Statement of

Nina E. Olson

Executive Director, Center for Taxpayer Rights

Hearing on

Minding the Tax Gap:

Improving Tax Administration for the Twenty-first Century

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Chairmen Thompson and Pascrell, Ranking Members Smith and Kelly, and Members of the Subcommittees:

Thank you for inviting me to appear before you today at this hearing to discuss the important issue of the federal tax gap and lost revenue attributable to noncompliance and offshore tax evasion. I have spent my entire professional career wrestling with taxpayer compliance, taxpayer rights, and the tax gap, first as an unenrolled return preparer helping individuals and small businesses comply with the tax laws, next as a tax controversy attorney representing low income taxpayers and others before the IRS and in the courts, then for 18 years as the National Taxpayer Advocate, and today, as the Executive Director of the Center for Taxpayer Rights,[1] where our focus is awareness and protection of taxpayer rights in the United States and internationally.

As National Taxpayer Advocate, I regularly made the case for increased IRS funding in order to maintain and improve tax compliance, not just for additional hiring of audit and collection employees but also those in the taxpayer service functions, the Office of Appeals, and the Taxpayer Advocate Service (TAS). I first identified the Cash Economy Tax Gap as a Most Serious Problem of taxpayers in my 2003 Annual Report to Congress, and recommended withholding on non-wage workers in that report.[2] I identified the tax gap as a Most Serious Problem or made legislative recommendations to address it in at least three other Annual Reports.[3] As early as 2006, I submitted a legislative recommendation for revising Congressional Budget Procedures both to increase IRS funding and accountability.[4] In my 2011 Annual Report to Congress, I identified IRS (under)funding as a Most Serious Problem, and raised that issue again in my 2012 and 2013 Annual Reports.[5] In 2018, I made a legislative recommendation to address sustained Information Technology (IT) multi-year funding.[6] All of these proposals are framed in the context of taxpayer rights and the fundamental principle that the government must treat the taxpayers on which it relies for its "lifeblood" with decency, respect, accuracy, and integrity.

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[1] The Center for Taxpayer Rights is a 501(c)(3) corporation that promotes taxpayer rights in the United States and internationally. For more information about the Center, see https://www.taxpayer-rights.org/

[2] National Taxpayer Advocate 2003 Annual Report to Congress, Most Serious Problem: *Nonfiling and Underreporting by Self-Employed Taxpayers,* 20-25; and Legislative Recommendation: *Tax Withholding on Nonwage Workers,* 256-269.

[3] National Taxpayer Advocate 2004 Annual Report to Congress, Legislative Recommendation: *Tax Gap Recommendations*, 478-489; National Taxpayer Advocate 2005 Annual Report to Congress, Most Serious Problem: *The Cash Economy,* 55-75; Legislative Recommendation, *Measures to Reduce Noncompliance in the Cash Economy,* 381-396; and National Taxpayer Advocate 2006 Annual Report to Congress, Most Serious Problem: *The Tax Gap,* 6-9.

[4] National Taxpayer Advocate 2006 Annual Report to Congress, Legislative Recommendation: *Revising Congressional Budget Procedure to Improve the IRS Funding Decisions,* 442-457.

[5] National Taxpayer Advocate 2011 Annual Report to Congress, Most Serious Problem: *The IRS is Not Adequately Funded to Serve Taxpayers and Collect Taxes,* 3-14; National Taxpayer Advocate 2012 Annual Report to Congress, Most Serious Problem: *The IRS is Significantly Underfunded to Serve Taxpayers and Collect Tax,* 34-41; and National Taxpayer Advocate 2013 Annual Report to Congress, Most Serious Problem: *IRS Budget: The IRS Desperately Needs More Funding to Serve Taxpayers and Increase Voluntary Compliance,* 20-39.

[6] National Taxpayer Advocate 2018 Annual Report to Congress, Legislative Recommendation: *IT Modernization: Provide the IRS with Additional Dedicated, Multiyear Funding to Replace Its Antiquated Core IT Systems Pursuant to a Plan that Sets Forth Specific Goals and Metrics and is Evaluated Annually by an Independent Third Party,* 351-358.

Despite its funding challenges, the IRS has plugged on, and in many instances has performed admirably. Its issuance of three rounds of Economic Impact Payments is nothing short of miraculous. Notwithstanding this performance, in my testimony today I will describe the problems created by the current state of IRS resources, technology, and skillsets. To address the tax gap we need transformational change, and that change must occur in the context of minimizing undue taxpayer burden and protecting taxpayer rights. That change also will require significant investment in new technology, leadership, employees, training, procurement skills, and funding. It requires a massive redesign of IRS systems, phased in over all IRS systems, so that they can process information and talk to one another in real time in order to keep up with current and trending issues. It requires upgrading the input systems – those that receive data and complete error processing, and it requires all systems to update quickly and be flexible. "Flexible" is not a word often applied to IRS systems today.

All of this is not going to happen overnight. And although this is a monumental undertaking, I want to emphasize that such change is possible. It will take a lot of work, in increments. It will take sustained funding, and sustained oversight. It will require additional hiring authorities, and it will require IRS leadership and personnel who are experienced and capable of overseeing and delivering a project of this magnitude. In my opinion, there really is no choice about all of this – it must occur. If we do not make these investments in the IRS, we will not only *not* address the upper reaches of the tax gap, but we will actually risk *increasing* the tax gap: by failing to meet the needs of taxpayers who are trying to comply with the law, the IRS will be creating more noncompliant taxpayers. That is a result we cannot allow.

In the drive to "enforce" the tax laws, we cannot allow the emphasis on enforcement to come at the expense of taxpayer service

I first appeared before the Oversight Subcommittee of the Ways and Means Committee in September, 1997, as the Executive Director of The Community Tax Law Project, the first independent low income taxpayer clinic in the country.[7] I testified about how the Service's drive to collect taxes and its failure to consider the facts and circumstances of individual taxpayers' situations led to harmful overreach, especially for low income and middle class taxpayers who could not afford representation. The passage of the landmark Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98)[8] was a watershed in the advancement of taxpayer rights, followed by the passage of the Taxpayer Bill of Rights in 2015,[9] and the Taxpayer First Act in 2019.[10]

[7] *Taxpayer Rights Proposals and Recommendations of the National Commission on Restructuring the Internal Revenue Service on Taxpayer Protections and Rights: Hearings Before the H. Comm. On Ways and Means, Subcomm. On Oversight,* 105th Cong. 105-62, at 145-154 (1997) (statement of Nina E. Olson, Executive Director, The Community Tax Law Project).
[8] Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. 105-206, 112 Stat. 685.
[9] Protecting Americans from Tax Hikes Act of 2015, Pub. L. No. 114-113, § 401, 129 Stat. 3040, 3117.
[10] Taxpayer First Act, Pub. L. No. 116-25, 133 Stat. 981.

Approximately 2 percent of the $3.6 trillion the IRS collects each year comes from direct enforcement actions.[11] The remaining 98 percent comes from the indirect effect of a mixture of the public's fear of IRS enforcement and its desire to be compliant with the tax laws (tax morale). Even the compliance of purely wage-earning taxpayers, who are subject to reporting *and* withholding, is attributable to their employers' voluntarily withholding and depositing payroll taxes. Because it is easier to measure the direct revenue effect of enforcement, however, budgets for administrations of both parties have consistently proposed increased enforcement spending, usually through the device of a program integrity cap, giving taxpayer service short shrift.[12]

The chronic underfunding of taxpayer service has led to an environment where we routinely see delays in mail handling and telephone "level of service" (LOS) performance at 50 to 60 percent, measured as the percentage of calls the IRS directs to a live assistor and that actually reach a live assistor.[13] According to the National Taxpayer Advocate, the IRS LOS on the main 1040 number plummeted to 5 percent during the current filing season, and the TAS measure of LOS actually placed it at 2 percent.[14] This means 98 percent of calls to the main IRS number did not get through to a live assistor. For FY 2021, the IRS requested funding that would provide LOS at 60 percent, which Congress approved. This means that Congress has accepted that it is okay for the IRS to *not answer four out of ten calls* from taxpayers who the IRS identifies for receipt of live assistance.[15]

As its workload grows, the IRS has increasingly turned to the use of automated compliance approaches, with minimal opportunities for human contact.

Today, much of the IRS's compliance contacts fall in the category of what I call "unreal audits."[16] According to IRS chief counsel, these contacts do not meet the definition of an audit, which involves an examination of the taxpayer's books and records (IRC § 7602). Yet for millions of taxpayers each year, these unreal audits certainly feel like an audit, and they can

[11] IRS, 2019 Data Book, Table 1 and Table 25. (June 2020). The IRS collected a total of $3.56 trillion in FY 2019. It reported approximately $60.1 billion in revenue attributable to its collection activities, including $44 billion (net after credit transfers) on balance due returns, $1.89 billion on delinquent returns, $289 million on offers in compromise, and almost $14 billion on installment agreements.

[12] The National Taxpayer Advocate reports the IRS Taxpayer Service enacted appropriations provided for 28,531full-time employees in FY 2019, 26,760 in FY 2020, and down to 25,678 for FY 2021. National Taxpayer Advocate 2020 Annual Report to Congress 32.

[13] *Id.* at 31.

[14] NTA Blog: *2021 Filing Season Bumps in the Road: Part I* (April 22, 2021) at https://www.taxpayeradvocate.irs.gov/news/nta-blog-2021-filing-season-bumps-in-the-road-part-1/

[15] *Id*. at 30. Of course, this LOS does not account for the calls the IRS phone tree directs away from a live assistor, even though the caller may want to talk to someone and not reach an automated line. In this way, the IRS performance measure misrepresents the taxpayer experience on the phones.

[16] *See* National Taxpayer Advocate 2017 Annual Report to Congress, Most Serious Problem: *Audit Rates: The IRS is Conducting Significant Types and Amounts of Compliance Activities That It Does Not Deem to Be Traditional Audits, Thereby Underreporting the Extent of its Compliance Activity and Return on Investment, and Circumventing Taxpayer Protections,* 49-63. *See also* NTA Blog: *"Real" vs. "Unreal" Audits and Why This Distinction Matters* (July 6, 2018) at https://www.taxpayeradvocate.irs.gov/news/ntablog-real-vs-unreal-audits-and-why-this-distinction-matters/

result in an assessment of additional tax (and penalties) just like an audit, even if the IRS does not include these contacts in its calculation of audit rates.

The shift to automated correspondence and unreal audits has profound implications for taxpayer rights. Take summary assessments under IRC § 6213(b), for example, also known as "math error" assessments. Summary assessment authority (SAA) allows the IRS to make an immediate adjustment to a taxpayer's return and only follow deficiency procedures (including the right to petition Tax Court before paying the tax) if the taxpayer objects within 60 days. Yet the math error notices are incomprehensible. The typical math error notice (Notice CP-11) reads as follows:

> **Changes to your 2019 Form 1040**
> We found miscalculations on your 2019 Form 1040, which affect the following areas of your return:
> - Income
> - Tax Computation
>
> We changed your return to correct these errors. As a result, you owe $xxxx.

Buried on page 3 of this 4-page notice is some language that is only marginally more helpful:

Changes to your 2019 tax return:

	Your Calculation	IRS Calculation
Adjusted Gross Income, Line 8b		
Taxable Income, Line 11b		
Total Tax, Line 16		

That's all the information a taxpayer gets about this "error" and change. This vague language, which fails to put the taxpayer on notice of precisely what was changed on a taxpayer's return so they can decide if the IRS is correct or not, contravenes Congress' explicit direction to the IRS when it expanded math error authority in 1976. At that time, Congress granted this expansion to address fairness concerns about removing more situations from deficiency procedures, Congress added IRC § 6213(b)(1), which requires that "[e]ach notice under this paragraph shall set forth the error alleged and an explanation thereof." The House and Senate Committee Reports both directed the IRS to phrase the notice regarding inconsistent entries on returns in such a way as to include questions designed to show why the IRS had chosen to challenge a particular entry on the taxpayer's return.[17] It is now almost 50 years later, and IRS math error notices are as vague and imprecise as they were in 1976. This is a violation of the taxpayer's *right to be informed, to quality service, and to challenge the IRS and be heard*.[18]

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[17] *See* H.R. Rep. 94-658, at 289 and S. Rep. No. 94-938(l), 94th Cong., 2d Sess. 375 (1976). The reports cited an example where the taxpayer enters six dependency exemptions, but then calculates for seven exemptions; in this case, the IRS should phrase its notices to show the taxpayer the specific discrepancy and inform the taxpayer they might be eligible for the greater number of exemptions. For a detailed discussion of math error notices, *see* National Taxpayer Advocate 2014 Annual Report to Congress, Most Serious Problem: *Math Error Notices: The IRS Does Not Clearly Explain Math Error Adjustments, Making It Difficult for Taxpayers to Understand and Exercise Their Rights,* 163-171.

[18] I.R.C. § 7803(a)(3); IRS, Publication 1, *Your Rights as a Taxpayer* (Rev. Sept. 2017).

Upon receipt of a summary assessment/math error notice, the taxpayer has 60 days to dispute the IRS's assessment in order to have the tax abated. If the taxpayer disputes it in a timely manner, the IRS will review the change and if the IRS believes the original assessment is correct, the IRS must issue a Notice of Deficiency, giving the taxpayer the opportunity to petition the U.S. Tax Court before having to pay the tax.

If taxpayers call the IRS to get clarification about the specific item that was changed pursuant to a SAA/math error notice so that they can decide whether to dispute the notice, technology defeats them. IRS assistors answering the phone number listed on the notice cannot see the taxpayer's return to know what caused the problem. That assistor must fill out the dreaded Form 4442 "referral" to another IRS function.[19] That function may or may not provide the taxpayer with a substantive answer, but it will generally send a letter saying it needs 30 days to review. And then the taxpayer will get another letter, saying that the IRS it needs another 30 days to review. (This letter is referred to as a "stall letter" in IRS jargon.) By this time taxpayers are in an anxiety-producing situation – 60 days will soon elapse and taxpayers cannot know if the IRS has abated the assessment or if the taxpayer's account will proceed to collection.

Customer service representatives and other IRS employees have no access to a 360-degree view of the taxpayers' account because the IRS has no database in which all taxpayer information is stored or linked. Although the IRS has been working on an Enterprise Case Management system since at least 2015, it still has 60 separate major databases containing taxpayer information. The lack of a full picture of the taxpayer's tax life has significant consequences not only for taxpayer assistance but also for audit selection, collection prioritization, and protection of taxpayer rights.

Dreams of the future IRS having purely digital communications with taxpayers will likely not materialize any time soon. Dealing with the IRS has consequences that don't accrue to a bad Amazon or airline transaction. For example, over the next two years, there will be millions of taxpayers with Paycheck Protection Program loans and Employee Retention Credits, hundreds of millions reconciling Rebate Recovery Credits for two years straight, millions claiming and reconciling a new advanced child tax credit, and an influx of reporting on gig economy workers. If these taxpayers receive an IRS notice questioning their return, it is unlikely they will be comfortable with just going online to resolve the matter (if they make it through the IRS online account authentication required to open an account), especially when their bank accounts could be levied, their refunds offset, and their wages levied, all without any judicial review. Taxpayers want to know that they have been listened to and they want answers. They have the *right to be informed, the right to quality service, the right to pay no more than the correct amount of tax, and the right to challenge the IRS and be heard*.[20] Taxpayer service, which is so important to achieving the level of compliance we have today, must be funded to maintain that level.

> Recommendation: Amend IRC § 6213(b)(1) to require any notice of assessment issued pursuant to the IRS's summary assessment authority under that section to include a reference to the specific form and line that has been adjusted as well as a detailed explanation of the adjustment, including the amount of adjustment and the

[19] *See* IRM 21.3.5.
[20] I.R.C. § 7803(a)(3); IRS, Publication 1, *Your Rights as a Taxpayer* (Rev. Sept. 2017).

reason therefor. Further, require that the notice prominently displays on its first page the last date for requesting abatement and explain on the first page the consequences of not requesting abatement before the last day listed. Finally, require the IRS to provide the taxpayer with a dedicated phone number for making an oral abatement request, and a fax number or email address for making the request in writing, if the taxpayer so desires, and require the IRS to issue an acknowledgement letter or email, informing the taxpayer the request has been received and the tax is abated pending further review.[21]

To effectively administer the tax code in the 21st century, the IRS must embrace its dual role as revenue collector and benefits administrator

Since 2010, I have urged the IRS to recognize that as of the 2000s, its mission has undergone a major paradigm shift.[22] No longer is the IRS just a revenue collector for the federal fisc. It is, instead, both a revenue collector and a benefits administrator. Here are just a few of the social benefit programs it administers:

- Earned Income Tax Credit – As of December 2020, the IRS issued $ 62 billion in payments to about 25 million low income working taxpayers and households;[23]
- Premium Tax Credit – For Tax Year 2018 the IRS issued $ 41.8 billion in payments to 5.4 million taxpayers;[24]
- Economic Impact Payments – over three rounds of payments in 2020 and 2021, under incredibly difficult pandemic conditions, the IRS issued almost $ 800 billion in economic impact payments to about 160 million taxpayers.[25]
- Advanced Child Tax Credit – The IRS has projected it will be issuing monthly payments of half the annual credit to approximately 39 million taxpayers beginning July 15, 2021.

This shift in the type of IRS program responsibilities has major ramifications for how it conducts business. To date, the IRS has treated these programs in the same way it treats other tax administration programs, which is to say, from an enforcement-oriented perspective. Its emphasis has been on using remote correspondence examinations, pre-refund fraud detection filters, and automated summary assessment authorities (math errors), sprinkled sporadically with some outreach efforts (*e.g.*, annual EITC day events). Its ongoing outreach efforts basically

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[21] Regarding similar shortcomings of IRS notices providing taxpayers their right to a Collection Due Process hearing, see National Taxpayer Advocate 2018 Annual Report to Congress, Most Serious Problem: *Collection Due Process Notices: Despite Recent Changes to Collection Due Process Notices, Taxpayers Are Still at Risk for Not Understanding Important Procedures and Deadlines, Thereby Missing Their Right to an Independent Hearing and Tax Court Review,* 212-222.

[22] National Taxpayer Advocate 2010 Annual Report to Congress, Most Serious Problem: *The IRS Mission Statement Does Not Reflect the Agency's Increasing Responsibilities for Administering Social Benefit Programs,* 15-27.

[23] *See* https://www.irs.gov/credits-deductions/individuals/earned-income-tax-credit/eitc-reports-and-statistics.

[24] IRS, *Statistics of Income, Individual Income Tax Returns, Complete Report, 2018* (Publication 1304, Rev. 09-2020) 26-27.

[25] *Filing Season and COVID Recovery: Hearing before the Senate Committee on Finance*, 117th Cong. (April 13, 2021) (statement of Charles P. Rettig, Commissioner, Internal Revenue Service) at 2.

involve issuing electronic alerts and creating posters and flyers in multiple languages to distribute to its ever-expanding stakeholder base. The IRS's stakeholder base, on the other hand, is having an increasingly difficult time carrying the IRS message because it is shouldering so much of the service delivery burden and has very little opportunity to influence both the operations and the message. To many, it feels like a one-way street.

Establishing a dual mission means that, rather than lumping the EITC and other benefits in with offshore noncompliance and pass-through underreporting, the IRS will have to go through a separate strategic planning and performance management process for the mission of delivering social benefits through the tax code to eligible individuals. The goal for such a program will be achieving the highest participation rate possible, while protecting taxpayer rights and minimizing undue burden. Thus, instead of focusing on the improper payment rate as the primary driver of all EITC/CTC/PTC initiatives, the IRS will focus on understanding the particular characteristics of the eligible population that might create challenges for benefit delivery and program integrity and use that information to design and staff a program delivery approach that meets the needs of the target population, rather than forcing the target population to fit the needs of the IRS.

In order to accomplish this, the first thing the IRS needs to do is establish a *Family and Worker Benefit Unit* (and because it is the IRS and it will need an acronym, I suggest FAWBU). This unit will be responsible for program design, implementation, assistance, and compliance for all tax provisions that hinge on family status. It would absorb the functions of the Stakeholder, Partnership, Education, and Communication unit (SPEC) and Return Integrity Compliance System (RICS), but these functions would be redesigned to incorporate a renewed focus on delivering benefits to eligible taxpayers. Program integrity under RICS would be redefined to include using data not only to identify ineligible taxpayers but to proactively identify eligible persons who have not claimed the benefits and also persons for whom the benefits can be issued automatically where data indicate there is low risk of an improper payment. Outreach and education would be transformed to include the establishment of a *Family and Worker Benefit Federal Advisory Committee* under the Federal Advisory Committee Act (FACA), which would advise the IRS on all things related to these programs – including communication strategy, taxpayer assistance (including the advisability of digital approaches and account authentication), and education and compliance initiatives.

The FAWBU would also be staffed with employees with the particular skillsets best adapted to achieve the goals and implement the strategies and initiatives deriving from the IRS's social benefits delivery mission. This unit's taxpayer-facing employees should have social work skills; compliance personnel should also have that background, especially important as approaches are developed to address compliance issues that can arise not because the individual is a bad actor but rather is experiencing the challenges that arise in the context of poverty and near-poverty. Thus, in achieving the social benefits mission, the FAWBU would place heavy emphasis on its employees (1) directly assisting individual taxpayers with applying for the credits by maintaining a toll-free line pre- and during filing season dedicated to answering taxpayer questions about eligibility; (2) answering questions upfront and quickly; (3) resolving discrepancies quickly with clear explanations; (4) actively partnering with stakeholders, listening to recommendations, and incorporating them into IRS approaches; (5) emphasizing education and compliance touches over enforcement.

The FAWBU would be responsible for all aspects of family benefit program delivery. Some might say the IRS already has a division that has these responsibilities, namely the Wage & Investment Operating Division. But as I noted in 2010, the vast majority of W&I's employees are dedicated to tasks that affect *all* taxpayers – *e.g*, submission processing (processing all types of returns, information reports, and other submissions); accounts management (handling the main phone numbers and correspondence for accounts of many different types of taxpayers, including all individual taxpayers); forms and publications (designing and writing all IRS forms and publications for all types of taxes and taxpayers).[26] These functions need to be moved into a separate division, since they serve all taxpayers.

The Family and Worker Benefit Unit would not only absorb SPEC and RICs, but would also maintain its own compliance staff – which would have a small component of audits but primarily focus on preventive initiatives. It would incorporate soft compliance touches such as letters, and maintain a staff of researchers, data scientists, and psychologists who could assist in the planning of initiatives that would influence compliance behavior in the taxpayer population. This unit would be responsible for providing expedited administrative review of denials of the Advanced Child Tax Credit if it is permanently enacted. And it would include an office that coordinates and conducts initiatives to oversee return preparer integrity.

While the EITC and other family and worker tax benefits are a small portion of the tax gap, we do need to address overpayments and underpayments. Traditional enforcement measures such as correspondence audits are particularly ill-suited for issues as personal as household composition and for populations that face challenges arising from limited financial means. Creating a unit that is singularly focused on addressing the unique needs of these populations will ensure program integrity and protection of taxpayer rights.

> Recommendation: Require the IRS to restate its mission statement to reflect its dual function as revenue collector and benefits administrator, and to incorporate its obligation to protect taxpayer rights and minimize taxpayer burden in accomplishing that mission.
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> Recommendation: Require the IRS to establish a Family and Worker Benefit Unit to oversee and execute all aspects of its mission relating to the delivery of credits, exemptions, and deductions that promote the welfare of families and workers.

The Tax Gap does not equal tax evasion

Recent studies estimating the amount of unreported income by the highest income taxpayers, and proposals to reduce the underreporting component of the tax gap by increased information reporting, along with the Commissioner's guestimate that the annual tax gap could be as much as

[26] National Taxpayer Advocate 2010 Annual Report to Congress, Most Serious Problem: *The Wage and Investment Division is Tasked with Supporting Multiple Agency-Wide Operations, Impeding Its Ability to Serve its Core Base of Individual Taxpayers Effectively*, 49-70.

$1 trillion, have led policymakers, commentators, and the media to equate the tax gap with tax evasion.[27] The ubiquitous usage of the phrase "tax evasion" actually dilutes its meaning and impact. It also allows very different types of noncompliance attributable to very different causes to be lumped together. And framing noncompliance as tax evasion not only undermines compliance among the currently compliant, who will begin to feel naïve for complying, but it creates an environment in which tax agency personnel can feel justified in undermining if not outright ignoring taxpayer rights and protections.

I have always viewed tax noncompliance as a continuum of behavior and causes – *i.e*., factors that influence that behavior.[28] Even as the financial, technological, and economic landscapes evolve, not all noncompliance can be categorized as "tax evasion." Take crypto-currency, for example. A wide variety of human beings use crypto-currency for a wide variety of reasons. Not all of that usage is on the dark web – some people purchase it for novelty or for investment, some people use it for everyday transactions. An article about the recent Coinbase initial public offering on Nasdaq notes that one-third of small and medium-sized U.S. businesses accept crypto-currency as payment.[29] Not everyone understands which crypto-currency transactions constitute a realization event for tax purposes, much less when that event generates gross income. Indeed, the IRS only issued guidance on cybercurrency in 2014.[30] Yet the IRS has clearly adopted the viewpoint that mere *ownership or acquisition* of cybercurrency is an act worthy of closer scrutiny – in a prominent place on the 2020 Form 1040, Individual Income Tax Return, it asks *every taxpayer* the following question (under penalties of perjury): *"At any time during 2020, did you receive, send, sell, exchange or otherwise acquire any financial interest in any virtual currency?"* This question, on its face requiring the reporting of the acquisition of virtual currency, has brought almost universal condemnation as overreach.[31]

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[27] *See., e.g.,* Washington Post, *IRS chief says cheats are costing the U.S. $1 trillion a year,* April 13, 2021 at https://www.washingtonpost.com/business/economy/irs-chief-says-cheats-are-costing-the-us-1-trillion-a-year/2021/04/13/128f1b0c-9c5d-11eb-b7a8-014b14aeb9e4_story.html; and New York Times, *Tax cheats cost the U.S. $1 trillion per year, I.R.S.* chief says, April 13, 2021, at https://www.nytimes.com/2021/04/13/business/irs-tax-gap.html

[28] Professor Leslie Book described a typology of tax noncompliance, based on the work of sociologists Robert Kidder and Craig McEwen. See L. Book, *The Poor and Tax Compliance: One Size Does Not Fit All*, in Kansas Law Review, vol. 51, 1145- 1195 (2003). Kidder and McEwan identified eight types of tax noncompliance: procedural, "lazy" or characteristic, unknowing, asocial, brokered, symbolic, social and habitual.

[29] *"It's more than just Coinbase": Crypto Giant snares $85.8 billion valuation in Nasdaq debut*, Washington Post, Apr. 14, 2021 at https://www.washingtonpost.com/business/2021/04/14/coinbase-ipo-crypto-bitcoin/?utm_source=rss&utm_medium=referral&utm_campaign=wp_business.

[30] Internal Revenue Service, Notice 2014-21, at https://www.irs.gov/pub/irs-drop/n-14-21.pdf. In 2013 I identified the IRS Chief Counsel's failure to address the treatment of cryptocurrency as a Most Serious Problem of taxpayers. National Taxpayer Advocate 2013 Annual Report to Congress, Most Serious Problem: *Digital Currency: The IRS Should Issue Guidance to Assist Users of Digital Currency*, 249-255.

[31] *See* National Taxpayer Advocate, *NTA Blog: Wait, When Did This Virtual Currency Question Appear on My 1040 Tax Form*, March 3, 2021 at https://www.taxpayeradvocate.irs.gov/news/nta-blog-wait-when-did-this-virtual-currency-question-appear-on-my-1040-tax-form2/; *see also* Guinevere Moore, *IRS Rules on Reporting Bitcoin and Other Crypto Just Got Even More Confusing,* Forbes, March 3, 2021 at https://www.forbes.com/sites/irswatch/2021/03/03/irs-rules-on-crypto-reporting-just-got-even-more-confusing/?sh=2a393e487850.

Leaving crypto-currency aside, of the current $441 billion gross tax gap estimate by IRS,[32] some portion of the underreporting gap is attributable to errors made as a result of tax law complexity (unknowing noncompliance) and others are attributable to procedural complexity and barriers – for example, where taxpayers are eligible for a deduction or credit but cannot navigate the bureaucracy on their own and cannot afford representation, so they just give up (functional or characteristic noncompliance).

Then there is that component of the tax gap attributable to underpayment, which will most assuredly increase as a result of the pandemic economy. Are the taxpayers who failed to make tax payments during this period *tax evaders* and *tax cheats* because their businesses shut down or went under during this period, or because they lost their jobs? Maybe some actively engaged in evasion, but most faced extraordinary challenges making ends meet and simply weren't able to pay their taxes as well. Failure to differentiate between the causes of noncompliance results in the tax agency taking disproportionate actions and risks turning struggling noncompliant taxpayers into determined and intentional tax evaders. At a minimum, such a failure erodes trust, which is never good for a tax system and which research has shown is vital to achieving and maintaining voluntary tax compliance.

Lessons from the OVD settlement initiatives: one size does not fit all

As the IRS continues to focus on the tax gap attributable to offshore activities and tax havens, one can learn a lot about the risks of classifying noncompliance as tax evasion by looking at past IRS offshore initiatives. Painting everyone with one brush can lead to programs that treat a taxpayer who has simply made a mistake in the same way as a taxpayer who has engaged in complex tax planning. For example, between 2009 and 2012, the Internal Revenue Service offered a series of settlement programs for US taxpayers with unreported foreign bank accounts and income.[33] The initiative came in the aftermath of congressional hearings and a 2004 amendment to § 31 U.S.C. 5321(a)(5), which strengthened the penalties for underreporting the existence of foreign financial accounts, including a penalty of up to the greater of $100,000 or 50% of the maximum account balance for the period. Recognizing that not every failure to report was willful, however, the statutory scheme provided a flat $10,000 penalty for nonwillful failures to report and the discretion to impose no penalty at all where the failure to report had reasonable cause.

The IRS's 2009 Offshore Voluntary Disclosure Program (OVDP), on the other hand, provided for taxpayers to pay a flat 20% penalty of the highest account balance over a 6-year period as well as all other tax and interest on the unreported income, and a 20% accuracy-related penalty. The IRS simultaneously made clear that failure to enter the OVDP could result in an extensive audit and could also lead to criminal investigation. The 2009 OVDP thus failed to differentiate between those taxpayers who had small offshore accounts for family reasons (*e.g.*, providing support for a parent who lives overseas), or those taxpayers who, although being "accidental" US

[32] IRS, *Tax Gap Estimates for Tax Years 2011-2013,* at https://www.irs.gov/newsroom/the-tax-gap.
[33] For an extensive discussion of the IRS offshore settlement programs between 2009 and 2018, see National Taxpayer Advocate, NTA Blogs: *An Analysis of Tax Settlement Programs as Amnesties*: Part 1, Part 2, and Part 3 (March 14, 21, and 30, 2018).

citizens, had lived their adult lives without any professional nexus with the IRS and were surprised to learn they had an obligation to file returns with the IRS, and those taxpayers who were actively seeking to shelter their assets and income offshore so as to escape US taxation. Although the IRS recovered $9.9 billion USD from these settlement programs through October 2016, the data for the 2009 OVDP paints a shocking picture of a regressive penalty structure, whereby the taxpayers with the lowest dollar accounts and least amount of unreported income paid the highest percentage rate of penalty (as a percentage of tax due on the unreported income). The 2009 initiative clearly violated the principle of proportionality, a fundamental taxpayer rights protection.

FIGURE 1, Comparison of Median Offshore Penalties to Unreported Tax by Median Account Size and Representation for the 2009 OVD Program

	Bottom 10%	Middle 80%	Top 10%
Offshore account(s) balance	$44,855	$607,875	$7,259,580
2009 OVD penalty	$8,540	$117,803	$1,410,517
Additional tax, tax years 2002-2011	$1,472	$30,894	$452,966
Offshore penalty as a percent of tax assessed	580%	381%	311%
Unrepresented percent	31%	11%	4%
Offshore penalty as a percent of tax assessed (unrepresented taxpayers only)	772%	474%	398%

Source: NTA Blog, March 21, 2018

An additional point about the offshore initiatives – they occurred during a time when the Department of Justice was successfully breaching the wall of Swiss bank secrecy. Whistleblowers were coming forward. IRS, Treasury, and Justice were all focused like a laser on offshore noncompliance. Taxpayers had a strong incentive to enter the programs. Yet when the programs ended in 2018, the IRS announced in a press release that it had collected $11.1 billion through the programs over the period of 2009 to 2018. That is a little over $1 billion a year, for ten years.

IRS automated application of penalties demonstrates the continuing need for IRC § 6751 protection and reform

I have written on many occasions about the IRS's use of automated or systemic penalties in situations that actually require some determination of the taxpayer's intent (either negligence or reckless disregard of rules and regulations). Currently, penalties that are "automatically calculated through electronic means" are excluded from the protections afforded by IRC § 6751, which requires that an employee's initial determination to propose certain civil penalties must receive written approval by the employee's immediate supervisor before the imposition of such penalties. In enacting IRC § 6751, Congress was concerned the IRS was proposing or assessing penalties as bargaining chips, even where penalties were not warranted. Despite having more than twenty years to do so, Treasury has promulgated no regulations setting forth the procedures and timing for obtaining such approvals, and over the years IRS employees ignored this important taxpayer protection. Part of the difficulty may be the wording of the statute, which doesn't really align with IRS processes; the IRS, however, has had plenty of time to seek clarification or even issue notice-and-comment guidance that provided greater clarity. Its failure to do so has opened the door for some taxpayers to escape penalties while millions of taxpayers are annually subjected to systemic penalties without any managerial (human) review.

In recent years taxpayers have successfully challenged in Tax Court the imposition of various civil penalties where an immediate supervisor's approval was not obtained, to the IRS's and Chief Counsel's great consternation. Many of these cases involve taxpayers with large tax liabilities who have been able to avoid penalties because the IRS has not followed the Code. However, low and moderate income taxpayers who are subject to correspondence audits or "unreal" audits such as Automated Underreporter assessments are consistently hit with penalties simply because the IRS has designed a system that conducts examinations without any human intervention. Thus, in *Walquist v. Commissioner*, because the IRS conducted an audit through the Automated Correspondence Exam (ACE) system, there was no human intervention.[34] Instead, the substantial understatement penalty under IRC § 6662 was computed and the notice of deficiency issued entirely by computer. Therefore, the protections afforded more wealthy taxpayers who are audited by revenue agents are not available to low and moderate income taxpayers who are audited through correspondence.

In 2017, 81 percent of individual audits were conducted by correspondence.[35] Therefore, eight out of 10 audited individual taxpayers are at risk of falling outside of the protections of IRC § 6751.

The recently released Green Book proposes to "reform" this section to permit the IRS to:

1. Expand approval authority to *any* supervisory official;
2. Allow approval *at any time prior to the issuance* of a notice providing the opportunity for Tax Court review of the penalty;
3. Allow the IRS to raise a penalty in Tax Court if supervisory approval is obtained prior to doing so; and
4. Allow approval *at any time prior to assessment* where the penalty is not subject to Tax Court review.

Further, according to the Green Book, "this proposal eliminates the written approval requirement under section 6662 for underpayments of tax; section 6662A for understatements with respect to reportable transactions; and section 6663 for fraud penalties."[36] In support of its proposal, the

[34] Walquist v. Comm'r, 152 T.C. No. 3 (Feb. 25, 2019). For a more detailed discussion of this topic, *see* Patrick Riley Murray, Procedurally Taxing, *Walquist Harms the Poor: Revisiting Supervisory Approval for Accuracy Penalties* (May 25, 2021).
[35] B. Erard, E. Kirchler, and J. Olsen, *Audit Impact Study: The Specific Deterrence Implications of Increased Reliance on Correspondence Audits*, in National Taxpayer Advocate 2019 Annual Report to Congress, 258.
[36] Department of the Treasury, *General Explanation of the Administration's Fiscal Year 2022 Revenue Proposals* (May 2021) 100.

Green Book states the "courts have barred penalties without considering whether the penalties were appropriate under the facts of a particular case."[37]

While I believe clarity is needed about the timing of the initial approval and the treatment of subsequently developed facts that might warrant penalty imposition, the Green Book proposal simply helps the IRS without protecting the vast majority of taxpayers. The purpose of IRC § 6751 is to ensure that civil penalties are imposed only where they are warranted. The IRS, however, has increasingly imposed penalties on a systemic/automated basis. For example, it automatically imposes the accuracy-related penalty in Automated Underreporter cases if certain conditions exist, imputing negligence "without considering whether the penalties were appropriate under the facts of a particular case."[38] Thus the IRS, in the Green Book, is asking to be treated better than it treats taxpayers.

The Green Book proposal allows the IRS to justify (approve) the imposition of a penalty at the 11th hour. The IRS could propose systemic penalties on taxpayers without any prior approval and only approve them if they are caught out, but only by those taxpayers who are savvy enough or who have representation who know enough to object. Moreover, by allowing *any supervisory personnel* to approve a penalty, a mere program manager could approve the imposition of systemic penalties on millions of taxpayers and still say there was approval.

In the 2014 National Taxpayer Advocate Report to Congress, I noted that in FY 2013, the IRS assessed $25.9 Billion in civil penalties, but it also abated $11.5 Billion in civil penalties.[39] Improper imposition of penalties actually encourages noncompliance and erodes compliance. A 2013 Taxpayer Advocate Service research study showed that automated and default application of the negligence penalty actually made those taxpayers *more noncompliant* in the following year, as well as five years later; a similar noncompliance effect occurred where taxpayers were assessed penalties that were later abated.[40] If anything, IRS penalty administration requires closer oversight and scrutiny, not less, as is proposed in the Green Book.

The proposed revisions to IRC § 6751 increase the risk of improperly assessed penalties, especially against taxpayers who are low income and unrepresented. The wording of the statute has allowed some taxpayers to escape a warranted a penalty on procedural grounds. This can be

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[37] *Id.*

[38] The IRS does this despite Congress' direction in 1989 that the IRS "make a correct substantive decision in the first instance rather than mechanically assert penalties with the idea that they will be corrected later." H.R. Conf. Rep. No. 101-386, at 661 (1989). In implementing IRC § 6751, the IRS early concluded that "Section 6751(b) provides an exception for managerial approval of penalties calculated through electronic means. This means that the penalty must be free of any independent determination by a Service employee as to whether or not the penalty should be imposed against a taxpayer." National Taxpayer Advocate 2007 Annual Report to Congress, Most Serious Problem: *The Accuracy-Related Penalty in the Automated Underreporter Units*, 277 (quoting Memorandum from Martha Sullivan, Deputy Director, Compliance Policy, *Revision to Memorandum (Aug. 14, 2000) Restructuring and Reform Act of 1998 (RRA 98) Section 3306 – Managerial Approval and Notice Requirements of Penalties* (Apr. 24, 2001)). Thus, the IRS can simply avoid any supervisory approval requirement by designing systems that eliminate any human interaction.

[39] National Taxpayer Advocate 2014 Annual Report to Congress, Most Serious Problem: *Penalty Studies: The IRS Does Not Ensure Penalties Promote Voluntary Compliance, as Recommended by Congress and Others*, 95.

[40] National Taxpayer Advocate, 2013 Annual Report to Congress, vol. 2, Research Study: *Do Accuracy-Related Penalties Improve Future Reporting Compliance by Schedule C Filers?* 1-13.

fixed by clarifying the statutory language around the timing of approvals. But the statute must be amended to ensure that low and moderate income taxpayers who are subject to the increasingly automated exam processes are not subjected to penalties that require an individual determination. The current statute and Tax Court case law results in two classes of taxpayers – those who are wealthy enough to be audited by a human being and can afford representation to avoid penalties, and those (mostly low and moderate income) whose tax matters are so routine as to be relegated to a machine and no human intervention, with systemically applied penalties for which there is no oversight.

> Recommendation: Amend IRC § 6751 to require immediate supervisory review of any IRC § 6662 penalty imposition, even where imposed via a computer-based system.
>
> Recommendation: Require the IRS to annually report to Congress and to the public the number and dollar amount of abatements of civil penalties, by type of penalty.

Enhanced information reporting and data use can improve case selection and taxpayer service but it requires a change in IRS culture, staffing, and systems

Intelligent use of data can improve tax administration enormously *if* it is fit for the purpose intended and used in algorithms and other techniques that mimic human reasoning and *if* it does not displace human decision making and discretion. Data about a taxpayer's business or family status can identify services and information taxpayers need to meet their tax obligations and lead to more tailored and relevant communications; this information can minimize errors by enabling taxpayers to access their own information and download that information into return preparation programs;[41] it can identify taxpayers who are eligible for certain tax provisions such as the childless worker EITC and compute and refund credits when taxpayers fail to claim them; and it can identify questionable refund claims while at the same time minimize false positives and false negatives. Data also can ensure that the IRS selects the most appropriate cases to audit.[42] IRS also can, and should, identify taxpayers at risk of economic hardship so the IRS does not take harmful collection action against them. However – and this is a big however – because there is so much pressure on the IRS to collect revenue, there is a risk that the IRS will not deploy the data intelligently or effectively, and instead will use enhanced information reporting to go after the lowest hanging fruit.[43]

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[41] In 2011, for example, I recommended that Congress accelerate third-party information reporting and use that data to pre-populate returns. *See* National Taxpayer Advocate 2011 Annual Report to Congress, Legislative Recommendation: *Accelerated Third-Party Information Reporting and Pre-populated Returns Would Reduce Taxpayer Burden and Benefit Tax Administration But Taxpayer Protections Must Be Addressed,* 284-295.

[42] *See* National Taxpayer Advocate 2009 Annual Report to Congress, Most Serious Problem: *The IRS Does Not Have a Significant Audit Program Focused on Detecting the Omission of Gross Receipts,* 185-190.

[43] In 2011, in the introduction to a series of Most Serious Problems about the IRS questionable refund program, identity theft filters, math error assessments, automated substitute for returns, and automated lien filing procedures, I wrote about my concerns regarding the potential of automation to lead to taxpayer abuses. *See* National Taxpayer Advocate 2011 Annual Report to Congress, Most Serious Problem Introduction: *As the IRS Relies More Heavily on*

Today, IRS data use is mired in the 1980s, with some notable exceptions. There is heavy emphasis on data-matching and rule-based systems, instead of pattern/network recognition algorithms that include feedback loops. The IRS underutilizes financial account data it receives pursuant to FATCA because it cannot match much of it to existing returns. The manner in which IRS receives data can limit its effectiveness. For example, in 2015 to 2016, the IRS created a program whereby it matched Forms 1042-S associated with the 1040-NRs filed by foreign students. Because IRS systems could not accept these returns electronically, IRS employees had to keystroke in the entries on the returns, including the 18 fields on Form 1042-S. The IRS sent out thousands of letters to foreign students (most of whom were no longer in this country) notifying them that they had to obtain corrected Forms 1042-S from their educational institutions since the payor data did not match their returns. Further investigation found over 90 percent of those "errors" were actually keystroke errors attributable to IRS data entry. The IRS's assumption that taxpayers themselves were to blame imposed undue burden on the taxpayers and educational institutions and created significant rework for the agency itself.[44]

Many IRS systems have high false positive and abatement rates. The National Taxpayer Advocate has reported that during the 2020 filing season, the IRS "refund fraud filters" selected 3.2 million returns, up 107 percent from the 2019 filing season.[45] Of those returns, approximately 66 percent were false positives.[46] *That is, two-thirds of the refund returns IRS systems labelled as potentially fraudulent turned out to be legitimate.* About 25 percent of the returns the IRS froze as potentially fraudulent took longer than 56 days to be unfrozen and released for processing and appropriate refund issuance.[47] While some of the delay may be attributable to closures during the pandemic, this high false positive rate associated with non-identity theft refund fraud filters has persisted for years – including 72 percent for the 2019 filing season.[48] These are very high rates, and they are exacerbated by the inadequate staffing and assistance to taxpayers who try to demonstrate the legitimacy of their returns. As a consequence, this issue has been #1 among case receipts for the Taxpayer Advocate Service for the last four years.[49]

Automation to Strengthen Enforcement, There is an Increased Risk it will Assume Taxpayers are Cheating, Confuse Taxpayers About Their Rights, and Sidestep Longstanding Taxpayer Protections, 15-17.

[44] For a detailed discussion of this issue, *see* National Taxpayer Advocate Fiscal Year 2017 Objectives Report t Congress, Area of Focus: *IRS Implementation and Enforcement of Withholding on Certain Payments to Foreign Persons is Burdensome, Error-ridden, and Fails to Protect the Rights of Affected Taxpayers,* vol. 1, 80, 82-83. *See also* https://www.irs.gov/newsroom/irs-takes-steps-to-help-students-and-others-outlines-interim-process-for-obtaining-refunds-of-withholding-tax-reported-on-form-1042-s-foreign-persons-us-source-income-subject-to-withholding.

[45] The Pre-Refund Wage Verification Program, a component of RRP and administered by the Return Integrity Verification Operation (RIVO), freezes returns claiming refunds while the IRS attempts to verify wages and withholding claimed on the return. National Taxpayer Advocate, 2020 Annual Report to Congress, 230. RIVO utilizes "an obsolete case management and screening system called Return Review Program Legacy Component (RRPLC) (or Electronic Fraud Detection System), which the IRS has been planning to replace for more than a decade." *Id.* at 156.

[46] *Id*. at 151, note 19.

[47] *Id.* at 231. 18 percent took longer than 120 days for refund issuance.

[48] *Id*. at 151.

[49] *Id.* at 148.

Clearly, archaic data practices create burdens for taxpayers of all types and are especially harmful for the lowest income taxpayer who depend on their refunds to meet basic living expenses. Moreover, these systems label legitimate returns as "potentially fraudulent," which has consequences with respect to how IRS employees view these taxpayers and the quality of assistance provided them. This points to the culture change necessary before the IRS can utilize data and advanced systems effectively.

The IRS also does not use data proactively to alleviate burden and prevent harm to taxpayers. I have advocated and written extensively about the need for IRS to use its taxpayer income data and the allowable expense guidelines developed under IRC § 7122(d)(2) to identify taxpayers who may be at risk of economic hardship.[50] The IRS can use this data both as part of its case selection and assignment criteria and as a tool to prompt its collection employees to gather sufficient financial information when a taxpayer calls or is contacted, in order to make an actual determination as to the taxpayer's ability to pay a tax debt while paying for basic living expenses. The IRS has stubbornly refused to adopt this approach, asserting it does not have sufficient information to identify those risks.[51] This, of course, is simply not a credible assertion. Financial institutions and debt collection agencies make assessments like this every day with far less financial information than the IRS has at its figurative fingertips.

The shortcomings of a pure "matching" program without attendant intelligent programming are evidenced by the IRS's approach to math errors relating to dependent Taxpayer Identification Numbers (TINs). IRC § 6213(g)(2) authorizes the IRS to summarily assess additional tax by disallowing dependent exemptions, EITC, child tax credit, and the child and dependent care credit where the qualifying child's TIN does not match Social Security or other records. In 2011, a research study conducted by my former office showed the IRS abated, at least in part, 55 percent of the summary assessments related to incorrect TINs, and in 56 percent of those returns with abatements, the IRS possessed internal information that would clearly show the source of the error (*e.g*, systemically reviewing past year returns to determine that the taxpayer merely keystroked and inverted digits on the child's TIN in the current year).[52] The failure to do something so simple as an historical systemic review of taxpayer data on-hand demonstrates a disturbing lack of concern on the IRS's part with imposing undue and significant burden on taxpayers, who have to call or write the IRS to obtain their legally owed refunds. That the IRS has been aware of this problem (and its solution) since 2011 and has not prioritized fixing it, even when it is in the IRS's own best interests (because the programming will reduce phone calls and correspondence) is troubling indeed.

I raise these examples not as an objection to proposals for more information reporting, but rather to make clear that in addition to modernized technology and data integration and design,

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[50] *See, e.g.,* Nina E. Olson, Procedurally Taxing: *My IRS Wishlist for 2021, Part 2: The Economic Hardship Indicator,* at https://procedurallytaxing.com/my-irs-wishlist-for-2021-part-2-the-economic-hardship-indicator/ ; National Taxpayer Advocate 2018 Annual Report to Congress, Most Serious Problem: *The IRS Does Not Proactively Use Internal Data to Identify Taxpayers at Risk of Economic Hardship Throughout the Collection Process,* 228-239.

[51] *See*, *e.g.,* IRS response to the Most Serious Problem, cited at note 35, in National Taxpayer Advocate FY 2020 Objectives Report to Congress, vol. 2, 93-94.

[52] National Taxpayer Advocate 2011 Annual Report to Congress, Research Study: *Math Errors Committed on Individual Tax Returns: A Review of Math Errors Issued for Claimed Dependents,* vol. 2 at 113-144.

including a 360-degree taxpayer account, the IRS must have a culture shift about how it approaches data – including using it proactively to assist taxpayers, and guarding against labelling taxpayer returns as "potentially fraudulent" before it has conclusive evidence of fraud. Most taxpayer error is not fraud. Repeat as needed.

> Recommendation: Require the IRS to use tax returns and other information reports to proactively identify taxpayers who may be at risk of economic hardship.
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> Recommendation: Clarify the IRS may use its summary assessment authority under IRC § 6213 to make assessments with respect to refundable credits, such as the childless worker EITC, and similar items for which it has information that enable it to determine eligibility with sufficient accuracy and issue refunds accordingly.
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> Recommendation: Require the IRS, as a prerequisite to using summary assessment authority for an addition to tax, to utilize historical and other taxpayer account data to minimize the use of the summary assessment procedures.

Artificial intelligence systems that lack transparency and displace human decision-making and discretion may violate privacy, human, and taxpayer rights: case studies from other countries

There are lessons to be learned from other countries' experiments with data use and artificial intelligence systems to identify fraud in welfare and tax credits. Data and AI can improve detection of noncompliance, but human intervention must be retained and these systems must adhere to basic principles of human dignity and privacy. Moreover, intelligent systems must not be designed as black boxes – they must be transparent and explainable.

In 2016 the Australian government announced the Online Compliance Intervention (OCI), an automated debt recovery system that matched data from Centrelink with averaged income data from the Australia Tax Office.[53] As a result of several Parliamentary inquiries and several legal challenges, the program was scrapped in May 2020, after it was alleged that 470,000 welfare recipients were wrongfully issued debt notices and paid these nonexistent debts in full. In June 2020, the Prime Minister apologized, and the government agreed to pay $720 million to the individuals who received the incorrect collection notices and paid the tax on the incorrect bill. In November 2020, the amount the Australian government committed to resolving the wrongful collection under this program expanded to $1.2 billion AUD to include settlement of a class action lawsuit.[54]

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[53] Centrelink is a system that is administered by Services Australia, a government agency. Centrelink delivers payments and services for retirees, the unemployed, families, carers, parents, people with disabilities, Indigenous Australians, and people from culturally and linguistically diverse backgrounds.

[54] The Guardian, *Robodebt Class Action: Coalition Agrees to Pay $1.2bn to Settle Lawsuit,* Nov. 16, 2020 at https://www.theguardian.com/australia-news/2020/nov/16/robodebt-class-action-coalition-agrees-to-pay-12bn-to-settle-lawsuit.

In 2020, the Hague District Court, reviewing a civil complaint filed by several nongovernmental organizations, found that the System Risk Indicator (SyRI), a system established by the Dutch government to use 17 types of data, including tax, assets, and social benefits, to identify various types of fraud in government programs, violated the European Convention on Human Rights Article 8 which provides a right to the protection of private life, including the protection of personal data.[55] Although this right may be interfered with in the interests of society, the court found that there was no balance between those interests because the system was not transparent – there was no information available about how it worked or what data was actually used, (i.e., it was a black box) and there was no notice to a person when they were flagged as a "fraudster" and information was passed on to prosecutors and police. This created a risk of discriminating and profiling against certain vulnerable groups of persons.

Finally, in January 2021, the entire government of The Netherlands resigned after it was disclosed that a separate government initiative to investigate welfare fraud, including sharing and matching income information with other authorities, had resulted in parents being labeled as fraudsters and incurring thousands of euros in fines for simple mistakes, including missing signatures on forms. Moreover, the Dutch Data Protection Authority found the program was discriminatory against dual nationality citizens. The government announced that nearly 10,000 families will receive 30,000 euros (about $36,500) in damages.[56]

> Recommendation: To ensure AI systems comport with privacy and taxpayer rights protections and have the requisite level of transparency, the IRS should follow the practices recently recommended by the U.S. Administrative Conference of the United States.[57]

Proposals to expand information reporting are promising but should be accompanied by additional taxpayer protections

With respect to specific proposals for expanded information reporting, I note that the information reporting proposal, Shrink the Tax Gap, from former Commissioner Rossotti targets the largest component of the tax gap – underreported unincorporated business income, and the related self-employment tax – and leverages information already compiled by financial and other institutions for issuance of a new information report, Form 1099-NEW.[58] Further, the proposal explicitly states it is not a "matching" proposal. Instead, it requires the highest income taxpayers in this category to reconcile their aggregate financial account deposits and withdrawals (reported on Form 1099-NEW) to the income and expenditures reported on their returns, and for the IRS to use this reconciliation to score returns based on a mapping of the reconciliation categories to

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[55] See Nederland Juristen Comite Voor De Mensenrechten v. The State of The Netherlands, Hague District Court (05 Feb. 2020) (English translation at https://uitspraken.rechtspraak.nl/inziendocument?id=ECLI:NL:RBDHA:2020:1878)

[56] New York Times, *Government in Netherlands Resigns After Benefit Scandal,* Jan. 15, 2021 at https://www.nytimes.com/2021/01/15/world/europe/dutch-government-resignation-rutte-netherlands.html

[57] *See* Administrative Conference of the U.S., *Administrative Conference Statement #20: Agency Use of Artificial Intelligence* (Dec. 16, 2020) at https://www.acus.gov/recommendation/agency-use-artificial-intelligence

[58] See Shrink the Tax Gap proposals at https://shrinkthetaxgap.com/

audit results for those categories. Further, those taxpayers with incomes above a certain threshold and below the "reconciliation" threshold will still receive a Form 1099-NEW reporting their deposits and withdrawals. This form will put taxpayers on alert that the IRS has this information, and the IRS can use this information for real-time scoring of returns not subject to the reconciliation and use the results to identify potential noncompliance and to provide more detailed communication (non-audit) with taxpayers.[59]

One of the challenges with this proposal is the IRS's ability to execute it – the IRS today lacks the expertise and systems to achieve this level of sophisticated tax administration. It requires a sustained investment in leadership, technology, employees, training, and procurement. It is not really a matter of if the IRS can make these changes in its culture, because to fulfill its mission of collecting revenue and administering social benefit programs in the 21st century, it simply must change. All of this is achievable. The question is when and how it will make that change. Congress, through appropriations and oversight, including setting goals for the agency, is key to effecting this change.

There is a second challenge with this proposal. As noted above, it seeks to identify taxpayers who are underreporting their gross receipts of business income. Perhaps to target information reporting to the group most able to accommodate the administrative burden, it proposes that Form 1099-NEW reporting will be limited to business accounts, and related pass-throughs, of taxpayers reporting unincorporated business income whose adjusted gross income (AGI) is in the top quartile, currently about $92,000. The difficulty with this approach is that targeting information reporting in this way may imply, in many people's minds, the presumption that these taxpayers are evading tax. The other drawback to this approach is it relies on taxpayers' own self-reporting of gross receipts to identify taxpayers who are not properly reporting their gross receipts.

In 2007, as the National Taxpayer Advocate, I recommended that Congress require information reporting on all bank accounts as a measure to address cash economy noncompliance.[60] The IRS already received 1099 forms indirectly reporting the existence of interest or dividend bearing accounts. What was missing were the accounts that were non-interest bearing. We believed the mere requirement of reporting the existence of these accounts would have a direct compliance effect, because taxpayers would know the IRS could, if it wanted to, look at the deposits in the minimal or non-interest-bearing accounts.

Thus, to avoid the appearance and implication that a targeted group of taxpayers whose account deposits and withdrawals are subject to information reporting are in some way *prima facie* noncompliant or tax cheats, I recommend Congress require financial institutions to report deposits and withdrawals on all accounts designated by the taxpayer as used for business, regardless of AGI levels. In this way the IRS can identify those taxpayers whose tax returns

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[59] Shrink the Tax Gap, Appendix E: Taxpayer Impact (April 7, 2021) at https://shrinkthetaxgap.com/appendix-e-burden-model/.

[60] National Taxpayer Advocate 2007 Annual Report to Congress, Legislative Recommendation: *Measures to Address Noncompliance in the Cash Economy,* 490-502.

report income below the threshold in the Shrink the Tax Gap proposal but whose financial accounts show deposits significantly above that threshold.[61]

But I would not stop there, because if the IRS received this mother lode of data, it would be too tempting for it to resist falling back on its income matching techniques rather than utilizing the data in a more sophisticated and targeted way. If it did that, the IRS would be focusing its efforts on the lowest hanging fruit and not using the data to identify the most serious noncompliance, thereby defeating the entire purpose of the information reporting. Bank account information alone will not identify who the IRS should look more closely at, nor is it *prima facie* evidence of underreporting. Therefore, if Congress authorizes bank account information reporting, I recommend that it also restrict the IRS's use of this data by prohibiting it from utilizing it in the Automated Underreporter Program. While this restriction may seem counter-intuitive, I believe it is necessary to change the IRS's approach to the use of data and to bring it into the 21st century.

Finally, as noted earlier, many of the IRS's adjustments to returns occur outside of the traditional "audit" context. In FY 2019, the IRS closed 1.96 million automated underreporter assessments, and 365,000 automated substitute for return assessments.[62] These assessments historically have experienced high abatement rates. One reason for AUR and ASFR abatements is that these adjustments are made based on third-party information reports, which may contain errors or be the result of identity theft (as in the recent case with pandemic-related unemployment insurance scams). Normally, the IRS's Notice of Deficiency (NOD) receives the presumption of correctness and taxpayers bear the burden of disproving it in Tax Court. Since 1991, however, federal courts have consistently held that in court proceedings where a taxpayer disputes a proposed assessment based solely on a third-party document, the presumption that the subsequent NOD is correct does not automatically apply. This position is incorporated in IRC § 6201(d), which provides that if in any court proceeding the taxpayer "asserts a reasonable dispute" of the accuracy of an information reporting document and the taxpayer "fully cooperates" with the IRS, the government shall have the burden of producing "reasonable and probative information" concerning the proposed deficiency, beyond the information reporting document. There is, however, no complimentary provision to IRC §6201(d) that requires an IRS audit employee to take on the burden of running down the underlying information where the taxpayer raises a reasonable dispute about an information document and cooperates in a "real" or "unreal" audit. Thus, I recommend that Congress extend IRC § 6201(d) to apply to IRS examination and matching activities, to ensure the proper use and application of expanded information reporting and to avoid unnecessary litigation.

> Recommendation: If information reporting is expanded to require financial institutions to report on the aggregate deposits and withdrawals for business accounts of sole proprietors and other pass-through entities, the use of this data in the IRS Automated Underreporter Program should be prohibited.

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[61] Some taxpayers, of course, will avoid designating accounts as business accounts and thus escape detection. There will always be these types of actors (asocial noncompliance). As noted above, no one proposal will address all forms of noncompliant behaviors. The Shrink The Tax Gap proposal will help close some of the unincorporated business underreporting tax gap, if not all.

[62] IRS, FY 2019 Data Book, Table 22.

Recommendation: Amend IRC § 6201(d) to require the IRS in examinations and in information document matching compliance programs to support a proposed assessment with "reasonable and probative information" beyond the information document, where the taxpayer has cooperated with the IRS and raised a reasonable dispute about that information document(s) and cooperated with the examination.[63]

Additional recommendations to protect taxpayer rights in an environment of increased enforcement and information reporting

In addition to the recommendations mentioned above, I recommend that Congress enact or amend the following provisions so taxpayers can ensure the IRS administers these new technologies and sources of data appropriately, in accordance with taxpayer rights and not arbitrarily and capriciously.

1. *Clarify that certain timeframes are claims processing deadlines and not jurisdictional.* The United States Tax Court has consistently held that certain statutory time periods for seeking judicial review are jurisdictional; thus, if the taxpayer misses the deadline for filing by one day, even where the lateness is due to good cause or even no fault of the taxpayer's, the Tax Court will dismiss the case for lack of jurisdiction.[64] The United States Supreme Court has held, in other contexts, that jurisdictional timeframes must be explicitly described as such in the statute; otherwise the timeframes should be treated as claims processing rules, subject to equitable tolling.[65] I recommend that Congress amend the Code to make clear that except where explicitly stated, the time periods for seeking judicial review or seeking relief from the IRS are not jurisdictional but are claims processing rules subject to equitable tolling if the taxpayer has good reason for missing the deadline. This clarification is particularly important in the context of IRC § 6213(a) (deficiency jurisdiction); IRC § 6015 (relief from joint and severability); and IRC §§

[63] For a discussion of a compelling case that makes clear just how important such protections are at the administrative level, *see* John A. Clynch and Scott A. Schumacher, Procedurally Taxing, *Oral Persuasion: Taxpayer Testimony and the Burden of Proof* at https://procedurallytaxing.com/oral-persuasion-taxpayer-testimony-and-the-burden-of-proof/. Congress should amend IRC § 7430 to provide for an award of attorney fees where the IRS fails to comply with its obligation under the amended IRC § 6201(d), even if the position of the IRS in Tax Court is "substantially justified." If the taxpayer has tried his or her best to provide information at the administrative level and is forced to keep providing it or to go to court because the exam and appeals level are not listening, then the taxpayer should be compensated.
[64] *See, e.g.,* Castillo v. Commissioner, Docket No. 18336-19L (order dated Mar. 25, 2020) (notice of determination mailed by IRS to taxpayer's last known address but never delivered by post office – case dismissed for lack of jurisdiction due to untimely petition) (appeal pending at Second Circuit, Docket No. 20-1635). The Center for Taxpayer Rights has filed an *amicus* brief in this appeal.
[65] *See* Henderson v. Shinseki, 131 S. Ct. 1197, 1203 (2011) (indicating a preference that claim-processing rules, which require parties to take certain steps by certain times in order to promote the orderly progress of the matter, should not be treated as jurisdictional.)

6320 and 6330 (collection due process hearings).[66]

2. *Extend certain timeframes by 60 days when the taxpayer is outside of the United States at the time of notice issuance.* IRC § 6212 extends the deadline for filing a petition in the Tax Court by 60 days where the taxpayer is outside of the United States. There are many other provisions providing taxpayers the right to administrative and judicial review where such an extension for international taxpayers would protect those rights, including petitions to appeal IRS denials of relief from joint and several liability under IRC § 6015(e) and petitions to appeal from IRS Collection Due Process Determinations under IRC § 6330(d)(1).

3. *Repeal the "full-pay" requirement for refund litigation in federal district courts and the U.S. Court of Federal Claims.* In *Flora v. United States,* 362 U.S. 145 (1960), the United States Supreme Court held that, with a few exceptions, taxpayers must fully pay a tax liability before filing a refund suit in a U.S. district court or the U.S. Court of Federal Claims under IRC § 7422. This rule deprives taxpayers who cannot full pay, including taxpayers who the IRS has determined to be "currently not collectible" because of economic hardship, of the opportunity to press their refund claims in court. Moreover, taxpayers who do fully pay under lengthy installment agreements will not be able to recover all their payments if they ultimately prevail in court, because under IRC § 6511(b)(2)(B), such refunds are generally limited to those payments made within two years before the date of filing the refund claim. Further some assessable penalties, which are not subject to deficiency procedures, may be so large that the prepayment requirement deprives a taxpayer of any ability to challenge the penalty in court.

   In the event full repeal is not possible, I recommend Congress adopt the National Taxpayer Advocate's recommendations to address this issue:[67]

- Amend IRC § 6212 to expand the deficiency process to cover all penalties in Title 26, including the penalties located in Chapter 68, Subchapter B, and those located in Chapter 61, so that taxpayers can obtain judicial review by the Tax Court before they are assessed.

- Clarify that a person is not required to fully pay before filing suit in a U.S. district court or the U.S. Court of Federal Claims under 28 U.S.C. § 1346(a)(1) (*i.e.*, repeal the *Flora* Court's full payment rule).

- Amend IRC §§ 7442 and 7422 to give the Tax Court jurisdiction to determine liabilities in refund suits to the same extent as the U.S. district courts and the U.S. Court of Federal Claims, without regard to how much of the liability has been paid.

[66] For a detailed discussion of this issue, *see* Bryan Camp, *New Thinking About Jurisdictional Time Periods in the Tax Code,* 77 Tax Lawyer 1 (2019).
[67] *See* National Taxpayer Advocate 2018 Annual Report to Congress, Legislative Recommendation: *Fix the Flora Rule: Give Taxpayers Who Cannot Pay the Same Access to Judicial Review as Those Who Can,* 364-386. *See also,* National Taxpayer Advocate 2020 Purple Book, *Repeal Flora: Give Taxpayers Who Cannot Pay the Same Access to Judicial Review as Those Who Can,* 82-84.

4. *Amend IRC § 3401(p)(3) to explicitly authorize voluntary withholding agreements between independent contractors and service-recipients.* According to the IRS, the portion of the tax gap attributable to underpayment is $50 billion.[68] The requirement that platforms must now issue a Form 1099-K where payments to a service provider are $600 or more per year will bring to the surface previously unreported income. Allowing independent contractors and service providers to voluntarily agree to withholding on payments will avoid increasing the underpayment tax gap even as the underreporting tax gap is reduced.

5. *Allow certain contests of regulations outside of case specific contexts*. In other areas of law, interested parties generally have the opportunity to litigate the application of the Administrative Procedure Act (APA)[69] to rules and regulations before the agency enforces those rules against the public. The ability to generate prompt court review helps ensure that agencies comply with the APA by appropriately seeking and applying input from the public when promulgating rules that have the force and effect of law.

   Tax law, however, differs from this norm. Because of the Anti-Injunction Act (AIA),[70] parties only generally have an opportunity to judicial review of IRS APA compliance during enforcement proceedings or in refund litigation. Those proceedings can arise years after the guidance is promulgated. Any challenge requires disobeying the rules or complying with the rule, paying any associated taxes and penalties, and seeking a refund.

   The tax system's limited opportunity for court review means that taxpayers and third parties may not have a meaningful opportunity to challenge IRS actions. While the recent Supreme Court decision in *CIC Services v IRS*[71] creates some additional pre-enforcement opportunities to challenge certain rules or regulations, especially if the challenge relates to certain information reporting regimes, Congress should provide a uniform legislative path to prompt court review. That would allow for earlier efficient resolution of possible disputes and help ensure that IRS actions are consistent with the APA before taxpayers and third parties are placed in the difficult situation of either 1) complying with a rule that may be in conflict with the APA or 2) failing to comply with a rule and subjecting themselves to penalties for that noncompliance.

   In the last few years, academics have highlighted this problem and offered legislative solutions. For example, in the article *Restoring the Lost Anti-Injunction Act*, Professor Kristin Hickman and Gerald Kerska propose legislation that would allow an opportunity for parties or persons affected by agency rules or regulations to seek court review to ensure compliance with the APA in a defined, prompt and orderly manner. They propose a legislative amendment to the AIA that would allow judicial review of IRS rules or

[68] IRS, *Tax Gap Estimates for Tax Years 2011-2013* at https://www.irs.gov/pub/irs-pdf/p5365.pdf
[69] 5 U.S.C. §§ 500 *et seq.*
[70] IRC § 7421.
[71] 593 U.S. ___(2021). The Supreme Court held that a suit to enjoin IRS Notice 2016-66 does not trigger the Anti-Injunction Act despite the fact that a violation of the Notice may result in a tax penalty, because the suit challenges the legality of the Notice and not the statutory penalty.

regulations in both the pre-enforcement and enforcement context.[72] This legislative change would help ensure that the IRS acts lawfully and in a manner that appropriately seeks and reflects public input. I recommend Congress adopt the Hickman-Kerska proposal.

6. *Amend the Internal Revenue Code to require the National Taxpayer Advocate to develop a rights-based administrative burden analysis process; require the IRS to follow that procedure with respect to the development and implementation of major initiatives; and require posting of such analysis and the accompanying Taxpayer Rights Impact Statement on a dedicated public webpage.* In an upcoming article Professors Leslie Book and Keith Fogg and I are proposing a rights-based framework for assessing the excessive administrative burden and taxpayer rights impact of a given IRS initiative or system.[73] An initial challenge with this approach is how to require the Service to be more cognizant of how its actions impose excessive administrative burden and harm on particular taxpayer populations and sub- populations *before and during* program design and implementation.[126] Building on elements present in the Paperwork Reduction Act, the Privacy Act, and the Privacy Impact Assessment, we recommend the IRS conduct a Taxpayer Rights Impact Statement (TRIS) with respect to all prospective programs. Additionally, we propose a method for systematic review of existing programs. We recommend placement of the design and oversight of the TRIS process within the Office of the Taxpayer Advocate. This arrangement would ensure the process is driven by the external, taxpayer-oriented perspective of the National Taxpayer Advocate. The framework and approach discussed above accomplishes several things. First, it requires the Service, *before programs are implemented,* to identify under-resourced populations that are affected by its actions; to articulate how the design of agency programs may undermine taxpayer protections or access to benefits, based on the specific characteristics of the taxpayer segment; and to make recommendations to mitigate those burdens. Second, it requires that the Service's assessment – the Taxpayer Rights Impact Statement and the related questionnaire – is posted on the agency's website so the public, Congress, and IRS oversight agencies can see how the Service is conducting the rights-based administrative burden framework. This transparency will enable stakeholders to raise concerns where the analysis provided by the Service has fallen short, and it provides an important tool to conduct ongoing oversight of the agency. Third, and most important, it is the first step in driving a culture change in the agency, where it recognizes its dual mission as both a revenue collector and a social benefits administrator. The framework

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[72] Kristin E. Hickman & Gerald Kerska, Restoring the Lost Anti-Injunction Act, 103 Va. L. Rev. 1683 (2017); Stephanie Hunter McMahon, The Perfect Process Is the Enemy of the Good Tax: Tax's Exceptional Regulatory Process, 35 Va. Tax Rev. 553 (2016).
The legislative amendment Hickman and Kerska propose is as follows:

> Notwithstanding section 7421(a), not later than 60 days after the promulgation of a rule or regulation under authority granted by this title, any person adversely affected or aggrieved by such rule or regulation may file a petition for judicial review of such regulation with the United States Court of Appeals for the District of Columbia or for the circuit in which such person resides or has their principal place of business.

[73] A working draft of this article, *Administrative Burdens, Sludge, and Taxpayer Rights,* is available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3545357

analysis will require the Service to establish different measures of program success, which in turn will require the agencies auditing its performance to shift their audit focus of these programs solely from measures of revenue collected to measures of taxpayer burden and rights impaired.