



*While Examinations of High-Income  
Taxpayers Have Increased, the Impact on  
Compliance May Be Limited*

**July 25, 2006**

**Reference Number: 2006-30-105**

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.

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TREASURY INSPECTOR GENERAL  
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C. 20220

July 25, 2006

**MEMORANDUM FOR** COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED  
DIVISION

*Michael R. Phillips*

**FROM:**

Michael R. Phillips  
Deputy Inspector General for Audit

**SUBJECT:**

Final Audit Report – While Examinations of High-Income Taxpayers  
Have Increased, the Impact on Compliance May Be Limited  
(Audit # 200530015)

This report presents the results of our review to determine whether the Internal Revenue Service's (IRS) examinations of high-income taxpayers<sup>1</sup> provided efficient and effective coverage.

*Synopsis*

The IRS has increased its examination coverage rate<sup>2</sup> of high-income taxpayers. However, the increased coverage has been due largely to an increase in correspondence examinations,<sup>3</sup> which limit the tax issues the IRS can address in comparison with face-to-face examinations. In

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<sup>1</sup> The IRS considers high-income taxpayers to be those who file a U.S. Individual Income Tax Return (Form 1040) with Total Positive Income (TPI) of \$100,000 or more and those business taxpayers who file a Form 1040 with Total Gross Receipts of \$100,000 or more on an attached Profit or Loss From Business (Schedule C) or Profit or Loss From Farming (Schedule F). Generally, the TPI is calculated by using only positive income values from specific income fields on the tax return and treats losses as a zero. For example, a tax return filed with wages of \$90,000, interest of \$12,000, and a \$25,000 loss from an interest in a partnership would have a TPI totaling \$102,000 and be considered a high-income tax return by the IRS.

<sup>2</sup> The examination coverage rate is calculated by dividing the number of examined returns in a category by the number of returns in the same category filed in the previous year.

<sup>3</sup> Correspondence examinations are important compliance activities focusing on errors and examination issues that typically can be corrected by mail. They are conducted by sending the taxpayer a letter requesting verification of certain items on the tax return. These examinations are much more limited in scope than office and field examinations in which examiners meet face to face with taxpayers to verify information.



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addition, the compliance effect may be limited because over one-half of all high-income taxpayer examination assessments are not collected timely.

The examination coverage rate of high-income taxpayers increased from 0.86 percent in Fiscal Year (FY) 2002 to 1.53 percent in FY 2005. Included in this statistic is an increase in the examination coverage rate of high-income tax returns, U.S. Individual Income Tax Returns (Form 1040) with a Profit or Loss From Business (Schedule C). This examination coverage rate increased from 1.45 percent in FY 2002 to 3.52 percent in FY 2005. However, the increase in examination coverage is due largely to an increase in correspondence rather than face-to-face examinations. While face-to-face examinations increased by 25 percent from FYs 2002 through 2005, correspondence examinations increased by 170 percent over the same period.

As a result, the percentage of all high-income taxpayer examinations completed through the Correspondence Examination Program grew from 49 percent in FY 2002 to 67 percent in FY 2005. The increase in correspondence examinations for high-income taxpayers who filed a Schedule C was even larger. Examinations closed by correspondence comprised about 30 percent of all high-income taxpayer Schedule C examinations from FYs 2002 through 2004. In FY 2005, approximately 54 percent of all high-income taxpayer Schedule C examinations were conducted by correspondence.

High-income households typically have a large percentage of their income not subject to third-party information reporting and withholding. The absence of third-party information reporting and withholding is associated with a relatively higher rate of underreporting of income among business taxpayers. It is difficult to determine through correspondence examination techniques whether these taxpayers have reported all of their income.

In FY 2004, the IRS assessed over \$2.1 billion in additional taxes on high-income taxpayers through its Examination program. This figure includes assessments of \$1.4 billion (66 percent) on taxpayers who did not respond to the IRS during correspondence examinations. Based on our statistical sample of cases,<sup>4</sup> we estimate approximately \$1.2 billion<sup>5</sup> (86 percent) of the \$1.4 billion has been either abated<sup>6</sup> or not collected after an average of 608 days, almost 2 years, from the date of assessment. The Examination and Collection programs for high-income taxpayers may not be positively affecting compliance given the substantial assessments that have been abated or not collected.

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<sup>4</sup> We selected our sample from cases completed in FY 2004 to provide sufficient time for collection activities.

<sup>5</sup> Margin of error  $\pm$  5.05 percent.

<sup>6</sup> Abatement occurs when the IRS reduces an assessment, in this case from reversing examination findings that had uncovered apparent misreported income, deductions, credits, exemptions, or other tax issues.



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*Recommendation*

We recommended the Directors, Examination and Collection, complete their plan to maximize the compliance effect of high-income taxpayer examinations. This should include the mixture of examination techniques, issues examined, and collection procedures.

*Response*

The IRS agreed with our recommendation. Management will continue their current plan to maximize the compliance efforts with a mixture of examination techniques, issues examined, and collection procedures. Management's complete response to the draft report is included as Appendix V.

Copies of this report are also being sent to IRS officials affected by the report recommendation. Please contact me at (202) 622-6510 if you have questions or Daniel R. Devlin, Assistant Inspector General for Audit (Small Business and Corporate Programs), at 202-622-8500.



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## *Background*

The Internal Revenue Service (IRS) recently released its first new tax gap estimate in several years. The IRS estimates the tax gap for 2001 was \$345 billion. The tax gap is the difference between total Federal taxes owed and total taxes paid. Historically, the majority of the taxpayers that make up the tax gap are:

- Individuals who underreport their income or claim too many credits or deductions.
- Individuals who simply did not file tax returns or pay any tax at all.
- Individuals who did not pay self-employment taxes.

For the 2001 estimate, individual underreporting alone accounted for more than one-half of the total tax gap. The added burden of the tax gap on taxpayers is very real. The IRS National Taxpayer Advocate recently testified<sup>1</sup> that the tax gap added about \$2,000 to the average tax bill in 2001.

The IRS conducts various enforcement actions in an effort to reduce the tax gap. Since Fiscal Year (FY) 2000, the Small Business/Self-Employed (SB/SE) Division has researched ways to better identify tax returns of potentially noncompliant high-income taxpayers to increase the numbers of tax returns examined for this taxpayer population. In FY 2005, examinations of high-income taxpayers were at their highest level since FY 1996. The IRS considers high-income taxpayers to be those who file a U.S. Individual Income Tax Return (Form 1040) with Total Positive Income (TPI)<sup>2</sup> of \$100,000 or more and those business taxpayers who file a Form 1040 with Total Gross Receipts of \$100,000 or more on an Profit or Loss From Business (Schedule C) or on an attached Profit or Loss From Farming (Schedule F).

When processing income tax returns, the IRS categorizes high-income returns by TPI levels. All returns with a TPI greater than \$100,000 that were filed before January 1, 2005, were in the same category. For returns filed on and after January 1, 2005, the IRS established several codes that provided tiered levels of TPI greater than \$100,000.

The IRS conducts examinations of taxpayer returns through two techniques: (1) correspondence examinations are conducted by sending the taxpayer a letter requesting verification of certain

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<sup>1</sup> Testimony of Nina E. Olson, National Taxpayer Advocate, before the Senate Committee on Finance on the Tax Gap and Tax Shelters, July 2004.

<sup>2</sup> Generally, the TPI is calculated by using only positive income values from specific income fields on the tax return and treats losses as a zero. For example, a tax return filed with wages of \$90,000, interest of \$12,000, and a \$25,000 loss from an interest in a partnership would have a TPI totaling \$102,000 and be considered a high-income tax return by the IRS.



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items on the tax return and (2) office and field examinations are conducted by examiners who hold face-to-face meetings with taxpayers to verify information. We initiated our review because of the high percentage of correspondence examinations we reported in March 2005.<sup>3</sup>

This review was performed at the SB/SE Division Office of Examination Planning and Delivery in New Carrollton, Maryland, during the period July 2005 through February 2006. The audit was conducted in accordance with *Government Auditing Standards*. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

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<sup>3</sup> *Trends in Compliance Activities Through Fiscal Year 2004* (Reference Number 2005-30-055, dated March 2005).



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## *Results of Review*

### ***Examination Coverage of High-Income Taxpayers Has Increased, Particularly in Examinations Conducted by Correspondence***

#### ***The examination coverage rate of high-income taxpayer returns has increased***

The IRS has increased its examination coverage<sup>4</sup> of high-income taxpayers. According to data from the IRS Audit Information Management System (AIMS),<sup>5</sup> the examination coverage rate of high-income taxpayers rose from 0.86 percent in FY 2002 to 1.53 percent in FY 2005. The IRS examined 219,208 high-income returns in FY 2005, the highest number since 1996.

Included in this statistic is an increase in the examination coverage rate of high-income Form 1040 tax returns with a Schedule C, which rose from 1.45 percent in FY 2002 to 3.52 percent in FY 2005.

#### ***Both face-to-face and correspondence examinations of high-income taxpayers have increased significantly***

As Figure 1 indicates, the overall increase in the examination coverage of high-income taxpayers is due largely to an increase in the number of correspondence examinations. The number of high-income taxpayer examinations conducted by office interview or field (face-to-face) examination increased by 25 percent from FYs 2002 through 2005. This is a significant achievement because these examinations are more complex and time-consuming than correspondence examinations. Correspondence examinations increased by 170 percent over the same period, resulting in the percentage of all high-income taxpayer examinations closed by correspondence examination growing from 49 percent in FY 2002 to 67 percent in FY 2005. The IRS was able to increase correspondence examinations at a greater rate because they are much less time-consuming than face-to-face examinations.

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<sup>4</sup> The examination coverage rate is calculated by dividing the number of examined returns in a category by the number of returns of the same category filed in the previous year.

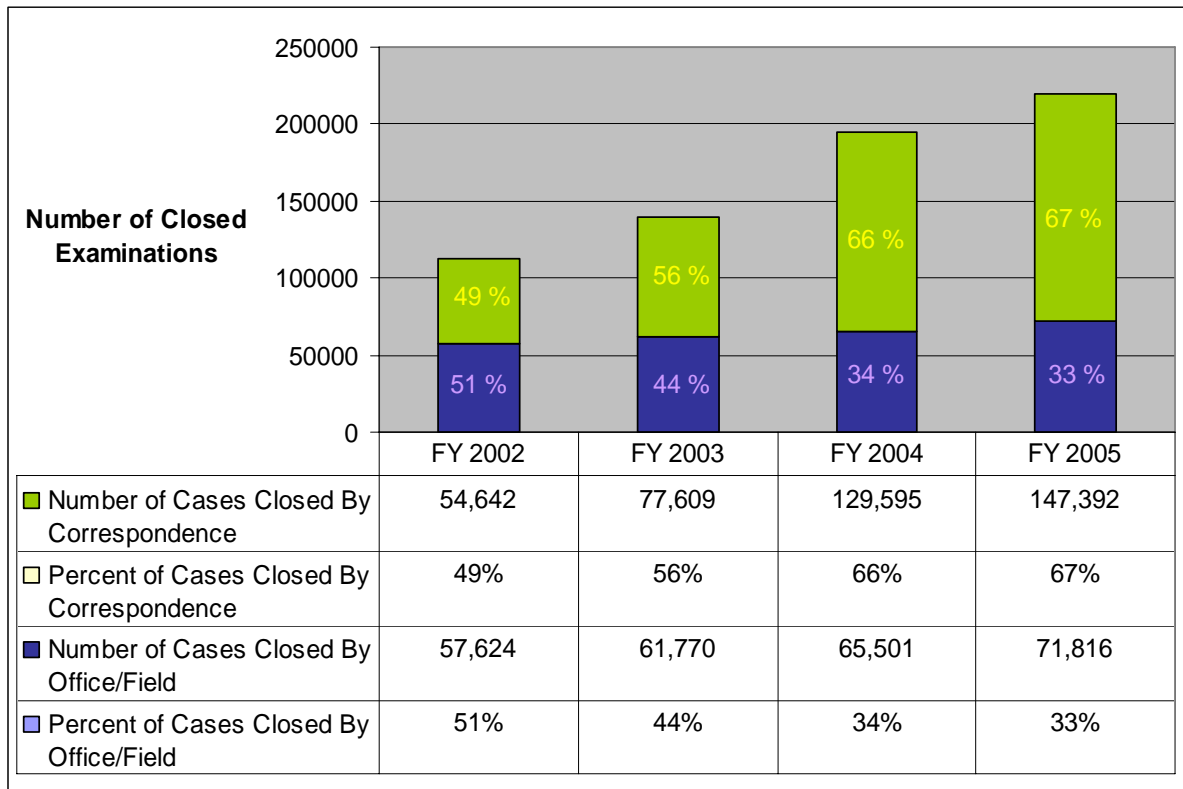
<sup>5</sup> The AIMS is a computer system used by the Appeals, Examination, and Tax Exempt and Government Entities functions to control tax returns, input assessments/adjustments to the Master File and provide management reports. The Master File is the IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.





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**Figure 1: Overall Growth of High-income Taxpayer Examinations**



Source: Treasury Inspector General for Tax Administration (TIGTA) analysis of AIMS closed case data for FYs 2002 through 2005.

The IRS can reach more taxpayers at a lower cost through correspondence examinations than through more labor-intensive, face-to-face examinations, thereby increasing the coverage rate. Correspondence examinations are very important to ensure compliance with tax laws; however, they focus on errors and examination issues that typically can be corrected by mail. By their nature, correspondence examinations are less complex and issues are limited, in comparison with face-to-face examinations.

High-income households typically have a large percentage of their income not subject to the third-party information reporting and withholding requirements applied to income such as wages, dividends, and Social Security benefits. It is difficult to determine through correspondence examination techniques whether these taxpayers have reported all of their income. Unreported income from individuals represents over one-half of the \$345 billion tax gap.



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In July 2004, the National Taxpayer Advocate testified<sup>6</sup> that the largest portion of the tax gap arises from underreporting of income by individuals with business income (Schedule C). Individual business income underreporting has two components: underreporting of business receipts and overreporting of business expenses. The relatively high rate of underreporting of income among business taxpayers is due largely to the absence of third-party information reporting. In addition, many high-income taxpayers have resources to avail themselves of sophisticated methods of tax avoidance. Examinations closed by correspondence comprised about 30 percent of all high-income taxpayer Schedule C examinations from FYs 2002 through 2004. In FY 2005, approximately 54 percent of all high-income taxpayer Schedule C examinations were correspondence examinations. These types of taxpayers and issues are very difficult to examine through correspondence.

In November 2003, we reported<sup>7</sup> that correspondence examinations did not always address strategic noncompliance priorities and, in FY 2003, Earned Income Tax Credit cases alone made up 33 percent of the SB/SE Division's Campus Correspondence Examination Program inventory. In our current review, we again found that in many cases an issue associated with the taxpayer's business may not have been the reason for selection of the return for correspondence examination.

We analyzed the IRS Examination Operational Automation Database (EOAD), which captures information on examinations closed and the issues under examination. EOAD data showed there were 19,966 high-income taxpayer Schedule C cases closed by correspondence examination in FY 2005 in which the issue field in the database was completed. We determined that issues pertaining to the taxpayers' businesses in these cases were present only 22 percent of the time. The remaining 78 percent pertained to issues such as exemptions claimed, qualifying child for the Child Care credit, and other nonbusiness issues (see Appendix IV for more information on the EOAD analysis).

***While Examination Coverage of High-Income Taxpayers Has Increased, the Impact on Compliance May Be Limited***

Because the trend in high-income taxpayer examinations is moving towards correspondence, the source of dollars assessed on high-income taxpayers has likewise shifted from the office or field examination program to the Correspondence Examination Program. Figure 2 shows that, from FY 2002 through FY 2005, the percentage of high-income taxpayer examination dollar assessments from cases conducted by office interview or field examination decreased from 65 percent to 42 percent. During this same period, the percentage from cases closed by

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<sup>6</sup> Testimony of Nina E. Olson, National Taxpayer Advocate, before the Senate Committee on Finance on the Tax Gap and Tax Shelters, July 2004.

<sup>7</sup> *Key Areas of Noncompliance Among Small Business and Self-Employed Taxpayers Could Be Addressed Through More Effective Use of Correspondence Examinations* (Reference Number 2004-30-005, dated November 2003).



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correspondence examination increased from 35 percent to 58 percent. Also, the percentage from cases closed by correspondence examination in which the taxpayer did not respond to the IRS during the examination increased from less than 9 percent to 49 percent. No-response cases include those for which the tax assessment notice came back undeliverable or the taxpayer simply did not respond.

**Figure 2: High-Income Taxpayer Examinations and Assessments by Fiscal Year**

		<b>FY 2002</b>	<b>FY 2003</b>	<b>FY 2004</b>	<b>FY 2005</b>
Totals All Examinations	Number of Examinations	112,266	139,379	195,096	219,208
	Additional Tax Assessments	\$382,736,506	\$976,499,668	\$2,199,410,130	\$6,059,694,199
	Average Assessment	\$3,409	\$7,006	\$11,273	\$27,644
Office/Field	Number of Examinations	57,624	61,770	65,501	71,816
	Additional Tax Assessments	\$248,149,111	\$406,020,400	\$537,564,124	\$2,535,232,344
	Average Assessment	\$4,306	\$6,573	\$8,207	\$35,302
	Percentage of Total Assessments	65%	42%	24%	42%
All Correspondence	Number of Examinations	54,642	77,609	129,595	147,392
	Additional Tax Assessments	\$134,587,395	\$570,479,268	\$1,661,846,006	\$3,524,461,855
	Average Assessment	\$2,463	\$7,351	\$12,823	\$23,912
	Percentage of Total Assessments	35%	58%	76%	58%
Correspondence Without Responses	Number of Examinations	3,267	17,395	53,559	42,838
	Additional Tax Assessments	\$34,267,006	\$400,209,126	\$1,444,828,800	\$2,969,095,382
	Average Assessment	\$10,489	\$23,007	\$26,976	\$69,310
	Percentage of Total Assessments	9%	41%	66%	49%
Correspondence With Responses	Number of Examinations	51,375	60,214	76,036	104,554
	Additional Tax Assessments	\$100,320,389	\$170,270,142	\$217,017,206	\$555,366,473
	Average Assessment	\$1,953	\$2,828	\$2,854	\$5,312
	Percentage of Total Assessments	26%	17%	10%	9%

Source: TIGTA analysis of AIMS closed case data for FYs 2002 through 2005.

IRS officials advised that these numbers were affected by a significantly large backlog of High-Income Nonfiler (HINF) cases that existed prior to FY 2003. These are cases in which taxpayers had not filed tax returns; however, the IRS had third-party information showing the taxpayer had substantial income but insufficient credits, resulting in an apparent balance-due condition. On these HINF cases, the IRS computed the tax based upon the third-party information and sent the taxpayer an examination assessment letter. Management believed the correspondence examination technique was the correct treatment of these taxpayers, and these cases contributed to the significant increase in correspondence examination cases.

We analyzed the results between the HINF and other cases. Figure 3 shows that HINF cases did significantly affect the number of, and results from, high-income taxpayer cases the IRS worked in FYs 2003 through 2005. Such cases ranged from 11 percent to 31 percent of all high-income taxpayer examinations and from 19 percent to 66 percent of total assessments on all high-income taxpayer cases.



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According to the IRS, processing this backlog by correspondence examination allowed it to make contacts on cases that may not have been worked otherwise. Although many of the assessments on these cases have not yet been collected, IRS officials believe establishing assessments on these HINF cases is important and will enable the IRS to pursue other compliance options, including criminal referrals, penalties, and other actions.

**Figure 3: Effect of HINF Cases on High-Income Taxpayer Examinations  
by Fiscal Year**

		<b>FY 2002</b>	<b>FY 2003</b>	<b>FY 2004</b>	<b>FY 2005</b>
Totals All Examinations	Number of Examinations	112,266	139,379	195,096	219,208
	Additional Tax Assessments	\$382,736,506	\$976,499,668	\$2,199,410,130	\$6,059,694,199
	Average Assessment	\$3,409	\$7,006	\$11,273	\$27,644
HINF Cases	Number of Examinations	163	15,443	60,070	42,827
	Percentage of Examinations	0%	11%	31%	20%
	Additional Tax Assessments	\$5,764,762	\$346,926,983	\$1,452,474,270	\$1,173,660,253
	Average Assessment	\$35,367	\$22,465	\$24,180	\$27,405
	Percentage of Total Assessments	2%	36%	66%	19%
High Income Results Without HINF Cases	Number of Examinations	112,103	123,936	135,026	176,381
	Additional Tax Assessments	\$376,971,744	\$629,572,685	\$746,935,860	\$4,886,033,946
	Average Assessment	\$3,363	\$5,080	\$5,532	\$27,702
	Percentage of Total Assessments	98%	64%	34%	81%

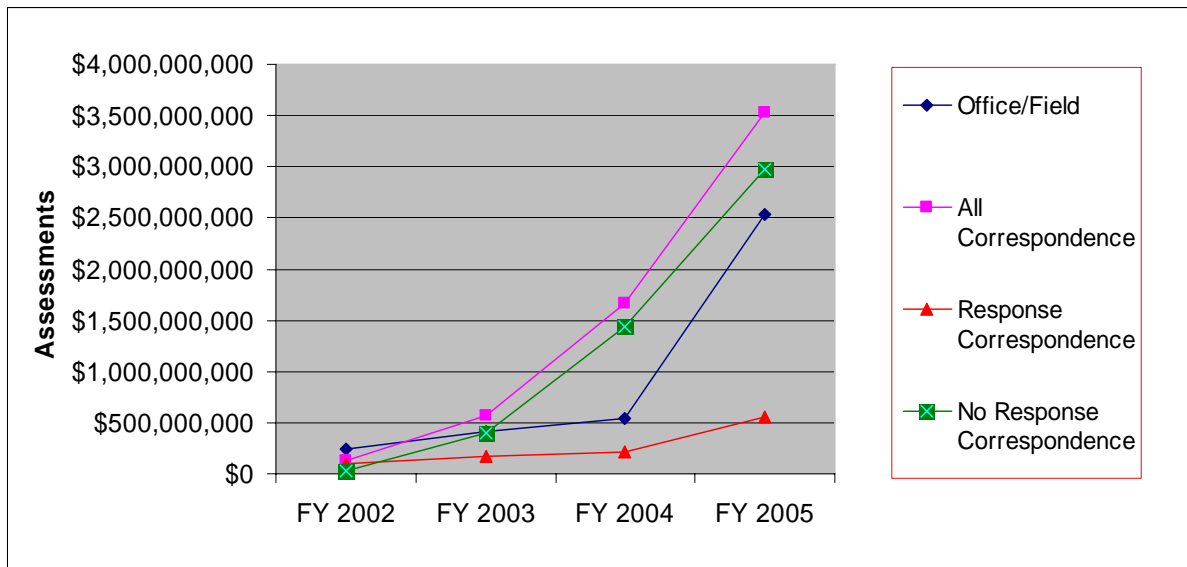
Source: TIGTA analysis of AIMS closed case data for FYs 2002 through 2005.

Figure 4 shows that assessments generated from correspondence examination cases are higher than those generated from office interview or field examination cases. Especially notable is the difference in assessments between correspondence examination cases with responses and correspondence examination cases without responses, which are significantly higher. Because of the high percentage of such cases, we plan to perform a review of the processes used to examine returns when the taxpayer does not respond to the assessment letter.



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**Figure 4: High-Income Taxpayer Examination Assessment Dollars**



Source: TIGTA analysis of AIMS closed case data for FYs 2002 through 2005.

**The compliance impact of high-income taxpayer examinations is limited because a significant percentage of the assessments are abated or not collected**

In FY 2004, the IRS assessed over \$2.1 billion in additional taxes on high-income taxpayers through its Examination program. This figure includes assessments of \$1.4 billion (66 percent) on taxpayers who did not respond to the IRS during correspondence examinations. Because these no-response cases represented the major portion of the dollar assessments, we selected a statistically valid sample of cases in which the taxpayers did not respond.<sup>8</sup> Based on the results of our sample, we estimate approximately \$1.2 billion<sup>9</sup> (86 percent) of the \$1.4 billion has been either abated<sup>10</sup> or not collected after an average of 608 days, almost 2 years, from the date of assessment. Of this \$1.2 billion, we estimate over \$216 million in assessments have been abated and \$992 million in assessments have not yet been collected. Our sample was taken from only HINF no-response correspondence cases. Therefore, the total uncollected or abated figures could be higher because taxes for some of the cases in other categories also may not have been paid.

Based on the age of the uncollected assessments, collection opportunities may be limited. Approximately 60 percent of the uncollected assessments in our sample are in the Collection

<sup>8</sup> We selected our sample from cases completed in FY 2004 to provide sufficient time for collection activities.

<sup>9</sup> Margin of error  $\pm 5.05$  percent.

<sup>10</sup> Abatement occurs when the IRS reduces an assessment, in this case from reversing examination findings that had uncovered apparent misreported income, deductions, credits, exemptions, or other tax issues.



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function Queue inventory.<sup>11</sup> While this inventory is a source of work for Collection Field function employees, a significant amount may never be worked. Any future refunds could be applied to the balance due on these cases; however, the probability of refunds for these types of taxpayers is low.

The IRS has procedures for determining whether an assessment would be collectible, to increase the quality of its assessments. This determination should be made when the assessment being proposed exceeds the taxpayer's current and future ability to pay. Whether the assessment would be collectible is based on the taxpayer's present financial condition, not when the tax return was filed (which reflects the taxpayer's past financial condition). However, the procedures for determining whether an assessment would be collectible do not apply to correspondence examination cases in which the taxpayer does not respond to the IRS during the examination.

The results of IRS examinations should affect the condition or behavior of taxpayers, including their compliance with the tax laws, the payment of taxes, and their perception of how fairly taxpayers are treated. The overall effect on compliance by high-income taxpayer examinations may be diminished because a significant amount of the assessments are not collected. As a testimony to this principle, the IRS Commissioner has stated, "A vigorous enforcement program is important. Americans deserve to feel confident that when they pay their taxes, neighbors and competitors are doing the same."<sup>12</sup> The same holds true for those taxpayers examined and assessed additional tax.

IRS management officials stated they are working on a plan to better identify high-income tax returns for examination, including placing less emphasis on nonfilers. At the time of our review, this plan was incomplete.

## ***Recommendation***

***Recommendation 1:*** The Directors, Examination and Collection, should complete their plan to better maximize the compliance effect of high-income taxpayer examinations. This should include:

- The effectiveness of the mixture of face-to-face and correspondence examination techniques, including the issues examined.

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<sup>11</sup> The Queue is an automated holding file for unassigned inventory of low-priority delinquent cases for which the Collection function does not have enough resources to immediately assign for contact.

<sup>12</sup> Prepared remarks of IRS Commissioner Mark W. Everson, November 18, 2004.



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- Procedures that would determine the collectibility of and collection priority assigned to assessments proposed on high-income taxpayer correspondence examination cases.

**Management's Response:** The IRS agreed with this recommendation. Management will continue their current plan to maximize compliance efforts with a mixture of examination techniques, issues examined, and collection procedures.





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## Appendix I

### *Detailed Objective, Scope, and Methodology*

The overall objective of this review was to determine whether the Internal Revenue Service's (IRS) examinations of individual tax returns with Total Positive Income (TPI)<sup>1</sup> of \$100,000 or more provided efficient and effective coverage. During the review, we relied on databases maintained by the IRS. Although we did not assess the accuracy and reliability of the information in any of the databases, we checked the accuracy and reliability of the data against the IRS Master File.<sup>2</sup> Our checks are described below and did not identify any material errors in the information used from the databases. To accomplish our objective, we:

- I. Assessed the efficiency of the resources being used on high-income individual tax return examinations.
  - A. Developed a trend analysis of examinations of individual tax returns with TPI of \$100,000 or more using the Audit Information Management System (AIMS)<sup>3</sup> closed case data for Fiscal Years (FY) 2002 through 2005. We focused on the examinations of individual tax returns with TPI of \$100,000 or more closed by correspondence examination. We also stratified closed examinations of individual tax returns with TPI of \$100,000 or more by several factors, including TPI, examination technique, and disposal code.
    1. Determined the growth in the examination coverage rate<sup>4</sup> of high-income taxpayer examination cases. We also compared the growth of high-income taxpayer examination cases closed by correspondence with those closed via a face-to-face examination.
    2. From the Examination Operational Automation Database,<sup>5</sup> reviewed data on 19,966 closed examinations of high-income U.S. Individual Income Tax Returns

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<sup>1</sup> Generally, the TPI is calculated by using only positive income values from specific income fields on the tax return and treats losses as a zero. For example, a tax return filed with wages of \$90,000, interest of \$12,000, and a \$25,000 loss from an interest in a partnership would have a TPI totaling \$102,000 and be considered a high-income tax return by the IRS.

<sup>2</sup> The Master File is the IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

<sup>3</sup> The AIMS is a computer system used by the Appeals, Examination, and Tax Exempt and Government Entities functions to control tax returns, input assessments/adjustments to the Master File, and provide management reports.

<sup>4</sup> The examination coverage rate is calculated by dividing the number of examined returns in a category by the number of returns in the same category filed in the previous year.

<sup>5</sup> This Database captures information on examinations closed and the issues under examination.





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(Form 1040) with a Profit or Loss From Business (Schedule C) in which the issue field in the database was completed, to determine the examination issues.

3. Validated the data. We selected a random sample of 80 cases from the AIMS closed case data for FYs 2002 through FY 2005 to verify whether the examination results were posted properly to the taxpayers' accounts by reviewing Master File data on the 80 cases. We used a random sample to ensure each case had an equal chance of being selected. This provided us with confidence that the AIMS data we were using was reliable.
  4. Reconciled the total high-income taxpayer examination statistics from the AIMS with the annual AIMS Table 10 for FYs 2002 through 2005.
- II. Selected a statistically valid random sample of 202 closed high-income individual tax return examination cases from FY 2004<sup>6</sup> to determine their rate of collection. Our sample was taken from the 46,300 High-Income Nonfiler (HINF) examination cases closed in FY 2004 for which the Examination Technique Code was 6 (Initiated for Interview but closed by Correspondence – No taxpayer response) or 7 (Initiated for and closed by Correspondence - No taxpayer response). We selected a random sample so we could project the results against the population of HINF cases closed via Technique Codes 6 and 7. We used a confidence level of 95 percent, a precision factor of  $\pm 3$  percent, and an expected error rate of 5 percent in determining our sample size.
- A. For each case in our sample, confirmed whether the assessment was collected, uncollected, or abated.
  - B. Determined the collection status (e.g., case was in the Collection function Queue<sup>7</sup>) and the age of the assessment for the uncollected cases.

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<sup>6</sup> We selected our sample from FY 2004 cases to allow sufficient time for appropriate collection activities.

<sup>7</sup> The Queue is an automated holding file for unassigned inventory of low-priority delinquent cases for which the Collection function does not have enough resources to immediately assign for contact.



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## **Appendix II**

### *Major Contributors to This Report*

Daniel R. Devlin, Assistant Inspector General for Audit (Small Business and Corporate Programs)  
Parker Pearson, Director  
Richard T. Hayes, Audit Manager  
Timothy F. Greiner, Lead Auditor  
Cynthia Dozier, Senior Auditor  
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Linda Foye, Auditor  
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*While Examinations of High-Income Taxpayers Have Increased,  
the Impact on Compliance May Be Limited*

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**Appendix III**

*Report Distribution List*

Commissioner C  
Office of the Commissioner – Attn: Chief of Staff C  
Deputy Commissioner for Services and Enforcement SE  
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Director, Campus Compliance Services, Small Business/Self-Employed Division SE:S:CCS  
Director, Collection, Small Business/Self-Employed Division SE:S:C  
Director, Examination, Small Business/Self-Employed Division SE:S:E  
Director, Campus Reporting Compliance, Small Business/Self-Employed Division  
SE:S:CCS:CRC  
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Audit Liaison: Commissioner, Small Business/Self-Employed Division SE:S



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**Appendix IV**

*Issues Examined in High-Income Taxpayer  
Schedule C Cases*

Figure 1 shows the top 20<sup>1</sup> issue categorization numbers used for high-income taxpayer examinations of U.S. Individual Income Tax Returns (Form 1040) with a Profit or Loss From Business (Schedule C). The shaded items specifically address business issues.

**Figure 1: Issues Examined in High-Income Taxpayer Schedule C Cases**

10.86%	Schedule C expense
10.47%	Exemptions
9.26%	Schedule C income
7.97%	De Minimus – income or taxes
6.09%	Contributions – 50% limit
5.53%	Single filing status
5.23%	Net credit adjustment
5.21%	Frozen refunds
4.38%	Child Credit - qualifying child
3.78%	Other income
2.07%	Other income - investment income
1.77%	Partnership/corporation income
1.55%	Credit for Federal withholding
1.49%	Federal Insurance Contributions Act earnings from Wage and Tax Statement (Form W-2)
1.48%	Tax on Individual Retirement Arrangement
1.36%	Married Filing Separately filing status
1.27%	Income taxable to self-employed only
1.13%	Qualifying children
1.10%	De Minimus - expense or credit
1.05%	Low income housing credit

*Source: Our analysis of Examination Operational Automation Database data.*

<sup>1</sup> The top 20 issue categorization numbers make up 83.05 percent of the total. The remaining issue categorization numbers each make up less than 1 percent of the total.



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**Appendix V**

*Management's Response to the Draft Report*



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D. C. 20224

RECEIVED  
JUN 30 2006

June 29, 2006

MEMORANDUM FOR TREASURY INSPECTOR GENERAL FOR TAX  
ADMINISTRATION

FROM: Commissioner, Small Business/Self-Employed Division *ymz*

SUBJECT: Draft Audit Report – While Examinations of High-Income  
Taxpayer Returns have Increased, the Impact on Compliance  
May Be Limited (TIGTA Audit #200530015)

Thank you for the opportunity to respond to the draft report on Examinations of High-Income Taxpayer Returns.

We share your interest in addressing the tax gap attributable to high-income taxpayers. In fact, we have placed a significant emphasis on this group of taxpayers over the past few years. As noted in your report, we increased face to face examinations by 25 percent from FY 2002 to 2005. We believe this substantial increase in field examinations is especially noteworthy as it was achieved during a time period when the IRS budget remained flat.

In addition, we increased our efforts to address the high income non-filer population. In 2003 we developed a strategy to address the most egregious and high-risk segments of the non-filer population. This included increasing our correspondence examinations of high-income taxpayers where there was third party information. While the results of your review indicate a large volume of abatements and many assessments were not collected at the time of the review, the average return on investment for the non-filer examinations is approximately \$5,000 per return. Due to these results and our desire to bring high income taxpayers into filing compliance, this program remains a vital part of the overall examination portfolio. It is important to address high-income taxpayer issues as it promotes voluntary compliance by ensuring equitable coverage of all taxpayer populations.

Our comments on your recommendation are attached. If you have any questions please contact me at 202-622-0600 or Steve Burgess, Director, Examination at (904) 665-0503.

Attachment



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**RECOMMENDATION**

We recommend the Directors, Examination and Collection functions, complete their plan to maximize the compliance effect of high-income taxpayer examinations. This should include the mixture of examination techniques, the issues examined, and collection procedures

**CORRECTIVE ACTION**

We agree to continue the current plan to maximize the compliance efforts with a mixture of examination techniques, issues examined and collection procedures.

**IMPLEMENTATION DATE**

On-going

**RESPONSIBLE OFFICIAL(S)**

Commissioner, Small Business/Self-Employed Division

**CORRECTIVE ACTION MONITORING PLAN**

N/A