Report to Congress: IRS Tax Compliance Activities

Department of the Treasury
Internal Revenue Service
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Executive Summary
The Internal Revenue Service uses four main taxpayer contact programs to identify and treat reporting noncompliance. They are the Examination, Math Error, Underreporter, and Automated Substitute for Return (ASFR) programs. Generally, the particular noncompliance characteristics of a case determine the particular program to be used. The programs employ different degrees of automation and impose varying degrees of burden on the taxpayer. The IRS strives to minimize costs and reduce taxpayer burden by ensuring that it uses the least intrusive means to identify the correct tax liability.

With the exception of Math Error, IRS compliance contacts with taxpayers declined between fiscal years (FYs) 1996 and 2000, when they stabilized and began to increase. In FY 1996, IRS made 9.6 million contacts with taxpayers through its four programs. By FY 2001, that number had dropped to 8.4 million. Taxpayer contacts through the Underreporter and ASFR programs fell a combined 35 percent over the FY 1996 – 2002 period. In FY 2002, IRS staffing (as measured by full time equivalents) was down almost 20 percent from FY 1996 for the Examination and ASFR programs. Declines in the Examination program were the most significant. Examinations fell 62 percent, from over 2.1 million closed in FY 1996 to 824,000 in FY 2002. All of this decline occurred by FY 2000, and examinations have since increased somewhat. The decline in Examination activity was accompanied by a shift in the types of enforcement activities. In FY 1996, the Math Error, Underreporter, and ASFR programs constituted 77 percent of taxpayer contacts. By FY 2002, this share had risen to 95 percent.

Regardless of the level of case closures, the Examination program has displayed two general characteristics. First, it selects returns for audit based on the likelihood of a tax change. Returns that display a higher probability of reporting inaccuracy are more likely to be selected for audit. Second, the program maintains some minimum level of Examination activity across all taxpayer income classes. With the exception of the Earned Income Tax Credit, the data show individual income tax return coverage rates tend to be higher for taxpayers with higher incomes. For every year under review, taxpayers with income or receipts greater than $100,000 had a higher likelihood of examination than those with relatively low incomes.

Effective tax administration requires that simultaneous emphasis be placed on taxpayer service and enforcement. During the mid-1990s, the IRS experienced budget reductions, Congressional hearings that identified enforcement excesses, and a significant restructuring. The observed decline in enforcement statistics was a by-product of these factors. Budget cuts led to fewer resources being devoted to many important activities, including enforcement. Congress enacted legislation that emphasized the pre-eminence of taxpayer rights, requiring IRS to modify policies and procedures to comply with the law. The IRS reorganization established divisions with a clear mission to focus on specific groups of taxpayers, with the understanding that this would lead to improved taxpayer service. IRS has now accommodated these major changes, has worked through the transition to the new organizational structure, and has made significant strides in improving its level of service. IRS management intends to continue to improve taxpayer

service levels, while increasing enforcement efforts in a way that will improve overall compliance with the tax system.

Deteriorating compliance contact levels can have long-term negative ramifications for our tax system. If taxpayers perceive that the tax system is failing to fairly enforce the law for all, then overall voluntary compliance levels will erode. Therefore, reinforcing the role of enforcement is a key part of ensuring that compliance levels improve. Examples of how IRS is improving its operations through better enforcement include the National Research Program (which will help develop updated methods to select returns for Examination) and the Abusive Offshore Financial Transaction Initiative (intended to bring back into compliance taxpayers who have established offshore financial arrangements to mask their income). This compliance report provides a baseline against which to measure our improvement in the coming years.

Introduction

A Congressional directive contained within H.R. 107-575, requires the Internal Revenue Service (IRS) to provide an update to the June 2002 report on IRS tax compliance activities within 90 days of enactment of the IRS fiscal year 2003 appropriation. The directive specifically requests an update to the data presented in the prior report, along with an expanded analysis of the fairness with which the IRS implements its compliance efforts. In addition, the directive requests the IRS to provide an update regarding the status of the National Research Program (NRP) and discuss the resources necessary to accelerate NRP beyond individual income taxpayers to include all categories of taxpayers. Finally, the directive requests the IRS to provide a multi-year analysis of "recurring problem taxpayer segments."

To the extent possible, data for IRS compliance activity from fiscal years (FYs) 1996 through 2002 are presented by taxpayer income and by business activity. This report also provides an update on the status of the National Research Program. The NRP is designed to capture data on reporting compliance (in addition to filing and payment compliance) and identify improvements in the Examination program. This report discusses NRP progress to date, costs, future plans, and the issues and obstacles the program faces.

The IRS does not have a comprehensive, multi-year analysis highlighting taxpayer segments with habitual compliance problems. The NRP currently underway is the first comprehensive study of taxpayer compliance that IRS has conducted since Tax Year 1988. The IRS does, however, conduct other studies of taxpayer market segments that IRS believes exhibit above-average noncompliance. The IRS uses this research to target compliance activities more effectively and to improve IRS operations. Some examples of these research plans and reports are reviewed briefly in this report.

IRS Reporting Compliance Programs

IRS tax compliance activities cover multiple forms of action and taxpayer contact. The IRS generally considers three dimensions of compliance: filing, payment, and reporting compliance. Filing compliance refers to whether taxpayers filed required returns in a timely manner, or at all. Payment compliance considers whether taxpayers paid their reported tax liability in full on a timely filed return. Reporting compliance addresses the accuracy with which taxpayers report their tax liability to the IRS. Consistent with the June 2002 report, this paper focuses on the third dimension—IRS reporting compliance activities.

The IRS uses four main programs to identify and treat reporting noncompliance. The most commonly known is the IRS Examination, or Audit, program. This is a relatively expensive, labor-intensive program that requires direct examiner contact with the taxpayer either in person or through correspondence. The IRS also has three programs other than Examination to identify and treat taxpayer reporting accuracy issues in more automated and economical ways. IRS uses the Math Error, Document Matching (or Automated Underreporter), and Automated Substitute for Return (ASFR) programs to contact taxpayers and resolve reporting issues. Historical data on IRS compliance detection and enforcement activity will be presented for these four compliance programs.

Examination Program

An examination is one post-filing tool used to determine if the tax liability reported by the taxpayer for a specific tax year is correct. It may require the taxpayer to submit books and/or records for IRS review as defined by the Internal Revenue Code (IRC). Examinations can be done face-to-face or by correspondence. There is a significant difference between these two examination types. The face-to-face examination requires an examination of books and records, may be quite extensive in scope, and can take longer to complete. A correspondence examination is done through the mail, can be completed in a few hours, is limited in scope to a few issues, and does not include review of detailed accounting records.

Document Matching Program

The Document Matching program, also referred to as the Automated Underreporter (AUR) program, matches the income, deductions, and credits reported on an individual tax return with the wage and information return data reported by payers (e.g., employers, banks, and credit unions) on Information Returns. Although an automated program matches information returns to tax returns, the AUR program still requires significant IRS staff to "screen" apparent mismatches. The screening allows the IRS to avoid contacting taxpayers if a human screener can identify a valid reason for a mismatch. AUR contacts are made through the mail from six IRS campus locations. The program crosses all income levels, and focuses on individual taxpayers, including those filing a Schedule C or F. AUR contact volumes fluctuate from year to year depending on IRS resource availability.

Math Error Program

The IRS also conducts the Math Error program through the mail and by telephone. IRS campus personnel check all returns for internal consistency at the time they are processed. The program includes both mathematical errors and identified mismatches of taxpayer information that would result in a tax change. Examples include: validation of primary, secondary, and dependent Social Security Numbers (SSNs), Child Tax Credit, Earned Income Tax Credit, Rate Reduction Credit, and tax calculations. As with AUR, Math Error also has experienced considerable year-to-year fluctuation. However, in contrast to the three other programs discussed in this report, coverage in the Math Error program is 100 percent, so volumes generally fluctuate in response to the number of taxpayer errors that can be identified under Math Error authority, not to IRS resource availability.

Nonfiler Program

The Nonfiler program identifies potential individual nonfilers by using information returns and historical filing information. The size of the program has fluctuated due to resource availability and competing priorities in any given year. In addition, once contacted by notice, unresponsive nonfilers may never receive an IRS follow-up contact due to competing priorities.

Revisions to the June 2002 Report

This report updates and enhances the information presented in the June 24, 2002 IRS report to Congress titled *Report on Tax Compliance Activities: FY 1996 – FY 2002*. That report enumerated taxpayer annual contacts by the IRS for the four major programs described above. That report also provided data on the resources (in the form of full-time equivalents or FTEs) devoted to each program. This latter dimension served to show the relative resources IRS allocates to each program over time. This report presents data for the same historical period as the June 2002 report, although the FY 2002 counts represent actual historical values rather than projected ones.

In addition, this revision breaks out the Examination program taxpayer contacts and FTEs by IRS Examination Classes for the Individual, Corporation, and Estate tax returns. Reporting taxpayer contacts by Examination Class provides more detail on the types of return used by taxpayers, as well as more information on their income, receipt, or asset level.

The primary sources of data for this report are the IRS's Audit Information Management System (AIMS), as contained on the Service's Compliance Data Warehouse (CDW), and the IRS Master Files. The report Tables 1 – 3 and 5a – 5h present closed case Examination counts from CDW for all years except for FY 2002 (for which CDW was not yet ready). The closed case Examination counts for FY 2002 were tabulated from an extract of AIMS supplied by the Small Business/Self-Employed Operating Division. Detailed sources are cited in the table notes.

The data formats in this report generally tend to line up with, and resemble, those provided to Congress and other external stakeholders annually in the IRS Data Book. However, unlike the Data Book, we incorporate Employee Plans and Exempt Organization examinations in our Examination Volume tables. The Data Book contains a separate table for Employee Plans and Exempt Organizations. Second, due to system cut-off dates and differences in how the data were processed, the data presented here do not necessarily match exactly with data previously released in the June 2002 report or with the Data Book. The major difference is that the Data Book numbers came from Examination management reports used by the Small Business/Self-Employed Operating Division (SBSE), whereas this report derived its numbers directly from AIMS. Although SBSE Examination reports are generated from AIMS as well, we used the Research copy of AIMS maintained on the CDW[1]. A major advantage of using the CDW version of AIMS is that it is relatively easy to breakout Earned Income Tax Credit (EITC) contacts from other types of examinations. A final difference between this report's data and those presented in the Data Book is that our data do not include closed Examination cases appealed by the taxpayer.

[1] Counts will vary between the two systems because of the differences in which new data are processed. AIMS, as maintained by SBSE, is an inventory system. Therefore, corrections, additions, and deletions are made regularly to the entire database. In contrast, the CDW processes just the most recent month of closure. Generally, the numbers are very similar.

IRS Compliance Activity Overview

Tables 1 through 3 summarize IRS taxpayer contacts and coverage by type of contact and by type of taxpayer. The data presented in Table 1 document that, with the exception of Math Error contacts, compliance contacts generally declined between FY 1996 and FY 2002. For example, Examination coverage declined from 1.37 percent in FY 1996 to 0.48 percent in FY 2002. Coverage in the Underreporter and Automated Substitute for Return (ASFR) programs also fell from FY 1996 to FY 2002. The decline in these coverage rates reflects both an increase in taxpayer population over the period, and a drop in IRS's enforcement resources. One reason for the drop in enforcement resources is that the IRS shifted its attention toward improving customer service activities.

As noted earlier, Math Error program activity is not resource-driven in any given year. The IRS programs the parameters for Math Error authority before the filing season. Therefore, the number of applicable filing errors determines the amount of Math Error authority activity. The FY 1996 - 2002 growth in this program is due to several factors. First, Congressionally legislated expansion of Math Error authority increased the volumes. For example, Math Error authority was provided for taxpayer identification number verification for the Earned Income Tax Credit (EITC), personal exemptions, and child and dependent care tax credit in 1996 and for the child tax credit in 1997. In addition, the Math Error program experienced a marked jump in FY 2002 due to taxpayer confusion over the Rate Reduction Credit. We expect this portion of the FY 2002 increase to be temporary, however, and for the FY 2003 volume to return to approximately the pre-FY 2002 levels. Finally, the population of individual income tax filers has grown from 115 million in FY 1996 to 130 million in FY 2002 (Table 4).

Taken together, the programs with lower costs per taxpayer contact -- Math Error, Automated Underreporter, and Automated Substitute for Return -- grew relative to the Examination program. In FY 1996, these three programs constituted 77 percent of the total taxpayer contacts cited in Table 1. This proportion grew steadily over the FY 1996 - 2002 period. By FY 2001, 90 percent of the 8.4 million total taxpayer contacts (Table 1) were made by one of these three automated programs. In FY 2002, that coverage jumped to 95 percent -- in part due to the math error spike. Although the FY 2002 ratio is temporarily high, the long-term trend toward more automated contacts is unmistakable. Changes in the workforce are consistent with this shift to relatively automated taxpayer contact. Over the FY 1996 – 2002 period, FTEs devoted to Underreporter and ASFR remained stable or declined only slightly, while FTEs devoted to examinations experienced a sharp decline.

Resource constraints are not the only reason for this shift away from examinations. Besides being potentially more cost-effective, the three alternative programs impose less burden on the contacted taxpayer population than if the Service relied solely on Examination contacts. The IRS uses math error and document matching techniques as much as possible for likely areas of unintentional noncompliance. By their very nature, these programs address relatively simple compliance issues. Examination contact is reserved for more complex and/or less detectable noncompliance.

Examination Data

Table 1 shows the majority of IRS's taxpayer contact originates from the three non-Examination programs. However, the FTE allocation data (bottom panel of Table 1) show the majority of IRS resources are devoted to the Examination program. Excluding the Math Error program, roughly 90 percent of the FTEs associated with the remaining three compliance programs belonged to Examination throughout the FY 1996 – 2002 period, despite declining Examination coverage rates. The main reason for this is Examination's relatively high labor-intensity. Unlike the three other programs, Examination activity cannot rely mainly on automated methods. IRS can use automation to identify returns that should be examined, but actual detection of most noncompliant activity can be made only through one-on-one Examination contact with the taxpayer and other examiner actions.

Given the magnitude of Examination's resource requirements, IRS tracks data associated with this program in more detail than for the other programs. Tables 5 through 8 present historical data on Examination activity for FYs 1996 to 2002. Most of these data come from IRS's Audit Information Management System (AIMS) database. These tables present activity on closed Examination cases by major tax return type, taxpaying entity type (e.g., individual, corporate, trust), and income or asset level (i.e., by IRS Examination class) by year. The data also are broken out by three types of examinations: correspondence, field, and office. Field and office examinations involve face-to-face interaction with the taxpaying entity or representative. Field examinations typically are conducted at the taxpayer's home or place of business, whereas office examinations are conducted in IRS offices. Both field and office examinations may require examination of books and records, may be extensive in scope, and employ higher graded IRS staff. Correspondence examinations are done through the mail, generally can be completed in a few hours by the examiner, are limited in scope to a few issues, and can be completed by lower graded staff. Table 4 presents calendar year tax return filing volumes, and serves as the basis for coverage rate computations.

Tables 5 and 6 present Examination contact volumes and contact rates, respectively, with and without Earned Income Tax Credit (EITC) enforcement activity. Table 7 presents the FTEs used to work the various Examination classes. Because the EITC program has somewhat different characteristics from typical tax administration activities, and is funded by a separate Congressional appropriation, the EITC data are displayed separately in Tables 8a – 8d.

Examination Trends

Since FY 1996, Examination activity has dropped substantially. The count of examinations fell 62 percent, from over 2.1 million closed in FY 1996 to 824,000 in FY 2002 (Table 5a). Excluding EITC examinations,[2] there were 446,000 examinations

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[2] Congress funds compliance activities on tax returns claiming the Earned Income Tax Credit through a separate appropriation. Therefore, this report presents Examination data for total contacts and examinations excluding EITC. The exclusion of EITC allows the reader to see changes in the general examination program.

closed in FY 2002, or 34 percent of the comparable FY 1996 figure of 1.3 million closures (Table 5e).

The largest drop in Examination closures for a single Examination Class from FY 1996 to FY 2002 occurs for Form 1040A and 1040EZ individual returns (i.e., relatively simple returns) with total positive income under $25,000[3]. Examinations for these returns fell from 922,000 in FY 1996 to 286,000 closed in FY 2002 (Table 5a). This FY 2002 volume is 31 percent of the number in FY 1996. After removing EITC counts, this return type shows an even larger percentage drop. The 38,000 closed Examination cases in FY 2002 are just 11 percent of the 361,000 FY 1996 closures (Table 5e).

The main reason for the large decline in these closures is the overall drop in Examination resources. Table 7a shows that FTEs devoted to the Form 1040A and 1040EZ individual returns with income under $25,000 dropped from 1,154 in FY 1996 to 551 in FY 2002.

We cannot calculate annual Examination coverage rates precisely because the examinations closed in a particular year are not always associated with returns filed in the same tax year. As a proxy, we compute Examination coverage rates, as presented in Tables 6a and 6b, by the following ratio:

(# of examinations closed in FY X) / (# of returns filed in CY X-1)

or, for example,

(# of Gift Tax examinations closed in FY2002) / (# of Gift Tax returns filed in CY2001).

The rationale for using a one-year lag is that, in general, it takes one year after a return is filed and processed before the IRS can identify it for examination, conduct the examination, and close the Examination case. This cycle time, however, may be shorter or longer depending on the return type and the particular case. (Note, the coverage rates for Math Error, Underreporter, and ASFR, as reported in Tables 1 and 2 are computed using different lags, as described in those table notes.)

The Examination coverage rate, consistently calculated in this manner, dropped from 1.37 percent in FY 1996 to 0.48 percent in FY 2002 for all returns (Table 6a). Excluding EITC (Table 6b), the coverage rate declined from 0.83 percent in 1996 to 0.26 percent in FY 2002. The simpler Form 1040A and 1040EZ return individual taxpayers with income under $25,000 showed the largest decline in coverage rates. For these taxpayers, the coverage rate dropped from 0.79 percent in FY 1996 to 0.09 percent in FY 2002, a coverage rate of just over 12 percent of what it was six years earlier. The other individual return Examination classes experienced fairly uniform rate declines. In FY 2002, they were all roughly 25 to 35 percent of their level in FY 1996.

[3] Total Positive Income (TPI) is, in general, the sum of all positive amounts shown for various sources of income reported on the individual income tax return, and, thus, excludes net losses. For example, it includes “business or professional net income,” but not “business or professional net loss.”

Corporations in total experienced declines in coverage rates, as well. Interestingly, the number of examinations closed for corporations with assets over $100 million declined between FY 1996 and FY 2000. However, beginning in FY 2001, the number of examinations closed increased dramatically. While overall coverage rates decreased approximately one percentage point between FY1996 and FY 2002, approximately 2,100 more cases were closed in FY 2002 than in FY 1996. For the classes with assets under $10 million, Examination coverage is less than half of what it was in FY 1996. The Examination activity for estate tax returns also shows declines, with larger absolute drops in the higher dollar returns and larger percentage drops in the lower dollar returns. These declines reflect both a decline in and reallocation of IRS resources.

Assessing the Fairness of IRS Compliance Activities

The mission of the Internal Revenue Service is to "provide America's taxpayers top-quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all." The Congressional mandate for this report directs IRS to analyze the fairness with which the IRS implements its compliance efforts.

Each of the IRS's compliance activities supports that mission on an individual basis and in total. One reason the Service uses a variety of enforcement activities is to improve compliance at the lowest possible cost and least burden to taxpayers. From a fairness perspective, the different options help ensure that the Service uses the least intrusive means to identify the correct tax liability. Therefore, to the extent that the IRS uses Math Error authority, Automated Substitute for Return, Automated Underreporter, or correspondence audits to identify and correct reporting compliance issues, scarce field Examination resources are conserved for potentially more complex cases. In other words, if the Service did not use a variety of programs to identify and address potential reporting compliance issues, there would be fewer compliance contacts. Furthermore, for those taxpayers contacted, the probability would increase that they would be subjected to an inappropriate level of treatment.

There is no universally agreed upon standard of fairness for identifying returns for examination. But most would agree that selection methods should be based on some objective criteria that do not arbitrarily single out particular individuals or groups, except by reference to taxpayer behavior. As will be explained in this section, the IRS broadly meets that standard by selecting returns with a view towards identifying the least compliant taxpayers and promoting voluntary compliance. Ideally, selections should be based on recent data, and the potential burden on compliant taxpayers should be factored into the selection process.

Each of the programs relies, to varying degrees, on computer automation to identify workload. In the case of the Math Error program, arithmetic errors and certain types of mismatches of taxpayer information are identified as returns are processed. By definition, the IRS checks all returns for math error, and all identified math errors result in taxpayer contact.

The Underreporter program also relies on computer automation. It matches information reported on taxpayer returns with payer information reported on information returns such as Forms W-2 and 1099. This match occurs well after the filing season and encompasses the total population of individual tax returns and information returns. Where mismatches occur, tax examiners manually screen the cases to determine whether there really is a problem. Here, IRS resource constraints do limit the number of taxpayer contacts. Cases are grouped according to the type of mismatch and potential tax change. The groups with the highest potential change are worked first. However, the program does not discriminate between potential refund and potential balance due cases. A potential refund of $100 is weighted identically to a potential tax assessment of $100. The goal is to ensure, in a cost-effective way, that taxpayers pay the proper amount of tax.

The Automated Substitute for Return program uses automated systems to work cases from IRS's national inventory of identified nonfilers. The program generates letters to the taxpayer giving notice of their filing requirement. Based on resource availability, the ASFR program can print and mail a second round of letters advising the taxpayer that the IRS will generate a return and liability assessment. The IRS prioritizes these cases using a set of rules incorporated in the automated system. Many other aspects of the subsequent contact with the taxpayer, however, may require non-automated IRS resources. Therefore, the total number of taxpayer contacts under ASFR is determined by the amount of resources devoted to the program.

While processing tax returns, the IRS assigns each to an Examination class based on income, receipts, or asset size and certain other return characteristics. All individual returns and returns in the smaller corporation classes receive a discriminant function (DIF) score as well.[4] The formulas that generate the DIF score differ by Examination class and indicate the likelihood of significant tax change. In general, returns with high DIF scores have a higher likelihood of significant noncompliance than returns with low DIF scores. However, a high DIF score does not always mean that there is a reporting compliance issue with the return. Therefore, the Service uses experienced examiners to classify returns with relatively high DIF scores to determine whether there are potential compliance issues with the returns. In the Examination program, the Service attempts to ensure fairness by subjecting all returns to the same set of formulas used to identify returns with a high likelihood of significant noncompliance.

Examination also uses outside (non-IRS) sources of information to identify potential noncompliance. These sources may include newspapers, public records, and information from other individuals. The use of outside sources of information is particularly useful in identifying emerging compliance issues.

[4] The DIF (i.e., discriminant function) scores currently used by IRS were developed based on the results of the Taxpayer Compliance Measurement Program (TCMP). The last TCMP conducted by the IRS was for Tax Year 1988 and covered individual taxpayers. The Service currently is conducting the National Research Program to generate data similar to the data collected under TCMP. New workload selection formulas for examination will be developed following the completion of the current NRP reporting compliance study. In addition to the DIF scores, the Service recently implemented workload selection formulas for larger corporations. In FY03, IRS used UI-DIF scores to identify returns with a high likelihood of significant unreported income.

The IRS makes best use of its resources by Examination assignment -- correspondence examinations for relatively simple issues, office and field for the more complex. The goal is to resolve the potential reporting compliance problem using the least intrusive and least costly method where possible.

The Examination program also has a role in fostering voluntary compliance among taxpayers by ensuring at least some coverage across all Examination classes. If selection for Examination were based strictly on maximizing potential direct enforcement revenue relative to the cost of conducting examinations, it is conceivable that taxpayers in some classes would never be subject to examination of their returns. Therefore, the Examination program seeks to maintain a minimum level of coverage in each Examination class, while allocating more Examination resources to classes where non-compliance is believed to be highest.

The data for FY 1996 to FY 2002 reflect this management approach. Each of the Examination classes in Table 6a has some level of coverage. In general, coverage rates increase as income increases. That trend is masked in Table 6a in part by the inclusion of EITC returns. Due to concerns about compliance by EITC claimants, Congress has established a separate appropriation for IRS's EITC work. Therefore, the Examination rates in the lower income classes reflect that resource decision. Table 6b provides the coverage rates for the Examination program excluding audits made under the EITC program. Excluding EITC returns, high-income classes have higher Examination rates than lower income classes.

National Research Program
The National Research Program (NRP) represents a comprehensive effort to measure taxpayers' voluntary compliance with the tax law and develop updated return selection formulas that identify returns likely to be noncompliant. NRP will provide strategic measures of payment compliance, filing compliance, and reporting compliance. It will aid IRS in its pursuit of fairness and efficiency in tax compliance administration. The first phase of the reporting compliance portion of NRP is data collection and compliance measurement in the individual income tax return area. It involves an analysis of a random sample of income tax returns, and enlists the efforts of both IRS research and Examination personnel. IRS began planning and designing this study in FY 2000. The project is in the process of analyzing approximately 49,000 randomly selected individual income tax returns from tax year 2001 for identification of potential compliance issues. In an effort to reduce the burden on taxpayers selected in the sample, the IRS will classify the sample of returns into separate groups to receive varying levels of attention. About 39,000 returns will require field or office examination. The remainder either will be accepted as filed or handled through a correspondence audit of selected issues. The examinations began in FY 2003, and will continue into FY 2004.

This ongoing reporting compliance study has the following four major objectives.

1) Improve IRS's ability to detect noncompliance and develop appropriate cost-effective treatments for prevention and early intervention.

2) Update deteriorating Examination workload selection formulas. In recent years, the percentage of individual return audits closed with no tax change rose from 19.3 percent in 1994, to 24.4 percent in 1998. The increased "no change" rate means the IRS now devotes more resources to unproductive examinations and that compliant taxpayers are being burdened unnecessarily.

3) Provide IRS with results to develop customer-focused programs. The study will collect data to provide insight into the causes of reporting errors and improve customer service. If examinations turn up systemic compliance errors on particular items for otherwise compliant taxpayers, the IRS may be able to address the source of these errors through redesigned forms, better communications, improved taxpayer education, or perhaps through recommendations for legislative change.

4) Measure compliance. The study will provide data to update IRS estimates of the tax gap. Reporting noncompliance among individuals is the largest contributor to the tax gap. Misreporting of individual income tax is believed to account for over 40 percent of the total estimated $280 billion tax gap for tax year 1998.

Table 10 details the costs related to the first phase of NRP, from planning and design through implementation of examinations. These costs are divided further by the four main IRS organizations involved. In the aggregate, the study will cost an estimated $120 million. The largest single cost component is Examination staff resources. For FYs 2003 and 2004, the IRS plans to use about 1,200 FTEs from its Small Business/Self Employed operating division to perform the face-to-face NRP examinations. These resources will cost an estimated $90.1 million.

While these costs are not insignificant, the bulk of them would have been spent in a similar way regardless of whether the IRS implemented the NRP study. The largest costs -- those associated with examining returns -- would remain, as IRS examiners simply would have focused on other returns. The marginal costs of this study -- those that the IRS incurred by implementing the NRP -- include those associated with the NRP program office, IRS's Detroit Computing Center, and special field training for NRP examinations. These costs total an estimated $24.5 million.

Final but equally important aspects of the NRP program costs are the opportunity costs associated with the study. The IRS is foregoing revenues that would have been collected as a result of operational examinations by diverting resources to NRP examinations. In previous reporting compliance studies, the opportunity costs vastly outweighed the direct costs of the study. Approximately half of the cases in previous studies resulted in no change to the reported tax due to the random nature of the research sample. NRP has tried to reduce the lost revenue associated with the study. While the NRP sample is a random one, case-building (which provides extra taxpayer information that might allow the IRS to determine compliance) and classification processes eliminate some of cases from face-to-face audits. We expect approximately 5,000 "accepted as filed" returns in the sample that will require no work on the part of IRS examiners. The long interval between the current NRP study and the last reporting compliance study also works to reduce the opportunity costs of NRP. The no-change rate of NRP examinations should be much closer to that of current operational audits. The benefits of the reporting compliance information this study will produce should more than offset the costs.

Planning for the next NRP study is underway, even as the IRS is conducting the individual income tax return reporting compliance study. There are several other areas where the IRS needs to be concerned regarding reporting compliance. It has been nearly 20 years since the IRS examined reporting compliance for most businesses, and the populations of business returns have grown dramatically in these years. However, the resources available to perform these examinations have declined precipitously. As Table 7a shows, Examination FTEs have fallen from 16,515 in FY 1996 to 13,310 in FY 2002. The situation is not expected to improve in the short-term, as more experienced examiners exercise their retirement options. The expected decline in Examination staffing has significant implications for the next NRP study, as well as for regular operations. Two likely candidates for the next NRP study are flow-through entities (partnerships and Subchapter S corporations) and employment taxes. Current research on flow-through entities has revealed some extremely intricate relationships among partnership returns, corporate returns, and individual returns. These linkages can be associated with tax evasion strategies. Examining partnership returns alone, therefore, may not yield sufficient data to address the compliance questions at hand. In fact, the best approach may be to combine all related returns as a single economic entity and consider the accuracy of all returns within the economic entity. Employment taxes raise equally vexing questions, the largest being distinguishing between employees and independent contractors.

The IRS currently is considering which areas will be studied next, and is working to integrate the next study into its strategic planning process. The IRS recognizes Congress's desire to move forward with a research effort concentrating on business returns; and the Service will start a pilot study in FY 2004.

The House Committee on Appropriations expressed its desire for the IRS to accelerate the NRP to obtain more quickly critical information on all categories of tax filers. Although the next NRP study is still under discussion, IRS is focusing its resources by developing strategies to deal with emerging trends in noncompliance. In particular, IRS has developed strategies or initiatives for the following "high-risk" areas:

Promoter Investigations
The IRS has developed an initiative to identify and investigate individuals, promoters, or return preparers who sell or distribute any plan, arrangement, or transaction designed or structured for the purpose of circumventing tax laws or evading tax obligations.

Abusive Offshore Financial Transactions
This initiative is aimed at bringing back into compliance with tax laws those taxpayers who use "offshore" payment cards or other offshore financial arrangements to mask or shelter their income.

Abusive Tax Avoidance Transactions
This program is designed to bring taxpayers, who have used an abusive scheme to circumvent tax laws or evade tax obligations, back into compliance.

High Income Taxpayers (Total Positive Income Greater than $1million)
This initiative is directed at taxpayers with TPI greater than $1 million who are involved in structured financial transactions in order to lower their taxable income.

Unreported Income Discriminant Function (UI-DIF)
Formulas to score returns with a high likelihood of significant unreported income were developed. The IRS is using these scores to identify self-employed taxpayers with potential unreported income, particularly those taxpayers with total gross receipts of $100,000 or more and who file Schedules C or F.

High Income Non-Filers (Income over $100,000)
This initiative focuses on taxpayers with information reporting program income of $100,000 or more in one year who have not filed a tax return.

Recurring Noncompliant Taxpayers
Currently, the IRS does not have a comprehensive study on noncompliant taxpayer recidivism. However, the IRS does focus attention on particular taxpayer market segments that display higher than average noncompliance in a consistent way.

As part of the Service's reorganization, each operating division contains an embedded research unit. These units were charged, in part, to research compliance issues germane to the taxpayer segments served by their operating division. Each operating division has recurring, noncompliant taxpayers that have been, or are in the process of being, studied. Following are a few examples of research studies focused on these taxpayers. The *High-Income Repeat IMF Nonfiler Compliance Study Research Plan* (Small Business and Self-Employed Research, Dallas/New Orleans/Oklahoma City, 2003) is a current research proposal to investigate the causes and possible remedies to taxpayer segments that consistently fail to file their individual income tax returns. The IRS uses the results of these and other research efforts to target its compliance activities.

Somewhat related to habitual noncompliance is research focused on IRS's accounts receivable dollar inventory. The *Profiling Report for National Taxpayer Repeater Market Segment* (Nashville/Jacksonville/Seattle Research, 1997) found the individual return Schedule C filers market segment to be a major contributor to IRS's taxpayer delinquent accounts with high repeat rates. More recently, the *Accounts Receivable Dollar Inventory – Balance Due After Remittance Taxpayer* report (Wage & Investment Research Area 3, 2001) investigated similar issues on IRS accounts receivable.

Conclusion

The data presented in this report show how IRS allocates its resources to promote reporting compliance. One thing is certain. Whether we include or exclude EITC taxpayer contacts from the analysis, we have seen compliance contacts dropping. In FY 1996, IRS made 9.6 million contacts with taxpayers. By FY 2001, that number had dropped to 8.4 million. (The spike in FY 2002 is an aberration due to taxpayer confusion with the Advance Payment of the Rate Reduction Credit, as discussed earlier in this paper.) Examination, Underreporter, and Automated Substitute for Return program contacts all have declined over the period. Contact coverage rates also have declined significantly for these three programs. In FY 2002, IRS staffing (as measured by FTEs) is down almost 20 percent from FY 1996 for the Examination and ASFR programs. For the Underreporter program, staffing grew by approximately 9 percent over the FY 1996 levels, slightly less than the 10 percent growth in individual income tax return filings.

This deterioration in coverage can have long-term ramifications for our tax system. We must consider the effects beyond the revenues collected as a direct result of the contacts, in particular the long-term impacts on taxpayers' voluntary reporting compliance. For example, a 1996 study shows the IRS needs to maintain its investment in the Examination program to maintain voluntary compliance levels.[5] Other studies also demonstrate Examination presence has substantial indirect effects on voluntary compliance.[6] Because indirect effects from IRS enforcement play a key role in our voluntary tax compliance system, this system will be put at risk as taxpayers perceive an inability to enforce compliance.

Despite limited resources and coverage, the IRS continues striving for fairness and efficiency in its administration of the tax system. The Service attempts to adjust its resource allocation in response to the changing composition of the taxpayer population and changing marginal costs of program implementation. The Service also attempts to balance cost-effectiveness with respect to enforcement revenue with the need to foster voluntary compliance. In all these ways, the IRS seeks to fulfill its mission statement, to "provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all."

[5] *The Determinants on Individual Income Tax Compliance: Estimating the Impact of Tax Policy, Enforcement, and IRS Responsiveness*, Publication 1916 (Rev. 11-96).

[6] Dubin, Jeffrey A., Michael J. Graetz and Louis L. Wilde. *Effect of Audit Rates on the Federal Individual Income Tax, 1977 – 1996*, National Tax Journal 43(4), 1990: 395-409.
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