed as Earned Income Credit (EIC) on page 2 of your tax return. For one or more of the children listed on your Schedule EIC, Earned Income Credit: ▪ The Social Security Number is missing or ▪ The last name doesn't match our records or the records of the Social Security Administration. If you, your spouse, or any of your dependents do not qualify for an SSN, you may obtain an Individual Taxpayer Identification Number (ITIN) issued by the Internal Revenue Service by filing Form W-7, Application for IRS Individual Taxpayer Identification Number. This number will allow you to file your return and to claim an exemption but you will be ineligible to claim the Earned Income Credit. You may call 1-800-829-3676 to get Form W-7 or download it from our website at www.irs.gov.

National Taxpayer Advocate

Annual Report to Congress

2011 Annual Report to Congress

Analyzing Pay-As-You-Earn Systems as a Path for Simplification of the U.S. Tax System

Analyzing Pay-As-You-Earn Systems as a Path for Simplification of the U.S. Tax System[1]

INTRODUCTION

On numerous occasions, the National Taxpayer Advocate has identified the complexity of the Internal Revenue Code as the most serious problem facing taxpayers and the IRS, and urged Congress to simplify it.[2] According to a TAS analysis of IRS data, U.S. taxpayers and businesses spend about 6.1 billion hours a year complying with the filing requirements of the Code.[3]

The current tax system is driven by taxpayers' desire for a timely refund and the requirement that almost all individuals file tax returns, both of which result from imprecise withholding.[4] As stated in the 2010 Annual Report to Congress, individual taxpayers find return preparation so overwhelming that about 60 percent pay preparers to do it for them.[5] Among unincorporated business taxpayers, the figure rises to about 71 percent. Another 29 percent of individual taxpayers use tax preparation software that can cost $50 or more.[6]

In 2009, the National Taxpayer Advocate identified the additional problem of the IRS processing information returns after tax returns, which leads the IRS to accept incorrect returns and issue incorrect refunds to taxpayers.[7] Because the IRS must try to stop fraudulent refunds from going out, many returns are delayed for months while the IRS attempts to verify the information.[8] For taxpayers relying on a substantial refund to meet basic living expenses, these delays can cause extreme hardships.

The current filing system also results in the IRS using math error authority when it discovers mistakes on returns after the fact. Math error authority allows the IRS to summarily

1 The principal authors of this preliminary report are Rosty Shiller, Attorney Advisor to the National Taxpayer Advocate and Amanda Bartmann, Presidential Management Fellow, Taxpayer Advocate Service.

2 *Hearing Before the House Comm. on Ways and Means* (Jan. 20, 2011) (statement of Nina E. Olson, National Taxpayer Advocate); *Hearing Before the Senate Comm. on Finance* (June 28, 2011) (statement of Nina E. Olson, National Taxpayer Advocate); National Taxpayer Advocate 2010 Annual Report to Congress 3-14 (Most Serious Problem (MSP): *The Time for Tax Reform Is Now*); National Taxpayer Advocate 2008 Annual Report to Congress 363-69 (Legislative Recommendation (LR): *Simplify the Family Status Provisions*), 370-72 (LR: *Simplify and Streamline Education Tax Incentives*), 373-74 (LR: *Simplify and Streamline Retirement Savings Tax Incentives*), 410-13 (LR: *Eliminate (or Simplify) Phase-Outs*), 397-409 (LR: *Eliminate (or Reduce) Procedural Incentives for Lawmakers to Enact Tax Sunsets*); National Taxpayer Advocate 2005 Annual Report to Congress 375-80 (LR: *A Taxpayer-Centric Approach to Tax Reform*), 397-406 (LR: *Tax Reform for Families: A Common Sense Approach*).

3 National Taxpayer Advocate 2010 Annual Report to Congress 3-14 (MSP: *The Time for Tax Reform Is Now*).

4 Almost 120 million individual U.S. taxpayers (or about 85 percent of all individual tax returns) received refunds in fiscal year (FY) 2010 totaling over $358 billion. An average refund amounted to $3,001. IRS, FY 2010 Databook, Tables 2, 7, and 8.

5 National Taxpayer Advocate 2010 Annual Report to Congress 5.

6 *Id*.

7 *See* National Taxpayer Advocate 2009 Annual Report to Congress 338-346.

8 *See* MSP: *The IRS's Wage and Withholding Verification Procedures May Encroach on Taxpayer Rights and Delay Refund Processing*, *supra*. A TAS study of returns delayed by the Accounts Management Taxpayer Assurance Program (AMTAP) found the average delay for AMTAP returns was 25 weeks.

assess a tax without first giving the taxpayer the option to challenge the tax in Tax Court.[9] A math error assessment can result in an insurmountable tax debt because the IRS may not discover the problem until after it pays the taxpayer's refund for the entire year.

The requirement for individuals to file annual returns and the urgent need to pay out annual refunds make it difficult, if not impossible, to solve these problems without altering the current withholding system. For these reasons, and in pursuit of simplification, the National Taxpayer Advocate has commenced a comprehensive study of Pay-As-You-Earn (PAYE) systems around the world, which will analyze different methods of withholding and potential benefits of and obstacles to their use in the United States.

BACKGROUND

A pay-as-you-earn or PAYE system is the withholding system applied to employment income, in which employers generally withhold tax at source.[10] Generally, a PAYE tax is a withholding tax on income payments to employees. Amounts withheld are treated as advance payments of income tax due. They are refundable to the extent they exceed tax as determined on tax returns.

A PAYE system with more accurate withholding throughout the year could address some of the problems raised by the current U.S. tax system. PAYE systems allow countries to collect the right amount of tax on wages upfront, and concentrate their post-assessment collection resources on liability more at risk of not being collected.[11] Another benefit of more precise withholdings is a reduction in the size of annual refunds. When taxpayers receive tax benefits throughout the year, and any refund at the close of the year is negligible, it becomes less urgent for tax administrators to process returns and pay refunds immediately, which gives them the opportunity to verify the return before processing it. Further, some PAYE systems allow the majority of individual taxpayers to avoid filing an annual tax return.[12] In 2006, only 15 of the 30 countries then in the Organization for Economic Co-operation and Development (OECD) had a general filing requirement for individual taxpayers.[13]

9 *See* MSP: *Expansion of Math Error Authority and Lack of Notice Clarity Create Unnecessary Burden and Jeopardize Taxpayer Rights*, *supra*.

10 International Monetary Fund, *Tax Law Design and Drafting*, Vol. 2, *Chapter 14, Individual Income Tax*, 15 (1998). In situations where the withholding is used as a final tax on employment income, the definition of employment income for the purposes of the withholding should be identical to the definition of employment income for the purposes of collection. *Id*.

11 International Monetary Fund, *Tax Law Design and Drafting*, Vol. 2, *Chapter 15, The Pay-As-You-Earn Tax on Wages* 2 (1998).

12 In 2003, the Department of Treasury estimated that an additional 15 million taxpayers would not have to file annual returns if the current wage withholding formulas were more precise. If income taxes were withheld from income from interest, dividends, pensions, individual retirement accounts, and unemployment insurance, 35 million taxpayers would not have to file returns. U.S. Department of the Treasury, *Report to the Congress on Return-Free Tax Systems: Tax Simplification Is a Prerequisite* 3 (Dec. 2003).

13 OECD, *Using Third Party Information Reports to Assist Taxpayers Meet Their Return Filing Obligations— Country Experiences with the Use of Pre-populated Personal Tax Returns* 4 (Mar. 2006), *available at* http://www.oecd.org/dataoecd/42/14/36280368.pdf.

PAYE systems vary in how they calculate withholding and adjust it during the year. There are generally three types of PAYE systems:

- Simple PAYE;
- Cumulative PAYE; and
- Year-end adjusted or final PAYE.[14]

The United States uses a simple PAYE system, where an amount is withheld from each wage payment based on the predicted annual income and exemptions, and the withholding is not adjusted during the year for any wage changes. Under a cumulative PAYE system, when a taxpayer's wages change, the amount of withholding for the next pay period is increased or decreased to reflect that period's share of the difference between the tax projected for the year and the amount already withheld.[15]

The third type of PAYE system, known as a year-end adjusted PAYE or a final withholding system, does not make withholding adjustments throughout the year, but adjusts the taxpayer's final paycheck to reflect any changes in wages throughout the year.[16]

In addition to differences in wage withholding, countries also differ in terms of what items are subject to withholding. Withholding on interest income, dividends, and other nonwage payments vary across countries and systems.[17] PAYE systems differ further in how they calculate the exact amount of withholding based on variations in the number of tax brackets, the unit of taxation, and the tax treatment of different types of income.[18] Moreover, some PAYE systems also incorporate refundable tax credit provisions which may be paid out through the year and either treated as final or require year-end reconciliation through return filing. The variety provides an opportunity to analyze which PAYE methods are working well and what limitations may prevent the adoption or success of different PAYE methods.

While there have been other studies of PAYE systems, they are not comprehensive and often have used information or data from secondary sources.[19] Some of these studies are over a decade old, and many only analyze data from a handful of the countries that use a PAYE system.[20] TAS conducted preliminary research to identify which countries have

14 International Monetary Fund, *Tax Law Design and Drafting*, Vol. 2, *Chapter 15, The Pay-As-You-Earn Tax on Wages* 4 (1998).

15 *Id*. at 5. The United Kingdom and Russia use cumulative PAYE systems.

16 *Id*. at 5-8. For example, the United Kingdom and Russia use cumulative PAYE systems, in which the final withholding is computed on a cumulative basis.

17 Of eight PAYE countries surveyed in 2006, two did not withhold interest income. *See* OECD, *Using Third Party Information Reports to Assist Taxpayers Meet Their Return Filing Obligations – Country Experiences with the Use of Pre-populated Personal Tax Returns* 4 (Mar. 2006), *available at* http://www.oecd.org/dataoecd/42/14/36280368.pdf (last visited Dec. 22, 2011). International Monetary Fund, *Tax Law Design and Drafting*, Vol. 2, *Chapter 15, The Pay-As-You-Earn Tax on Wages* 18 (1998).

18 For example, countries withholding tax at the source or requiring tax be paid on annual returns differ in whether they tax interest income according to a rate for overall income, at a flat rate, or at a certain rate above a certain threshold. *See* General Accounting Office (GAO, now Government Accountability Office), *Tax Administration: Alternative Filing Systems*, GAO/GGD-97-6, Appendix 1 (Oct. 1997).

19 For example, the 1997 GAO report based its analysis on information from Price Waterhouse Individual Taxes: A Worldwide Summary, 1991 and 1994.

20 The 2006 OECD report referenced above is the most recent study, but it only analyzes data from eight countries.

public information available regarding withholding, tax rates, tax brackets, revenue by the source, and compliance and filing statistics. Of the 34 countries identified by GAO in 1997 as PAYE countries, TAS found only five with websites that had the necessary information in English.[21] The lack of primary source information necessitates a thorough research study to gather data about the countries using PAYE systems so we can analyze the advantages and disadvantages of the different systems.

OBJECTIVES

TAS plans to achieve the following objectives for its study of PAYE systems around the world:

- Retrieve and review current tax law requirements for the 193 UN-member countries and determine whether a PAYE regime exists;
- Determine the rates of withholding and if the withholding is final or cumulative, such that return filing is not required;
- Determine whether the tax regime incorporates refundable tax credits for individuals, and if so, whether taxpayers must file a return in order to reconcile such payments;
- Determine whether research data are available on the effectiveness of the PAYE system (if any) for each country, including what proportion of revenue PAYE collects, the level of compliance, enforcement mechanisms; and
- Identify tax administration practices and legal provisions that may help to simplify the U.S. tax system and increase voluntary compliance.

METHODOLOGY

In the first stage of our research, we will determine whether a country uses a PAYE system. For this purpose, a PAYE country is one that withholds tax on certain types of income, most commonly wages, when it is paid. To gather this information, TAS will research the Library of Congress' Global Legal Information Network (GLIN),[22] which provides a database of tax laws and regulations in other countries, and the CCH IntelliConnect database, which contains primary and secondary legal sources regarding international taxation. TAS will request information through the IRS delegation to the Forum on Tax Administration (FTA) and the Organization for Economic Cooperation and Development (OECD) from the 43 FTA member countries and the 34 OECD countries.[23] TAS plans to supplement this information with contacts to embassies of foreign countries in Washington, DC and request information on PAYE systems in place (if any) directly or through U.S. Department of State.

21 *See* GAO, *Tax Administration: Alternative Filing Systems*, GAO/GGD-97-6, Appendix 1 (Oct. 1997). The five countries TAS identified were Ireland, Japan, Kenya, Tanzania, and the United Kingdom.

22 For more information, see Global Legal Information Network, http://www.glin.gov/search.action (last visited Dec. 15, 2011).

23 Some of these countries overlap.

The second stage of the study involves the compilation of data from countries using PAYE systems. TAS will create a database of PAYE systems around the world, including tax rates and brackets, the unit of taxation, the tax treatment of different types of income, tax revenue by the source, withholding rates, refundable tax credits, compliance rates, and the finality of withholding. TAS will determine finality of withholding based on the absence of any tax liability at the end of the taxable year for income from which tax was withheld.

Stage three of the study will involve identifying beneficial characteristics of different PAYE tax systems, as well as obstacles to implementation. TAS will quantify the potential impact on the IRS and U.S. taxpayers for each best feature and obstacle, as well as the positive and negative effects from revenue, complexity, and administrability perspectives.

CONCLUSION

This research study is intended to gather primary source information from a maximum number of countries with PAYE systems in place. Using compiled data, TAS will analyze the beneficial aspects and obstacles of different systems and consider which approaches might be useful in the United States. Based on the results of this study, the National Taxpayer Advocate will consider legislative and administrative recommendations for the withholding system in the United States. TAS expects to complete this study by the end of calendar year 2012.

Publication 2104-B (Rev. 12-2011) Catalog Number 39588J Department of the Treasury **Internal Revenue Service** www.irs.gov