TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

The IRS Has Made Limited Progress Developing the Methodology to Comply With the Treasury Directive to Not Increase the Audit Rate for Taxpayers With Incomes Below $400,000 Due to Planning and Implementation Challenges

August 26, 2024

Report Number: 2024-308-043

Why TIGTA Did This Audit

The Inflation Reduction Act of 2022 (IRA) provided almost $80 billion to the IRS over a decade, with $45.6 billion towards enforcement activities. Through multiple subsequent recissions, these amounts were reduced to $57.8 billion and $24 billion, respectively.

In August 2022, the Secretary of the Treasury issued a memorandum (2022 Treasury Directive) to the IRS Commissioner directing the IRS not to use any additional resources to increase audits on small business or households earning below $400,000 per year. The overall objective of this audit was to review the IRS's methodology for ensuring that IRA funds are not used to increase the percentage of audits of taxpayers with incomes below $400,000.

Impact on Tax Administration

As noted by the Secretary of the Treasury in the 2022 Treasury Directive to the IRS Commissioner, *"enforcement resources will focus on high-end noncompliance. There, sustained, multiyear funding is so critical to the agency's ability to make the investments needed to pursue a robust attack on the tax gap by targeting crucial challenges, like large corporations, high-net-worth individuals, and complex pass-throughs, where today the IRS has resources to initiate just 7,500 audits annually out of more than 4 million returns received."* The $24 billion of IRA funds allocated to enforcement activities is intended in part to increase examinations of high-income taxpayers.

What TIGTA Found

To comply with the 2022 Treasury Directive, the IRS and the Department of the Treasury (hereafter referred to as the Treasury Department) must establish a base year upon which to compare future compliance with the Directive. Although the IRS and the Treasury Department chose Tax Year 2018 for the base year, the IRS has yet to calculate the audit coverage for Tax Year 2018 because it has not finalized its methodology for the audit coverage calculation. While the IRS routinely calculates audit coverage rates, the IRS and the Treasury Department have been exploring a range of options to develop a different methodology for purposes of determining compliance with the Directive.

The IRS initially proposed excluding certain types of examinations when computing the audit coverage rate and an authority to "waive" certain other examinations from the calculation if taxpayers appeared to have intentionally understated income to avoid the $400,000 threshold. During the audit, TIGTA expressed concerns that the waiver criteria had not been clearly articulated and that such a broad authority may erode trust in the IRS's compliance with the Directive. In May 2024, the IRS concluded that excluding types of examinations from the calculation of the base and comparison year audit rates has the potential to undermine the Directive, and it abandoned the concept of exclusions and waiver authority.

The IRS is not currently considering the potential of a marriage penalty that would subject married couples filing jointly with a combined total positive income of $400,000 to the same audit risk as an individual taxpayer with a total positive income of $400,000. When asked if this would be unfair to those married taxpayers, the IRS stated that the 2022 Treasury Directive made no distinction between married filing jointly and single households, so neither will the IRS.

The IRS stated that any deliberations to date should not be considered as definitive determinations until such time as the methodology is finalized. Before any decisions are made as to how the audit coverage rate will be calculated, the IRS and the Treasury Department would need to come to an agreement. However, the IRS has not maintained formal documentation on its decisions and processes to clearly document all exchanges of information and other significant events pertaining to the 2022 Treasury Directive.

What TIGTA Recommended

TIGTA made four recommendations. The IRS agreed to reach agreement with the Treasury Department and to document the development of the methodology. The IRS disagreed to use Return Transaction File data to produce counts of filing data on the threshold and instead will rely on Statistics of Income sampling data. After verifying the data field TIGTA identified, the IRS agreed to establish procedures and controls to update total positive income.

TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

U.S. DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20024

August 26, 2024

MEMORANDUM FOR: COMMISSIONER OF INTERNAL REVENUE

FROM: Danny R. Verneuille
Acting Deputy Inspector General for Audit

SUBJECT: Final Audit Report – The IRS Has Made Limited Progress Developing the Methodology to Comply With the Treasury Directive to Not Increase the Audit Rate for Taxpayers With Incomes Below $400,000 Due to Planning and Implementation Challenges (Audit No.: 2024308010)

This report presents the results of our review of the Internal Revenue Service's methodology for ensuring that Inflation Reduction Act of 2022[1] funds are not used to increase the percentage of audits of taxpayers with incomes below $400,000 and are instead used for examinations of taxpayers at or above this income threshold. This review is part of our Fiscal Year 2024 Annual Audit Plan and addresses the major management and performance challenges of *Tax Law Changes* and *Tax Compliance and Enforcement*.

Management's complete response to the draft report is included as Appendix III. If you have any questions, please contact me or Frank J. O'Connor, Acting Assistant Inspector General for Audit (Compliance and Enforcement Operations).

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[1] IRA § 10301, Pub. L. No. 117-169, 136 Stat. 1818.

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Background

On August 16, 2022, the Inflation Reduction Act of 2022 (IRA) was enacted, providing almost $80 billion (in addition to other funds made available) to the Internal Revenue Service (IRS) over a decade, including $45.6 billion for enforcement activities.[1] Through multiple subsequent recissions, these amounts were reduced to $57.8 billion and $24 billion, respectively.[2] The $24 billion of IRA funds allocated to enforcement activities is intended in part to increase examinations of high-income taxpayers.

On August 10, 2022, the Secretary of the Treasury (hereafter referred to as the Treasury Secretary) issued a memorandum (hereafter referred to as the 2022 Treasury Directive) to the IRS Commissioner directing the IRS not to use any additional resources to increase audits on small business or households earning below $400,000 per year. As the Treasury Secretary wrote to the then IRS Commissioner in the 2022 Treasury Directive, IRA enforcement funding was intended in part to increase examinations of high-income taxpayers. The Treasury Secretary stated:

> *The Inflation Reduction Act includes much-needed funding for the IRS to improve taxpayer service, modernize outdated technological infrastructure, and increase equity in the tax system by enforcing the tax laws against those high-earners, large corporations, and complex partnerships who today do not pay what they owe.*
>
> *Specifically, I direct that any additional resources—including any new personnel or auditors that are hired—shall not be used to increase the share of small business or households below the $400,000 threshold that are audited relative to historical levels. This means that, contrary to the misinformation from opponents of this legislation, small business or households earning $400,000 per year or less will not see an increase in the chances that they are audited.*
>
> *Instead, enforcement resources will focus on high-end noncompliance. There, sustained, multiyear funding is so critical to the agency's ability to make the investments needed to pursue a robust attack on the tax gap by targeting crucial challenges, like large corporations, high-net-worth individuals and complex pass-throughs, where today the IRS has resources to initiate just 7,500 audits annually out of more than 4 million returns received.*[3]

The Treasury Secretary reiterated the 2022 Treasury Directive in a March 2023 appearance before the Senate Finance Committee. The Treasury Secretary's testimony included the following statement: "The President and I have committed that there will be no increase in audit

[1] IRA § 10301, Pub. L. No. 117-169, 136 Stat. 1818.

[2] Fiscal Responsibility Act of 2023 § 251, Pub. L. No. 118-5, 137 Stat. 18, and Further Consolidated Appropriations Act, 2024 §§ 530 and 640, Pub. L. No. 118-47.

[3] See Appendix II for Correspondence, Secretary of the Treasury Janet Yellen to IRS Commissioner Charles Rettig. (Aug. 10, 2022).

rates on individuals or small businesses under $400,000. And I stand by that pledge, and I've issued a directive to IRS to that effect."[4]

Prior Treasury Inspector General for Tax Administration (TIGTA) reports on the IRS's compliance efforts with respect to high-income taxpayers

TIGTA has issued reports that address the IRS's challenge of using enforcement resources to more effectively focus on taxpayers who have the means to employ tax avoidance strategies. For example:

- In Fiscal Year (FY) 2015, we encouraged the IRS to increase its definition of high-income taxpayers from the $200,000 threshold that has existed since the 1970s.[5] While the IRS agreed to consider the issue, in FY 2017, it concluded that no changes should be made to the income threshold due, in part, to the significant costs and resource requirements that would go into increasing it. Also, the IRS stated that Congress still required it to report on taxpayers with total positive income (TPI) greater than $200,000.[6]
- In FY 2019, TIGTA reported that the formula for selecting high-risk returns in the Small Business/Self-Employed (SB/SE) Division more often than not resulted in higher scored returns having smaller adjustments than lower risk scored tax returns.[7]
- In FY 2020, TIGTA reported that the IRS had a lack of focus on high-income taxpayers who had not filed tax returns, with hundreds of thousands of high-income nonfilers not being pursued.[8]
- In FY 2021, TIGTA reported that the IRS's SB/SE Division terminated its High-Income Examination Initiative and made recommendations that the IRS should better track the results of high-income audits it performs.[9]
- In FY 2023, the IRS again disagreed with TIGTA's recommendation to increase the IRS's definition of high-income taxpayers from $200,000 to at least $400,000, *i.e.*, the threshold used by the Treasury Secretary in the 2022 Treasury Directive.[10]
- In FY 2024, TIGTA reported that the IRS had terminated its efforts to comply with a 2020 Treasury Directive by the previous Treasury Secretary that directed the IRS to audit at least 8 percent of taxpayers with incomes of $10 million or above because the audits

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[4] *The President's Fiscal Year 2024 Budget, Hearing Before the Sen. Fin. Comm.*, 118th Cong. (2023) (testimony of the Secretary of the Department of Treasury).

[5] TIGTA, Report No. 2015-30-078, *Improvements Are Needed in Resource Allocation and Management Controls for Audits of High-Income Taxpayers* (Sept. 2015).

[6] The IRS uses TPI when selecting returns for examination on specific income levels. TPI is the sum of all positive amounts shown for the various sources of income reported on the individual tax return and, therefore, excludes losses.

[7] TIGTA, Report No. 2019-30-024, *Improvements in Return Scoring and Resource Allocation at the Strategic Level Could Enhance Examination Productivity* (Apr. 2019).

[8] TIGTA, Report No. 2020-30-015, *High-Income Nonfilers Owing Billions of Dollars Are Not Being Worked by the Internal Revenue Service* (May 2020).

[9] TIGTA, Report No. 2021-30-041, *The IRS Continued Compliance Efforts for High-Income Taxpayers After Disbanding the High Income High Wealth Strategy, but With Less Effective Outcomes* (July 2021).

[10] TIGTA, Report No. 2023-30-054, *The IRS Needs to Leverage the Most Effective Training for Revenue Agents Examining High-Income Taxpayers* (Aug. 2023).

were unproductive and had high no-change rates.[11] However, TIGTA found that many of SB/SE Division examinations with incomes of $10 million or more were more productive that those in the $400,000 to $999,999 income range. On the other hand, Large Business and International Division case selection methods in place prior to the 2020 Treasury Directive resulted in better productivity metrics when compared to post-Treasury Directive results. For example, the no-change rate increased when comparing pre-directive tax years (Tax Years (TY) 2016 through 2017) to post-directive tax years (TYs 2018 through 2020).

These reports showed some of the difficult challenges the IRS faces when focusing on enforcement of high-income taxpayers. Implementation of the 2022 Treasury Directive may prove to be even more complex and difficult for the IRS to achieve.

Results of Review

The IRS Has Not Finalized a Methodology for Calculating the Audit Coverage Rate for the Base Year

To comply with the 2022 Treasury Directive, the IRS and the Department of the Treasury (hereafter referred to as the Treasury Department) must establish a historical, or "base year," audit rate for taxpayers with incomes under $400,000; however, the IRS and the Treasury Department have yet to finalize the methodology for calculating the base year audit rate.

In April 2023, the IRS Commissioner testified at a House Ways and Means Committee Hearing that the audit coverage rate the IRS will use to meet the 2022 Treasury Directive will be the same as the historical audit coverage rate from TY 2018.[12] This will be the "base year" that the IRS and the Treasury Department will use to compare future audits conducted with IRA funding. We were advised that the IRS selected TY 2018 because it is the most recent tax year outside of the normal statute periods.[13]

As of May 2024, the IRS and the Treasury Department have not finalized the methodology to calculate the TY 2018 audit coverage rate for tax returns with TPI under $400,000. The primary reason that the TY 2018 audit coverage rate has not been calculated is that the IRS and the Treasury Department have been exploring a range of options to develop a different methodology for purposes of determining compliance with the 2022 Treasury Directive. For example, decisions on how to calculate the audit rate for purposes of satisfying the 2022 Treasury Directive have not been finalized. The audit coverage rate for purposes of compliance with the 2022 Treasury Directive will not be calculated in the same way that the IRS calculates that statistic as part of its annual Statistics of Income (SOI) published every year. The IRS

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[11] TIGTA, Report No. 2024-300-028, *The IRS Ceased Compliance With the $10 Million Taxpayer Treasury Directive in Favor of an Overall Focus on High-Income Taxpayer Noncompliance* (June 2024).

[12] *Hearing with Commissioner of the IRS, Daniel Werfel, Before the H. Comm. on Ways and Means,* 118th Cong. (2024).

[13] Generally, the assessment statute expiration date is three years after the return was due, or six years if the income on the return was understated by 25 percent or more, and there is no statutory limit if a tax return was filed with the intent to commit fraud. Internal Revenue Code § 6501(a).

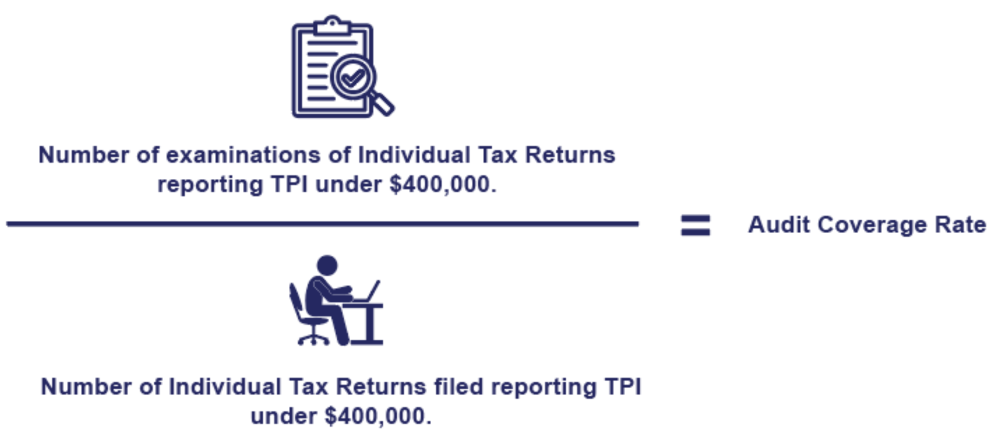
proposed removing certain classifications of examinations from the calculations for reasons that we subsequently discuss. According to the IRS, finalizing the methodology and calculation of the audit coverage rate for the base year has not been a pressing issue in FY 2024 because the examinations of TY 2023 returns (the first year of comparision) have yet to begin; however, the IRS's indecision has impacted development of the FY 2024 Examination Plan, which still has not been finalized.

Potential exclusions and an authority to "waive" certain types of examinations from the audit rate calculation were considered and rejected

The IRS has significant experience calculating audit coverage rates. Every year the IRS calculates audit coverage rates among different income categories in its SOI Data Book. For example, for TY 2018, the IRS published audit rates for taxpayers under $500,000. For taxpayers with TPI from $25,000 to less than $50,000, the IRS had an audit coverage rate of 0.3 percent, and for taxpayers with TPI from $200,000 to less than $500,000, the IRS also had an audit coverage rate of 0.3 percent.

IRS officials stated that they are not following their standard approach to calculate audit coverage because they want to have the flexibility to audit taxpayers who might be incentivized to take advantage of higher audit rates of taxpayers with TPI at or above $400,000 by reporting incomes below that amount. Additionally, the IRS wants to be able to maintain certain audit practices that make for efficient and effective tax administration without being constrained by the 2022 Treasury Directive.

Generally, the audit coverage rate is defined as the degree to which a certain type of tax return is audited compared to a total population of that type of tax return. To calculate the audit coverage rate, the number of tax returns audited (numerator) would be divided by the total population of returns (denominator). The basic formula the IRS is using for purposes of compliance with the 2022 Treasury Directive is the same as the SOI uses when computing audit coverage rates for its annual Data Book calculations and is as illustrated below:



Initially, the IRS proposed excluding certain types of compliance activities from the formula (both in the numerator and the denominator) for purposes of complying with the 2022 Treasury Directive. The proposed exclusions represented specific types of examinations that the IRS wanted to exclude from the 2022 Treasury Directive; meaning, these types of examinations would not be included in the calculation of the base year audit rate, nor will they be included in the comparison years. For example, IRS officials proposed excluding examinations of amended returns with refund claims because these examinations are not "discretionary," *i.e.*, the IRS cannot plan for the number of refund claims that require examination under IRS examination standards. However, because excluding types of examinations from the calculation of the base year and comparison year audit rates has the potential to undermine the 2022 Treasury Directive, in May 2024, the IRS abandoned the concept of exclusions.

The IRS also initially proposed an authority to waive certain other examinations from the calculation if taxpayers appeared to have intentionally understated income to avoid the $400,000 threshold. During the course of the audit, we raised concerns about the breadth of the IRS's proposed waiver concept. We were concerned that the proposed waiver authority would allow the IRS too much discretion to waive examinations that are under the $400,000 threshold, essentially permitting the IRS to say, "we'll know what constitutes a waiver when we see it." We were concerned that waiver criteria had not been clearly articulated and that type of broad authority could erode trust in the IRS's statements about compliance with the 2022 Treasury Directive. As of May 2024, the IRS also abandoned the concept of a waiver authority. The IRS stated that any deliberations to date should not be considered as definitive determinations until such time as the methodology is finalized.

Potential marriage penalty is not yet being considered

There are many treatises which have discussed what some have called the "marriage penalty" in the Internal Revenue Code that typically refers to tax brackets that appear to penalize dual income spouses.[14] In other contexts, the Code seeks to maintain equity for joint spouses. For example, the modified adjusted gross income for purposes of the phaseout of the child tax credit is $75,000 for single taxpayers and $150,000 for taxpayers filing jointly.[15]

While there are many items that were considered as exclusions or waivers for the audit coverage rate, one concept that is currently not under consideration by the IRS is a potential marriage penalty with regard to the under $400,000 TPI threshold. Specifically, whether the under $400,000 TPI threshold would apply, regardless of filing status. There will be households of married couples when TPI combined will exceed the under $400,000 threshold but not when determined for each individual. The potential marriage penalty exists because the threshold for married couple households is not double the amount allowed for single filer households, *i.e.*, for married couples filing jointly the TPI threshold does not increase to $800,000, thus increasing their chances of an examination.

When asked if this would be unfair to those married taxpayers, the IRS stated that the 2022 Treasury Directive made no distinction between married filing jointly and single households, so neither will the IRS. Further, the IRS mentioned that it would be best to keep the threshold at $400,000 regardless of filing status to make it easier for the IRS to monitor progress moving forward. As previously stated, the IRS indicated that any deliberations to date should not be considered as definitive determinations until such time as the methodology is finalized.

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[14] Rynar, Margaret, *A Practical Solution to the Marriage Penalty*, 44 Pepperdine L. Rev. 647, 651 (2017).

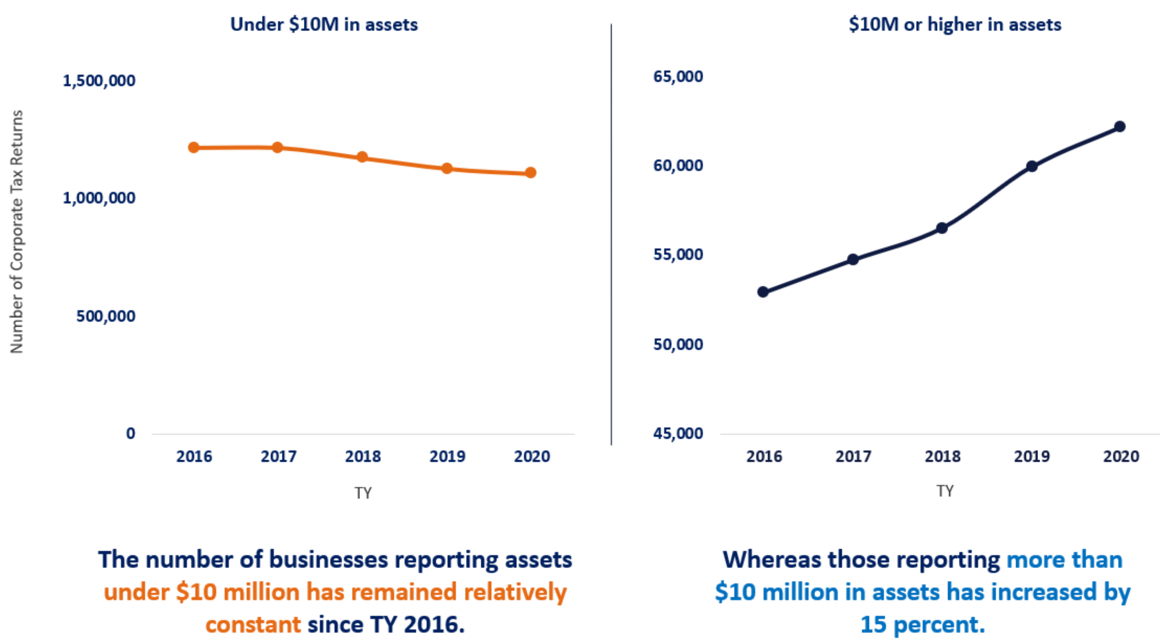
[15] I.R.C. § 24(i)(4).

Small business definition still needs to be addressed in order to ensure compliance with the 2022 Treasury Directive

Along with the directive not to increase audits on individuals with incomes under $400,000, the 2022 Treasury Directive also includes small businesses. However, the Treasury Department and the IRS have not yet defined small business with regard to the 2022 Treasury Directive. Further, the IRS has made no assumptions regarding small businesses in the FY 2024 Examination Plan because relatively few business return examinations are expected to be started for TY 2023 in FY 2024.

The tax code does not define a "small business." Currently, the IRS measures the audits of businesses by asset size, not gross receipts or revenue, and the IRS mentioned that it would be more convenient to use a measure that is already being used. The IRS stated it discussed with the Treasury Department defining a small business as a business having less than $10 million in assets, which it currently uses to identify small businesses for examination purposes. Figure 1 shows the number of businesses reporting assets under $10 million and $10 million or more.

Figure 1: Number of Corporate Tax Returns Reporting Assets Below $10 Million and $10 Million or More for TYs 2016 to 2020



Source: 2022 IRS Data Book.

While there is no official public classification, to many taxpayers, a small business is based on the amount of income earned and the total number of employees at all of its business locations. The definition of "small business" varies by industry, but the Small Business Administration established a size standard to classify small businesses for itself and Federal contracting programs. It defines small businesses by revenue (ranging from $1 million to over $40 million) and by employment (from 100 to over 1,500 employees).

Also, there has been no decision on whether the definition of small business will apply equally to corporations, S corporations, and partnerships. S corporations are corporations that elect to pass corporate income, losses, deductions, and credits through to its shareholders for Federal tax purposes.[16] Shareholders of S corporations report the flow-through of income and losses on their personal tax returns and are assessed tax at their individual income tax rates.

The IRS mentioned that because partnerships can be difficult to audit due to the tiering levels before the taxable entity, it may be easier to exclude them from the definition of small business. For Federal income tax purposes, a partnership is not a taxable entity. Partnerships are pass-through entities; therefore, the items of partnership income, deductions, gains, losses, and credits are reported on the partners' income tax returns. The push-out process of these items may continue through multiple tiers if pass-through partners make additional push-out elections.[17] Partnerships may have different types of partners, such as individuals, corporations, other partnerships, and S corporations.

The IRS has not established a timeline to develop the definitions and calculations

Because the IRS believes it has ample time to develop the methodology, currently it does not perceive the development as an urgent matter. The 2022 Treasury Directive calls for the IRS not to increase the examination rates past historical levels beginning with TY 2023. TY 2023 returns will not be examined until FY 2025, which begins in October 2024; therefore, the IRS will not need to start tracking audit coverage rates until that time. The IRS believes it has more time to work with the Treasury Department to finalize the audit coverage rate.

However, given the complexity of developing the methodology and that FY 2025 is only a few months away, we believe the IRS needs to expedite the finalization of its plan to comply with the Treasury Secretary's Directive. The IRS was unable to provide TIGTA with a timetable or milestone dates to ensure that it is progressing toward completion. The absence of timetables and milestones increases the risk that the methodology may not be developed in time to ensure compliance with the 2022 Treasury Directive.

Recommendation 1: The Deputy Commissioner should accelerate discussions with the Treasury Department to finalize the audit rate methodology for the 2022 Treasury Directive.

> **Management's Response:** IRS management agreed with the recommendation. The IRS will hold discussions with the Treasury Department to reach an agreement on the methodology.

Implementation of the 2022 Treasury Directive using TY 2018 as the base year presents challenges for the IRS

IRS executive management responsible for implementing the directive stated that they consider the 2022 Treasury Directive to be limiting and, therefore, it will be difficult to implement. We agree that implementing the 2022 Treasury Directive presents challenges for the IRS and will require a significant shift in examination resources. Specifically, the examinations of taxpayers reporting TPI under $400,000 consistently accounted for more than 90 percent of total examinations from FYs 2019 through 2023. Figure 2 shows that examinations of taxpayers

[16] S corporations must be domestic; have only individuals, certain trusts, and estates as shareholders; have no more than 100 shareholders; have only one class of stock; and not be certain financial institutions, such as an insurance company or a domestic international sales corporation.

[17] A push-out is an election made by a partnership to move the payment of tax due from the partnership to its partners.

reporting TPI under $400,000 accounted for 95 percent of total examinations in FYs 2019 to 2021 and 93 percent and 91 percent in FYs 2022 and 2023, respectively.

Figure 2: Examinations of Taxpayers Reporting TPI Under and Over $400,000 for FYs 2019 to 2023

Examinations Started	FY 2019	FY 2020	FY 2021	FY 2022	FY 2023
Total Number of Records	574,951	466,921	519,167	446,100	400,446
Examinations of TPI Less Than or Equal to $400,000	543,460	442,856	492,085	416,627	365,229
Examinations of TPI Greater Than $400,000	31,491	24,065	27,082	29,473	35,217
Percentage of Examinations of TPI Less Than or Equal to $400,000	95%	95%	95%	93%	91%
Percentage of Examinations of TPI Greater Than $400,000	5%	5%	5%	7%	9%

Source: TIGTA analysis of Audit Information Management System (AIMS) and Return Transaction File (RTF) data.

Increasing the audit coverage rate for those taxpayers reporting TPI greater than $400,000 will require a significant shift in examination resources. Audit coverage rates for TY 2018 tax returns are abnormally low. The overall audit rate for individual taxpayers was nearly 40 percent lower than for TY 2017. From TY 2010 to TY 2017, the overall audit coverage rate was 50 percent higher than that for TY 2018. The audit coverage rate we calculated for those taxpayers reporting TPI under $400,000 was less than one-half a percent (0.33 percent) for TY 2018. The low audit coverage rates for TY 2018 are most likely due to the effects of years of budget cuts and the effects of the Coronavirus Disease 2019 Pandemic (Pandemic) on IRS operations. We were advised that no further consideration will be given to selecting the base year, and the IRS intends to move forward with TY 2018 as the base year. A historically low audit rate as a base year presents a challenge for the IRS because taxpayers reporting TPI under $400,000 consistently account for more than 98 percent of all tax returns filed. Most of these examinations are typically correspondence audits (as opposed to field examinations of taxpayers' books and records) that focus on relatively easily identifiable errors on taxpayers' returns. Complying with the 2022 Treasury Directive while using TY 2018 as a base year for comparison poses challenges to the traditional IRS approach to examination strategy.

For example, examinations of taxpayers claiming the Earned Income Tax Credit (EITC) have made up a significant percentage of IRS examinations case selection processes. The EITC is as an anti-poverty program that provides a significant tax benefit for millions of low to moderate income workers.[18] EITC audit rates have historically been higher than audit rates for some categories of higher income taxpayers because erroneous EITC payments were deemed "improper payments" by the Office of Management and Budget and therefore subject to

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[18] TIGTA, Report No. 2021-30-051, *The Earned Income Tax Credit Examination Compliance Strategy Can Be Improved* (Sept. 2021).

continuous efforts to reduce improper payments under the Payment Integrity Information Act of 2019.[19] EITC audits are also limited in scope, less time consuming, and conducted by tax examiners who require less training and expertise; therefore, increasing EITC audits is easier for the IRS than increasing the percentage of audits of higher income taxpayers. However, maintaining or increasing traditional EITC audit rates would place compliance with the 2022 Treasury Directive at risk for the reasons described previously. Coincidentally, and for reasons unrelated to the 2022 Treasury Directive, the IRS is taking action to reduce EITC audits.

In September 2023, the IRS Commissioner acknowledged that there was an unintentional but disproportionate impact on Black taxpayers from the manner in which the IRS selected EITC tax returns for examination.[20] The IRS is currently studying ways to address this issue and is planning to conduct fewer EITC examinations in FY 2024. TIGTA is reviewing the IRS's new EITC compliance strategy in a separate audit.[21]

The IRS Has Not Consistently Documented Work Pertaining to the 2022 Treasury Directive

The IRS has not consistently or formally documented its decisions and processes pertaining to the 2022 Treasury Directive. According to Federal standards for internal control, the fundamental concepts of internal controls provide for appropriate documentation of transactions.[22] Specifically, management should clearly document all transactions and other significant events in a manner that allows the documentation to be readily available for examination, properly managed, and maintained.

During our review, we requested pertinent documentation concerning the IRS's internal plans to comply with the Directive and its ongoing conversations with the Treasury Department. In regard to those discussions, the IRS indicated that it did not document meetings or discussions with the Treasury Department because it was in the early stage of developing a methodology and no final decisions had been made. Both the Federal standards for internal control as well as the IRS's Internal Revenue Manual articulate the need for reliable information in order to make informed decisions.[23] We believe it is especially risky that the IRS has not formally documented pre-decisional discussions with the Treasury Department, as participant recollections of what was discussed are not as reliable as documentation.

We also were not provided with formal documentation regarding the IRS's internal plans pertaining to the 2022 Treasury Directive, *e.g.*, a clearly articulated and documented timeline for finalizing the methodology with the Treasury Department. As a result, we are concerned that almost two years since the Treasury Secretary's Directive was issued, the IRS has not yet

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[19] Pub. L. No. 116-117, 134 Stat. 113 (which amended earlier improper payment–related legislation such as the Improper Payments Information Act of 2002, as amended by the Improper Payments Elimination and Recovery Act of 2010 and the Improper Payments Elimination and Recovery Improvement Act of 2012).

[20] IRS Commissioner Daniel Werfel, Correspondence to Members of Congress, dated September 18, 2023.

[21] As part of TIGTA's coverage of the 2022 Treasury Directive and its impact on IRS examination strategy, TIGTA also initiated an audit to review IRS changes to the EITC audit examination strategy (TIGTA, Audit No. 2024308026).

[22] Government Accountability Office, *Standards for Internal Control in the Federal Government*, GAO-14-704G (Sept. 2014).

[23] Internal Revenue Manual 1.11.2.2.4 (Sept. 13, 2023)

developed a formally documented timeline and deliverables for development of the methodology and when it expects decisions to be finalized with the Treasury Department.

After repeated requests for information and documentation, the IRS provided 14 e-mails dating between October 2022 and March 2023. These e-mails reflected ongoing internal discussions and/or draft documents about potential exclusions, measuring taxpayer income, and the base year for the 2022 Treasury Directive. There was nothing in a final stage. While these e-mails indicated there was communication with the Treasury Department about the need to discuss items and a timeline on the discussion, there was no formal documentation of the discussions held with the Treasury Department. One of the documents lists some of the types of returns or examinations that the IRS may not include in its audit coverage rate calculation, as previously discussed. When we asked for documentation to support the reason for including each of the items in the document and how those decisions were made, we were told there were no additional documents available.

We believe that IRS management should have documented the discussions and meetings that took place with the Treasury Department regarding the development of the audit rate methodology. Documentation would have provided a better accounting of the discussion progress and where the IRS and the Treasury Department each stand on the numerous issues to be finalized.

Transparency in Government operations enables accountability. It is important for the IRS to remain as transparent as possible when considering decisions regarding the multiple assurances that the Treasury Secretary made to Congress. By formally and comprehensively documenting its processes and related requirements for complying with the 2022 Treasury Directive, the IRS would have greater assurance that its decision-making follows the intent outlined by the Treasury Secretary.

Recommendation 2: The Deputy Commissioner should document, in a formal and comprehensive manner, the processes, related requirements, pertinent discussions, and meetings regarding the development of the methodology established to ensure compliance with the 2022 Treasury Directive.

> **Management's Response:** IRS management agreed with the recommendation. The IRS will document substantive conversations within the IRS and with the Treasury Department to record the agreement on the methodology.

Improved Data Would Enhance Monitoring of Compliance With the 2022 Treasury Directive

To accurately calculate the audit coverage rate in accordance with the 2022 Treasury Directive, the IRS needs to know the number of taxpayers reporting TPI under $400,000 that were examined (numerator) and the number of tax returns that were filed reporting TPI under $400,000 (denominator). We were initially advised that the IRS intends to use the IRS Data Book (published annually) for both the number of taxpayers that were examined and the number of tax returns that were filed. We were also advised that beginning with the FY 2023 IRS Data Book, a new page would be added to report on audit rates for returns below the $400,000 threshold. The page would begin with TY 2022 returns. However, the FY 2023 IRS

Data Book was released on April 18, 2024, and as the methodology criteria are still under discussion, there were no tables with an under $400,000 threshold.

Given that the Data Book thresholds for TPI do not include a threshold for TPI of $400,000, but one at TPI of $500,000, the IRS later stated that it will use SOI data. On April 15, 2024, the IRS Chief Data and Analytics Officer stated that both the numerator and the denominator values will be computed using the agreed upon TPI criteria to classify returns into income categories below $400,000 and at or above $400,000.

For the numerator, the IRS Chief Data and Analytics Officer stated that AIMS will be used to produce counts of audited returns above and below a $400,000 threshold. We agree with this decision as AIMS contains a data field that reports the actual TPI from a taxpayer's return that has been examined.[24] Accordingly, the IRS will be able to filter AIMS data using the $400,000 threshold amount.

For the denominator, the IRS will use SOI statistical data to compute the number of filers above and below the $400,000 TPI category. SOI data are tested and edited to ensure accuracy. Our concern with using SOI data is that the data are derived from a probability sample, rather than an actual count. According to the IRS's Research, Applied Analytics, and Statistics function, the IRS/SOI Individual Income Tax sample is a probability sample of unaudited Individual Tax Returns (Form 1040, *U.S. Individual Income Tax Return*, and Form 1040-SR, *U.S. Tax Return for Seniors*) that have posted to the IRS Individual Master File.[25] The posting occurs during the calendar year in which most returns for a particular tax year will be filed by taxpayers. As a result, SOI data estimates use prior year returns to proxy for unfiled returns at the time official estimates are generated. For example, the SOI's TY 2020 sampled returns were filed during Calendar Year 2021 and may have included TY 2019 returns that were filed late.

We identified a potentially more accurate data source for return filing counts. The IRS RTF contains fields currently transcribed from Forms 1040; 1040-NR, *U.S. Nonresident Alien Income Tax Return*; and 1040-SR, along with the accompanying forms and schedules. The IRS can determine the actual number of Forms 1040 filed for a specific tax year and there would be no need to use sampling estimates, such as that from SOI data. The RTF also includes a data field in which the return's actual TPI is reported by the taxpayer enabling the IRS to classify returns into income categories below $400,000 and at or above $400,000.

To illustrate the accuracy of RTF and AIMS data, we performed our own analysis of TY 2018 data. For the denominator, we obtained all filings of TY 2018 returns from the RTF. We found more than 152 million (98 percent) of 155 million filings had a TPI of less than $400,000 and nearly 3 million (2 percent) had a TPI $400,000 or greater. To obtain the numerator, we downloaded AIMS data for TY 2018 returns that had been examined. We found more than 501,000 (97 percent) had a TPI of less than $400,000. Figure 3 provides the audit rates we calculated using RTF data as the denominator and AIMS data as the numerator.

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[24] AIMS provides inventory and activity controls of active examination cases. It uses linkage to the Integrated Data Retrieval System to input status changes, adjustments, and case closing actions.

[25] Form 1040-SR is available as an optional alternative to using Form 1040 for taxpayers who are age 65 or older. Form 1040-SR uses the same schedules and instructions as Form 1040.

Figure 3: AIMS and RTF Data TY 2018 Audit Rate Calculations

	Cases Examined (AIMS Data)	All Filings (RTF Data)	Rates
TPI Less Than $400K	501,326	152,526,709	0.33%
TPI $400K and Greater	16,148	2,737,646	0.59%
Total Records	517,474	155,264,355	0.33%

Source: TIGTA analysis of AIMS and RTF data.

With the RTF and AIMS, we were able to obtain accurate counts for the numerator and denominator. If the IRS is unable to use the appropriate returns filed that reported TPI above or below $400,000, it will be challenging to ensure compliance with the 2022 Treasury Directive.

AIMS can potentially provide the taxpayer's updated TPI after examination results

In addition, the IRS is discussing with the Treasury Department the option of using post-examination TPI to eliminate certain examinations from the 2022 Treasury Directive mandate. While a taxpayer's TPI is not updated with the results of an examination (income underreported by a taxpayer, but identified during the examination), we identified a data field in AIMS closed case data that could be used to capture this information. The field name and description indicate that it is to be used to show the TPI after an examination. However, we evaluated this field and determined that it is not being updated by examiners upon completion of examinations.

The Deputy Commissioner should:

Recommendation 3: Use RTF data to produce counts of filing data above and below the $400,000 threshold, rather than relying on SOI sampling data that support the IRS Data Book.

Management's Response: IRS management disagreed with this recommendation. In its response, the IRS stated the SOI performs comprehensive data testing and cleaning to ensure official tax return statistics are as accurate as possible. The IRS believes that RTF data are subject to inconsistent reporting and other data anomalies that are present in any raw administrative data source. The impact of these non-sampling errors on RTF data totals can be significant and non-random, making the RTF an inferior data source for statistical uses. The SOI data have the advantage of being accurately measured and produced in compliance with Office of Management and Budget quality standards. The IRS expects the public will have the greatest confidence in audit coverage rates based on population estimates produced in compliance with Office of Management and Budget standards and that align with other official statistical estimates released by the SOI.

Office of Audit Comment: While we acknowledge that the RTF contains raw administrative data, we used RTF data to obtain an accurate count for the total number of returns filed reporting TPI below $400,000 and at or above $400,000. As previously noted, we have a concern with the IRS using SOI data. By using RTF data, the IRS could determine the actual number of Forms 1040 filed for a specific tax year and there would be no need to use sampling estimates, such as that in SOI data. The RTF also includes a data field in which the actual TPI reported by the taxpayer on the return is entered, enabling the IRS to classify returns into income categories below $400,000 and at or above $400,000.

Recommendation 4: Establish procedures and controls to ensure that the appropriate field in AIMS is updated to include the taxpayer's reported TPI plus unreported income identified during the examination in order to develop a measure of post-audit TPI.

Management's Response: IRS management partially agreed with this recommendation. The IRS will verify TIGTA's analysis that AIMS has a separate field that can be used to report post-audit TPI as the IRS wants to retain TPI as filed by the taxpayer for historical purposes. If there is a separate field, the appropriate Business Operating Division Commissioners will develop Internal Revenue Manual procedures and controls to update TPI as a result of an examination that increases reported income.

Office of Audit Comment: While IRS management partially agreed with our recommendation, we believe their corrective actions are in the spirit of our recommendation.

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to review the IRS's methodology for ensuring that IRA funds are not used to increase the percentage of audits of taxpayers with incomes below $400,000 and are instead used for examinations of taxpayers at or above this income threshold. To accomplish our objective, we:

- Conducted interviews with IRS executives.
- Conducted interviews with Treasury Department executives.
- Reviewed documentation provided by the IRS.
- Downloaded and reviewed taxpayer data from the RTF and AIMS databases.

Performance of This Review

This review was performed with information obtained from the Services and Enforcement Office and the Data and Analytics Division both headquartered in Washington, D.C., during the period August 2023 through April 2024. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

Major contributors to the report were Phyllis Heald London, Acting Assistant Inspector General for Audit (Compliance and Enforcement Operations); Timothy Greiner, Director; Eugenia Smoak, Audit Manager; and Victor Taylor, Lead Auditor.

Data Validation Methodology

We performed tests to assess the reliability of data from the RTF and AIMS databases. We evaluated the data by 1) performing electronic testing of required data elements, 2) comparing a sample of 41 records from AIMS and the RTF to the Modernized e-File, 3) reviewing existing information about the data and the system that produced them, and 4) interviewing agency officials knowledgeable about the data. We determined that the data were sufficiently reliable for purposes of this report.

Internal Controls Methodology

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We did not assess internal controls because doing so was not applicable within the context of our objective. Our analyses were limited to determining the status of the development of the 2022 Treasury Directive methodology.

Appendix II

2022 Treasury Directive

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

August 10, 2022

Charles P. Rettig
Commissioner
Internal Revenue Service
Washington, DC 20224

Dear Commissioner:

The Inflation Reduction Act includes much-needed funding for the IRS to improve taxpayer service, modernize outdated technological infrastructure, and increase equity in the tax system by enforcing the tax laws against those high-earners, large corporations, and complex partnerships who today do not pay what they owe.

These crucial investments have been a focus of the Biden Administration since the President's first day in office, and I was heartened to see the legislation pass the Senate this weekend.

Notwithstanding the changes that arose because of Republican challenges during the Byrd process, I write today to confirm the commitment that has been a guiding precept of the planning that you and your team are undertaking: that audit rates will not rise relative to recent years for households making under $400,000 annually.

Specifically, I direct that any additional resources—including any new personnel or auditors that are hired—shall not be used to increase the share of small business or households below the $400,000 threshold that are audited relative to historical levels. This means that, contrary to the misinformation from opponents of this legislation, small business or households earning $400,000 per year or less will not see an increase in the chances that they are audited.

Instead, enforcement resources will focus on high-end noncompliance. There, sustained, multi-year funding is so critical to the agency's ability to make the investments needed to pursue a robust attack on the tax gap by targeting crucial challenges, like large corporations, high-net-worth individuals and complex pass-throughs, where today the IRS has resources to initiate just 7,500 audits annually out of more than 4 million returns received.

This is challenging work that requires a team of sophisticated revenue agents in place to spend thousands of hours poring over complicated returns, and it is also work that has huge revenue potential: indeed, an additional hour auditing someone making more than $5 million annually generates an estimated $4,500 of additional taxes collected. This is essential work that I know the IRS is eager to undertake.

For regular taxpayers, as you emphasized last week, the result of this resource infusion will be a lower likelihood of audit by an agency that has the data and technological infrastructure in place to target enforcement resources where they belong—on the high end of the income distribution, where the top 1% alone is estimated to not be paying $160 billion in owed taxes each year. That's important as a matter of revenue-raising, but it's also essential as a matter of fairness.

Crucially, these resources will support a much-needed upgrade of technology that is decades out-of-date, and an investment in taxpayer service so that the IRS is finally able to communicate with taxpayers in an efficient, timely manner. I look forward to working with you on creating new digital tools to allow taxpayers to get information from the IRS instantaneously and on improving taxpayer service, so the agency is well-equipped to answer calls when they come in.

This historic investment in our tax system will accomplish two critical objectives. It will raise substantial revenue to address the deficit; and it will create a fairer system, where those at the top who do not today comply with their tax obligations find it far less easy to do so, and where all taxpayers receive the service from the IRS that they deserve, and that your dedicated workforce is eager to deliver. The importance of the work ahead cannot be overstated.

Sincerely,

Janet L. Yellen

Janet L. Yellen

Appendix III

Management's Response to the Draft Report

DEPUTY COMMISSIONER

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, DC 20224

July 30, 2024

MEMORANDUM FOR DANNY R. VERNEUILLE
ACTING DEPUTY INSPECT GENERAL FOR AUDIT

FROM: Douglas W. O'Donnell
Deputy Commissioner

Douglas W. Odonnell Digitally signed by Douglas W. Odonnell Date: 2024.07.30 09:22:46 -04'00'

SUBJECT: Draft Audit Report – The IRS Has Made Limited Progress Developing the Methodology to Comply With the Treasury Directive to Not Increase the Audit Rate for Taxpayers With Incomes Below $400,000 Due to Planning and Implementation Challenges (Audit No. 2024308010)

Thank you for the opportunity to review and comment on the subject draft audit report. We appreciate TIGTA's review and input during development of the methodology to ensure compliance with the Secretary's Directive. While the methodology remains in the development stage, we have found your perspective and input helpful. This is especially the case in having an inclusive numerator and denominator for purposes of determining the coverage rate in the "historical level" as well as each tax year to which the Directive applies.

The Commissioner has publicly committed that the IRS will comply with the Secretary's directive to not increase audit rates above historic levels for small businesses or households earning less than $400,000. The IRS is using the enforcement funding provided by the Inflation Reduction Act (IRA) to hire accountants, engineers, economists, data scientists, attorneys, and tax experts with the specialized skills to examine the complex returns of large corporations, complex partnerships, and high-income individuals. As detailed below, the IRS will not increase audit rates relative to historical levels for small businesses and households making under $400,000 per year.

We have already announced that tax year 2018 will be the historical level; Total Positive Income (TPI) will be the measure of income for individuals; and tax year 2023 will be the first year that the directive applies to not increase audit rates for small businesses or households earning less than $400,000 above historical levels, e.g., tax year 2018 rates.

Audit coverage rates are computed on a tax year basis. Audit coverage rates are computed by the total number of examinations (closed and in process) divided by the number of specific (e.g., individual, corporate, etc.) tax returns filed. The coverage rates have been published annually in the IRS Data Book. The tables published in the Data Book allow for the calculation of an audit rate for individuals with TPI under $200,000 and for individuals with TPI under $500,000, but they do not allow for the calculation of an audit rate for individuals with TPI under $400,000. We are in process of generating data to report the audit rate for Tax Year 2018 for individual returns reporting TPI of less than $400,000. This rate will be reported in the FY 2024 IRS Data Book. We will continue to publish audit coverage rates above and below $400,000 in the IRS Data Book thereafter.

Examinations of tax year 2023 tax returns, filed in 2024, will begin as FY 2024 concludes and FY 2025 starts with a larger share of the examinations beginning later in FY 2025. IRS will continue working with the Treasury Department to reach an agreement on the methodology for the examinations of tax year 2023 returns.

Finally, although the Service is still finalizing the formal methodology to implement the Secretary's directive, we respectfully submit that the Service's commitment to administering the tax code in accordance with this directive is reflected in the enforcement efforts we have undertaken since implementation of the IRA in 2022. Specifically, we note the steps the IRS has taken to shift more tax compliance attention to high-income earners, partnerships, large corporations, and abusive promoters. These steps are summarized in a February 2024 memorandum to the Secretary, which we understand has been produced to you, as well as in public statements regarding IRS enforcement activities. We note, for example: that the IRS has intensified work on taxpayers with incomes over $1 million and more than $250,000 of recognized tax debt; that the IRS has identified high-risk issues among large and complex partnership returns; that, since December 2023, the IRS has opened 76 examinations of large partnerships with an average of more than $10 billion in assets; that the IRS has sent compliance alerts to more than 180 subsidiaries of large foreign corporations as part of its efforts to improve compliance with transfer pricing rules; and that the IRS has identified hundreds of possible high-income taxpayers with account balances averaging over $1.4 million that may have failed to file required reports regarding foreign bank accounts. Respectfully, we submit that these recent enforcement efforts should be considered in any comprehensive assessment of the Service's orientation of operations in accordance with the Secretary's directive.

Attached is our response to the recommendations. If you have any questions, please contact me at douglas.w.odonnel@irs.gov.

Attachment

ATTACHMENT

TIGTA Draft Audit Report – The IRS has made Limited Progress Developing the Methodology to Comply With the Treasury Directive to Not Increase the Audit Rate for Taxpayers With Incomes Below $400,000 Due to Planning and Implementation Challenges (Audit No. 2024308010)

Recommendation 1:

The Deputy Commissioner should accelerate discussions with the Treasury Department to finalize the audit rate methodology for the 2022 Treasury Directive.

Planned Corrective Action:

The IRS agrees with this recommendation. Discussions will be held with Treasury to reach agreement on the methodology.

Implementation Date:

12/31/24

Responsible Official(s):

Deputy Commissioner

Corrective Action Monitoring Plan:

Recommendation 2:

The Deputy Commissioner should document, in a formal and comprehensive manner, the processes, related requirements, pertinent discussions and meetings regarding the development of the methodology established to ensure compliance with the 2022 Treasury Directive.

Planned Corrective Action:

The IRS agrees with this recommendation. Documentation of substantive conversations in the IRS and with Treasury will be kept to record agreement on the methodology.

Implementation Date:

12/31/24

Responsible Official)s):

Deputy Commissioner

Corrective Action Monitoring Plan:

Recommendation 3:

Use RTF data to produce counts of filing data above and below the $400,000 threshold, rather than relying on SOI (Statistics of Income) sampling data that support the IRS Data Book.

Planned Corrective Action:

The IRS disagrees with this recommendation. SOI performs comprehensive data testing and cleaning to ensure official tax return statistics are as accurate as possible. In contrast, RTF data are subject to inconsistent reporting and other data anomalies that are present in any raw administrative data source. The impact of these non-sampling errors on RTF data totals can be significant and non-random, making the RTF an inferior data source for statistical uses. The SOI data have the advantage of being accurately measured and produced in compliance with OMB quality standards. We expect the public will have the greatest confidence in audit coverage rates based on population estimates produced in compliance with OMB standards and that align with other official statistical estimates release by SOI.

Implementation Date:

N/A

Responsible Official(s):

N/A

Corrective Action Monitoring Plan:

N/A

Recommendation 4:

Establish procedures and controls to ensure that the appropriate field in AIMS is updated to include the taxpayer's reported TPI plus unreported income identified during the examination in order to develop a measure of post-audit TPI.

Planned Corrective Action:

The IRS partially agrees with this recommendation. We are working to verify TIGTA's analysis that there is a separate data field in AIMS that can be used to report TPI post audit results as we want to retain TPI as filed by the taxpayer for historical purposes. The Chief Tax Compliance Officer will instruct the appropriate BOD Commissioners to form a team to work this issue and determine if AIMS has a separate field to report post-audit TPI. If there is a separate field, then the team will develop IRM procedures and controls to update TPI as a result of an examination that increases reported income.

Implementation Date:

10/31/25

Responsible Official(s):

Commissioner Small Business Self-Employed

Commissioner Large Business and International

Corrective Action Monitoring Plan:

The Chief Tax Compliance Officer will monitor this as a part of the BPR quarterly review.

Appendix IV

Abbreviations

AIMS	Audit Information Management System
EITC	Earned Income Tax Credit
FY	Fiscal Year
IRA	Inflation Reduction Act of 2022
IRS	Internal Revenue Service
RTF	Return Transaction File
SB/SE	Small Business/Self-Employed
SOI	Statistics of Income
TIGTA	Treasury Inspector General for Tax Administration
TPI	Total Positive Income
TY	Tax Year

**To report fraud, waste, or abuse,
contact our hotline on the web at www.tigta.gov or via e-mail at
oi.govreports@tigta.treas.gov.**

**To make suggestions to improve IRS policies, processes, or systems
affecting taxpayers, contact us at www.tigta.gov/form/suggestions.**

Information you provide is confidential, and you may remain anonymous.