Report from the Audit Disparities and Fairness in Tax Administration Subcommittee

Presented at the September 9, 2024 TACRE Meeting

OVERVIEW

In January 2023, the Stanford Institute for Economic Policy Research published the working paper "Measuring and Mitigating Racial Disparities in Tax Audits," which was joint work with academics outside government, and researchers at the U.S. Department of the Treasury and the Internal Revenue Service (IRS). The study reviewed nearly 800,000 audits and 148 million tax returns and found that the IRS audits Black taxpayers at a disproportionately higher rate than other taxpayers. Those claiming the Earned Income Tax Credit (EITC) were most likely to be audited, but the Stanford Study found all Black taxpayers are audited at a higher rate, not only EITC claimants. Overall, Black taxpayers were approximately 3 to 5 times more likely to be audited compared to non-Black taxpayers. Although the IRS does not collect data on race, the IRS and Treasury used imputed race values during the Stanford study and in their own subsequent research, to confirm the disparities found by the Stanford Study. In June 2023, the Treasury Advisory Committee on Racial Equity **(TACRE) recommended that Treasury and the IRS address racial disparities in audits** and in April 2024, TACRE formed the Subcommittee on Audit Disparities (the Subcommittee).

This letter summarizes the Subcommittee's findings and lays out recommendations for actions Treasury and the IRS should take to reduce the higher rate of audits of Black tax filers and move toward more equitable tax administration. The Subcommittee acknowledges that the IRS and Treasury have already taken steps to reduce this disparity, and that the IRS and Treasury staff have been committed, responsive, and transparent in their engagement with the Subcommittee since it was formed. The Subcommittee encourages further action on the IRS's commitment to shift attention from auditing low-income tax filings to instead prioritize more of its resources and attention toward high-income tax filings—a deviation from the historic pattern of focusing on low-income taxpayers.

FINDINGS

The root causes of the higher audit rate for Black taxpayers include:

I. Selection Bias

The IRS observed bias in the algorithm that selects taxpayers to audit, resulting in Black taxpayers being selected more than others, even though there was no difference in underlying risk. As USA Today reported in response to the Stanford Study, the IRS uses dated algorithms to select taxpayers for audits, and depleted IRS resources (discussed below) have prevented the agency from doing more in-person audits for complex tax situations. The IRS identified a number of drivers of this bias.

- Missing Data – The IRS draws on administrative social security records, including birth certificates, to help determine whether a taxpayer claiming a child satisfied the required relationship test for the EITC. The IRS is more likely to be missing data for Black taxpayers than other tax filers—especially unmarried parents claiming children for the EITC. IRS researchers have reported that they have made significant progress in reducing missing data on parental SSNs, which have contributed to racial disparity in EITC audit rates. The IRS is piloting using other data to fill the gap of this missing information, such as information reported on healthcare tax forms.

- Dated Models – Some models are old and no longer work to select the most productive cases, so the IRS is working to update those models as well. For example, many EITC claimants file early, and those who file late in the tax season look fundamentally different. It may not make sense to select a certain number of cases from this workstream since the cases are changing.

As of the time the Stanford Study was published in January 2023, the IRS's algorithms were picking too many filings from some workstreams, which resulted in disparate audit rates when they could have been focusing on more productive audits of more complex, higher income taxpayers. For example, many EITC filers file early, and those who file late in the tax season look fundamentally different. The IRS has changed this workstream to now select cases dynamically to pull the most productive cases rather than selecting a fixed number of cases from a changing workstream.

In his September 2023 Letter to Congress, IRS Commissioner Werfel highlighted changes the IRS began taking in 2023 to reduce audit rate disparities to improve accuracy of the automated risk scoring process by adjusting how the IRS considers information about where children live as well as piloting two alternative approaches to its EITC case selection process, committing to publicly report on the results of those pilots. Additionally, an emphasis on improper payments reports that highlight the EITC resulted in the Treasury Inspector General for Tax Administration, U.S. General Accountability Office, and Congress pushing the IRS to conduct more audits of EITC filers in response.

The Subcommittee acknowledges that there are perennial questions from Congress about the risk of fraud, waste, and abuse in refundable tax credit programs—particularly concerns about overpayments of the EITC. The Subcommittee takes seriously the government's need to ensure that accurate amounts of funds are getting to the right places to make sure these funds get to the people who need it most and to avoid waste or abuse of taxpayer funds. Notwithstanding appropriate efforts to safeguard the program, the Subcommittee asserts that the IRS and Congress can establish proper accountability without shifting enforcement out of balance, thereby causing undue harm to the taxpayers as occurred in the case of Black taxpayers claiming the EITC. The external emphasis on cracking down on overpayments played a role influencing human decisions at the IRS about how to set audit algorithms and prioritize workstreams.

In response to the Subcommittee's questions about which drivers of the disparity between Black EITC filers and non-Black taxpayers are most relevant, the IRS noted that all issues are connected and each of the items mentioned are relevant. The IRS has taken steps to change selection focus. The IRS has implemented updates to its workload selection tools and introduced a new EITC risk scoring system designed to better align audit rates with noncompliance risks. While these changes are promising, the Subcommittee has been unable to thoroughly assess whether these measures will effectively address the disparities in audit rates based on the data available today.

II. Funding

As Commissioner Werfel noted in a March 2024 speech, the IRS has been under-funded for more than a decade. From 2010 to 2021, the IRS budget was slashed by more than 22 percent while the

American population grew and the volume of annual tax returns increased by more than 15 million. During that time, the IRS has experienced staff attrition and there has been more attrition among senior staff who were handling complex audits and relatively less attrition among examiners handling EITC audits that tend to be less complex and from lower income taxpayers, resulting in an unintentional shift increasing the share of audits of low-income—and as we've learned, particularly Black—tax filers while the share of audits of high-income, complex tax returns decreased. Funding constraints within the IRS have resulted in the inability to hire more senior staff to conduct more complex audits among higher earning tax filers; but according to Commissioner Werfel, with the assistance of IRA funding, the IRS has rebalanced its audit portfolio to decrease audits of EITC and other refundable tax credits and focus on noncompliance on returns related to large, complex partnerships, large corporations, and high-income and high-wealth individuals.

III. Eligibility Criteria

Eligibility for tax benefits is based on tax units, which are defined on an annual basis determined by where people live and legally recognized relationships. Over time, these tax units have become less representative of how families live. Marriage rates have declined, particularly among lower-income families and unmarried cohabitation has increased. While a married couple can file a single tax return and claim benefits for the children who live with them, often only the adult related to a child can claim a child in a cohabiting household. Some children live in complex custody arrangements, shifting between multiple caregivers as circumstances dictate. Even though a child may be supported my multiple people, they are only allowed to be in a single tax unit. In a small number of households, children live with relatives other than parents and with multiple generations of family members. All of these can make determining tax benefits difficult and creates inconsistencies between different household types (Maag, Peters, and Edelstein 2016). For example, the IRS noted that married taxpayers can claim stepchildren for the EITC but adults who cohabit may only claim the children they are related to. This is much more likely to disadvantage Black taxpayers, who have lower marriage rates (Horowitz, Graf, and Livingston 2019). The IRS has done some work to simplify credit eligibility rules, but ultimately, the IRS is tasked with administering the law and it would take Congress passing legislation to change the existing law to make it more congruent with how families live.

IRS Declarations on Tax Preparers

Throughout the Subcommittee's engagement on audit disparities, the IRS has maintained that unscrupulous tax preparers, many of whom work with taxpayers in low-income communities and communities of color, have contributed to the higher audit rate for Black tax filers by giving faulty tax advice and directing Black taxpayers to submit returns claiming more of a refund than they are entitled to. IRS and Treasury staff have stated that Black EITC claimants are more frequently audited due to a higher likelihood of using high-risk tax preparers. The data they provided estimated that 39% of EITC claimants who used a high-risk preparer were Hispanic, whereas only 25% of EITC claimants in general are Hispanic. Similarly, they estimated that 26% of EITC claimants using high-risk preparers were Black, though they make up just 20% of all EITC claimants. In contrast, White taxpayers make up an estimated 47% of EITC claimants but accounted for just 25% of EITC returns completed by high-risk preparers. In light of these numbers, the Subcommittee has been unable to verify the IRS's claims that tax preparers contributed to Black taxpayers being audited at a higher rate than other taxpayers.

The National Taxpayer Advocate and other stakeholders are urging Congress to pass legislation to establish minimum standards for paid federal tax return preparers; and in the absence of legislation, they are urging the IRS to expand its efforts to both educate taxpayers and enforce penalties on exploitative tax preparers to the fullest extent of its current authority. The IRS and Treasury have proposed including regulating tax practitioners as part of their Fiscal Year 2025 Budget and they are increasing efforts to address tax preparers who are leading taxpayers to underreport income or overclaim credits and deductions. As an example, the IRS sent a letter to 1,000 taxpayers whose returns appear to have been completed by a paid preparer who did not sign and include their preparer tax identification number on the return—so-called "ghost preparers"—to help identify those preparers. The National Taxpayer Advocate's 2023 Report to Congress highlights that 92% of the tax preparers who prey on marginalized communities are non-credentialed.

Through various public communications, including press releases and letters to Congress, the IRS has committed to advance equitable tax administration by holding accountable tax preparers who fail to exercise due diligence and disadvantage taxpayers through poor-quality advice. The IRS has also committed to increase resources to educate taxpayers, particularly from communities most vulnerable to exploitative tax preparers, to make it harder for them to take advantage of tax filers. The Subcommittee took issue with an initial perception that the IRS was assigning even partial blame for the higher audit rates to Black tax filers for being misled by unscrupulous tax preparers. But through a series of engagements, information exchanges, and in-person and virtual meetings over the past five months, the Subcommittee is satisfied that the IRS is properly focusing its attention and resources on combating unethical practices by tax preparers instead of on the tax filers who are the victims. Educating all taxpayers to better defend themselves against faulty tax advice remains an important part of the remedy to audit disparities by race, however.

RECOMMENDATIONS

1. Improve Data Collection on Taxpayers' Experience by Race

The Subcommittee recognizes that the IRS does not currently collect data on race, so the disparate impact of higher audit rates experienced by Black taxpayers, particularly those claiming the EITC, appears to be an unintended consequence of dated IRS systems and policies. Even if unintentional, the resulting treatment of Black taxpayers has been unfair and is unacceptable. Not having race-specific data has clearly disadvantaged the IRS from identifying and counteracting disparities in tax administration that have produced a range of harms to Black taxpayers, from higher volumes of audits and the costs and burden associated with them to a chilling effect on the Black community's willingness to engage with the IRS and the process of filing taxes altogether. The Subcommittee re-asserts and reinforces **TACRE's December 2023 recommendation to increase the production of research on issues of racial equity**, including issuing requests for research proposals on a range of topics, including racial disparities in tax administration. The concept that you can't manage what you can't measure applies here. The Stanford Study and the significant research that has followed clearly identified a problem of imbalanced and unfair tax administration, and we know that we've only uncovered the impacts on Black tax filers claiming the EITC, so the Subcommittee is concerned about what we don't know about the experience of Black taxpayers who don't claim the EITC, Latinx taxpayers who we've seen are audited at higher rates than other taxpayers (except Black taxpayers), and others. Collecting race data will enable the IRS to better measure and ultimately address inequities in tax administration by race.

2. **Repair and Strengthen the Relationship Between the IRS and Black Taxpayers**
    a. **Acknowledge and apologize for unfair treatment**
    b. **Engage with organizations and leaders serving the Black community and other marginalized communities to:**
        i. **Improve understanding of Black tax filers' experience**
        ii. **Create and support user-friendly programs and information campaigns to disseminate accurate, useful information about how to seek unclaimed tax credits available to eligible filers as a wealth-building mechanism, including utilizing trusted messengers to help convey this information**
        iii. **Identify "ghost preparers" and decrease their influence on Black tax filers**
        iv. **Increase representation of Black tax professionals interacting with Black taxpayers at the IRS and among volunteer income tax assistance (VITA) centers**
    c. **Monitor future audits to ensure the IRS is not focusing on Black and Latinx taxpayers even after shifting focus to high-income taxpayers**

Commissioner Werfel and IRS leadership have shown a strong willingness to engage with trusted leaders who work in and represent the voices of Black communities across the United States. Commissioner Werfel's rhetoric about building a stronger relationship between the IRS and the Black community, and all marginalized communities—through his public and private communications—has been unprecedented by an IRS Commissioner, consistent, contrite, and committed to making a fundamental shift in fairness and equity in tax administration. These efforts to date have included acknowledging inequities in audits experienced by Black tax filers claiming the EITC in two letters to Congress, public speeches, appearing before TACRE, IRS press releases, meeting with groups of taxpayers and VITA workers in various communities of color and low-income communities, and meeting with the National Urban League's Board of Trustees. The Subcommittee acknowledges that this is a good start, but is just scratching the surface of the multifaceted, ongoing engagement necessary for the IRS Commissioner, IRS leadership, and other ambassadors for the IRS and Treasury to appropriately engage with the Black community to counteract generations of mistrust resulting from experiences like the audit inequities highlighted by the Stanford Study.

Working closely with Treasury's Counselor for Racial Equity, the Subcommittee is recommending a number of Black community leaders and organizations for the IRS to continue engaging with, in addition to the ongoing engagement with the National Urban League; as well as a consistent series of engagements, visits, and additional communication channels between the IRS and communities that have been hesitant to engage with the IRS for fear of negative consequences—such as being audited. In these engagements, the Subcommittee recommends that the IRS support the operationalization of two types of programs: first, programs that enable stronger mechanisms to identify and deter ghost preparers; and second, programs to increase tax credit claims, such as the ‘Claim Your Cash’ program led by the Economic Security Project.

The Subcommittee's various engagements with IRS leadership included acknowledgment of the lack of representation by Black and other people of color among the IRS employees who process the tax returns submitted by Black tax filers and taxpayers from marginalized communities and who interact with taxpayers themselves. In its ongoing efforts to build more bridges between marginalized communities and the IRS, the Subcommittee recommends that the IRS launch a concerted campaign to hire, retain, and promote more tax professionals from Black and other underrepresented communities. TACRE, including the Subcommittee on Internal Staffing & Culture, would be a valuable resource connecting the IRS to organizations and professionals to help socialize and source this ongoing search for talent to join the IRS.

3. **Utilize Inflation Reduction Act Funds to Improve Equity in Tax Administration**
    a. **Counteract algorithmic bias against Black tax filers**
    b. **Conduct additional research about audit disparities beyond Black tax filers claiming the EITC**
    c. **Fund opening and operating VITA Centers in geographic areas the IRS is aware taxpayers are being targeted by unscrupulous tax preparers including ghost preparers; and expand Direct File into these same geographic regions so taxpayers are able to file their taxes for free with VITA assistance, reducing reliance on tax preparers.**
    d. **Invite more external academics and researchers from outside the IRS to review the IRS's records and practices to validate the IRS's work and establish greater trust by increasing transparency. Engage minority-led think tanks, Historically Black Colleges and Universities, and Minority Serving Institutions in this work.**
    e. **Establish proactive stress testing of IRS algorithms to ensure the IRS is, in fact, removing and eliminating bias against Black and other taxpayers from marginalized communities.**

In 2023, the IRS received nearly $80 billion in funding to be spent over ten years from the Inflation Reduction Act (IRA), which the IRS emphasized it will focus spending on improving customer service and the scrutiny of high-income earners. The Subcommittee acknowledges that the IRS has already utilized some IRA funding to pilot new models intended to reduce unintended algorithm disparities in audit rates by race and hire appropriate staff to help taxpayers identify mistakes before filing, quickly fix errors that delay their refunds, and claim the credits and deductions they are eligible for in an effort to reduce the need for the IRS to contact taxpayers after filing through audits and other enforcement activities, according to a September 2023 IRS press release and Commissioner Werfel's September 2023 Letter to Congress. In the same letter, Commissioner Werfel also committed to substantially reduce the number of correspondence audits focused specifically on certain refundable credits, including the EITC, beginning in FY 2024. The Subcommittee calls on the IRS to level the playing field for all Black tax filers, not only those claiming the EITC.

The Subcommittee also reasserts the **TACRE Inflation Reduction Act Subcommittee's September 2023 recommendations** for the IRS to utilize IRA funding to ensure that outreach strategies for low-income tax credits reach populations who have historically been left behind; and to facilitate a strong and enduring focus on equitable outcomes for low-income populations, including publicly-available reports on IRA implementation.

CONCLUSION

The Subcommittee acknowledges the effective partnership with the IRS and Treasury staff, including IRS Commissioner Danny Werfel, for their genuine commitment to this process of fact finding and determining actionable steps to counteract the root causes of racial disparities in tax audits and build trust with Black and other marginalized communities. It is clear that the Internal Revenue Code in its current form and our current system of tax administration do not treat all taxpayers equally or fairly, and that taxpayers from low-income and marginalized communities have experienced unintended but disparately negative impacts of a system that is not built to meet them where they are. There is significant work to be done to level the playing field for Black taxpayers, and to build a stronger, more mutually beneficial relationship between the Black community and the IRS.

The Subcommittee is encouraged, however, by the efforts and the private and public commitments of the current IRS leadership, particularly Commissioner Werfel, to shift priorities and resources to advance the IRS's recent commitment under his leadership to establish fair, equitable, and effective tax administration and to engage more directly and frequently with marginalized communities that have not experienced fair treatment by the IRS historically. It is incumbent on the IRS, Treasury, TACRE, and all leaders who engage with tax administration and racial equity work to remain committed to counteracting the generations of imbalanced IRS funding, priorities, and practices to make sure the current focus on equity and fairness remains a hallmark of the IRS's transformation to the new digital economy, and that this work continues beyond the current presidential or IRS administration, to ensure fairness for everyone who plays by the rules and helps build a more effective and equitable tax system than our country has today and has ever had in the past.