TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

The IRS Ceased Compliance With the $10 Million Taxpayer Treasury Directive in Favor of an Overall Focus on High-Income Taxpayer Noncompliance

June 20, 2024

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HIGHLIGHTS: The IRS Ceased Compliance With the $10 Million Taxpayer Treasury Directive in Favor of an Overall Focus on High-Income Taxpayer Noncompliance

Final Audit Report issued on June 20, 2024 **Report Number 2024-300-028**

Why TIGTA Did This Audit

This audit was initiated to determine whether the IRS is meeting the former Secretary of the Treasury's established goal requiring the IRS to audit a minimum of 8 percent of all high-income individual returns, with incomes more than $10 million, filed each year.

On February 10, 2020, the then Secretary of the Treasury directed the IRS, pursuant to 26 United States Code Sections 7801 and 7803(a)(2), to audit a minimum of 8 percent of all high-income individual returns filed each year. On March 13, 2020, the IRS Commissioner responded that accomplishing the goal would require significant opportunity costs but agreed to comply using total positive income of $10 million or more to select returns (2020 Treasury Directive).

In August of 2022, the Inflation Reduction Act was enacted with the purpose in part to fund the IRS so that it could examine more high-income taxpayers. In an August 2022 directive to the IRS, the Secretary of the Treasury directed that no Inflation Reduction Act funding should be used to increase the audit rate of taxpayers with incomes below $400,000 (2022 Treasury Directive).

Impact on Tax Administration

An analysis of the 2020 Treasury Directive assists in understanding the impact on audit productivity that comes from focusing audit resources on taxpayers above certain high-income thresholds.

What TIGTA Found

The IRS complied with the 2020 Treasury Directive for three tax years but ceased monitoring it at the end of Fiscal Year 2023. At the start of this audit, an IRS executive informed TIGTA in December of 2022 that the 2020 Treasury Directive would no longer be followed because these audits were unproductive having high no-change rates. The IRS also stated it was embarking on a different approach focusing on complying with the 2022 Treasury Directive.

TIGTA found that many of the examined returns pursuant to the 2020 Treasury Directive were productive depending on which IRS function conducted the examinations and which case selection methods were used. The Small Business/Self Employed Division's closed examinations of individual taxpayer returns with income of $10 million or more, in Tax Years 2016 through 2021, were generally more productive than income ranges below $10 million, yielding four times more dollars assessed per return and two times more dollars assessed per hour when compared to examinations of returns with income of $400,000 to under $10 million.

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 has increased when comparing pre-directive tax years (Tax Years 2016 through 2017) to post-directive tax years (Tax Years 2018 through 2020).

TIGTA also found that some of the opportunity costs the IRS identified in response to the Department of the Treasury at the outset of the 2020 Treasury Directive were overstated by 190 examinations of large and mid-sized businesses.

What TIGTA Recommended

TIGTA made two recommendations to the IRS: (1) include a separate category for taxpayers with TPI of $10 million or more when evaluating the compliance of high-income individual taxpayers for Initiative 3.4 of the IRS Strategic Operating Plan to ensure the productivity of examinations on these high-income individual returns are tracked and analyzed in comparison to examinations of taxpayers at other income levels; (2) identify the potential causes for the Large Business and International Division's low productivity examination results and monitor measures to ensure that the most productive returns are selected for examination.

The IRS partially agreed with both recommendations stating that it already categorizes and monitors productivity measures for high-income high-wealth taxpayers, including those with TPI of $10 million or more, and that it will identify the potential causes for the low productivity examination results and will use enhanced data and analytics to select cases based on the highest risk of noncompliance.

TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

U.S. DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20024

June 20, 2024

MEMORANDUM FOR: COMMISSIONER OF INTERNAL REVENUE

FROM: Matthew A. Weir
Acting Deputy Inspector General for Audit

SUBJECT: Final Audit Report – The IRS Ceased Compliance With the $10 Million Taxpayer Treasury Directive in Favor of an Overall Focus on High-Income Taxpayer Noncompliance (Audit No.: 202330020)

This report presents the results of our review to determine whether the Internal Revenue Service (IRS) was meeting the Department of the Treasury's established goal of auditing a minimum of 8 percent of all high-income individual returns filed each year.[1] This review was part of our Fiscal Year 2023 Annual Audit Plan and addresses the major management and performance challenge of *Increasing Domestic and International Tax Compliance and Enforcement*.

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

[1] Our audit focused on IRS examinations of individual returns with total positive income of $10 million or more, which the IRS used to comply with the minimum 8 percent audit rate goal.

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Background

On February 10, 2020, the Secretary of the Treasury issued a memorandum to the Internal Revenue Service (IRS) Commissioner directing the IRS, pursuant to 26 United States Code Sections 7801 and 7803(a)(2), to take all steps necessary to audit a minimum of 8 percent of all high-income individual returns filed each year, starting with Tax Year (TY) 2016 (hereafter referred to as the 2020 Treasury Directive).[1] The 2020 Treasury Directive also defined "high-income individual returns" as individual tax returns with adjusted gross income in excess of $10 million.[2] In this communication, the Secretary also stressed that, *"Robust enforcement of the tax laws is critical to ensuring fairness in our tax system. By pursuing taxpayers who fail to comply with their tax obligations the IRS treats compliant taxpayers fairly and incentivizes all taxpayers to voluntarily comply with the law."* The IRS has traditionally categorized taxpayers with total positive income (TPI) of $200,000 or more as "high-income" taxpayers, which has not been updated since June 2006. In multiple reports, the Treasury Inspector General for Tax Administration (TIGTA) has recommended that the IRS reevaluate its threshold for what it considers high-income taxpayers.[3] The IRS agreed to study TIGTA's recommendation in 2015, but as recently as 2023 disagreed with TIGTA's recommendation to increase the dollar threshold for what constitutes high-income taxpayers.

"Robust enforcement of the tax laws is critical to ensuring fairness in our tax system. By pursuing taxpayers who fail to comply with their tax obligations, the IRS treats compliant taxpayers fairly and incentivizes all taxpayers to voluntarily comply with the law."

On March 13, 2020, then IRS Commissioner Charles Rettig provided a response to the Secretary of the Treasury's February 2020 Treasury Directive stating that the IRS would use TPI of $10 million or more to select returns.[4] The Commissioner expressed various limitations and trade-offs to comply with the 2020 Treasury Directive. First, the assessment statute of limitations is generally three years from the date a return is filed, and therefore, the IRS would generally be prevented from examining TYs 2016 and 2017.[5] New examinations are usually opened with more than 18 months remaining on the statute of limitations to allow sufficient time for an audit to be completed. For TY 2016, the IRS's projected coverage rate for taxpayers with TPI of $10 million or more would be around 6.5 percent because there was little time remaining on the TY 2016 statute of limitations to initiate additional examinations in a manner

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[1] Correspondence, Secretary of the Treasury Steven Mnuchin to IRS Commissioner Charles Rettig. (Feb. 10, 2020). See Appendix II. Generally, the tax year is synonymous with the calendar year. See Appendix V for a glossary of terms.

[2] Adjusted gross income, in the case of an individual, means gross income minus certain deductions and losses listed in Internal Revenue Code Section 62(a).

[3] TIGTA, Report No. 2015-30-078, *Improvements Are Needed in Resource Allocation and Management Controls for Audits of High-Income Taxpayers* (Sept. 2015); TIGTA, Report No. 2023-30-054, *The IRS Needs to Leverage the Most Effective Training for Revenue Agents Examining High-Income Taxpayers* (Aug. 2023).

[4] Correspondence, IRS Commissioner Charles Rettig to Secretary of the Treasury Steven Mnuchin. (Mar. 13, 2020). See Appendix III.

[5] Internal Revenue Code Section 6501(a).

that might materially improve that percentage. Similar challenges were referenced in meeting the audit rate for examinations of TY 2017 tax returns.

Second, was the need for additional resources and the opportunity costs associated with complying with the 2020 Treasury Directive, suggesting that achieving and maintaining an 8 percent audit rate for high-income individuals would require:

- More resources of at least 400 full-time revenue agents, with the majority being at the General Schedule Grade 13 level;[6] and
- Opportunity costs consisting of 900 fewer audits of large and mid-size business returns, 600 fewer audits of small corporate returns and 850 fewer audits of individual returns with TPI under $10 million.

The Small Business/Self-Employed (SB/SE) Division and the Large Business and International (LB&I) Division conduct the audits of higher income taxpayers, including those of individual returns with TPI of $10 million or more (hereafter referred to as "$10 million or more income" returns/audits). The IRS initially split the responsibility equally for complying with the 2020 Treasury Directive between the SB/SE and LB&I Divisions; however, because the LB&I Division's resources were limited due to other work, the allocation shifted starting with TY 2019 returns selected for examination so that the SB/SE Division would be responsible for two-thirds and the LB&I Division would be responsible for one-third of the audits.[7] As such, both divisions play a critical role in the IRS's compliance with the 2020 Treasury Directive.

In August 2022, the Inflation Reduction Act of 2022 was enacted, providing $79.4 billion (in addition to other funds made available) to the IRS over a decade.[8] Congress allocated $45.6 billion of Inflation Reduction Act funding towards enforcement activities. Through multiple subsequent recissions, these amounts were reduced to $57.8 billion and $24 billion, respectively.[9] As the Secretary of the Treasury wrote to the then IRS Commissioner in August of 2022, Inflation Reduction Act enforcement funding was intended in part to increase examinations of high-income taxpayers (hereafter referred to as the 2022 Treasury Directive). The Secretary stated:

> *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 businesses or households below the $400,000 threshold that are audited relative to historical levels.*

[6] Revenue agents at the General Schedule Grade 13 level are highly trained and are knowledgeable in the full range of tax issues, accounting systems, and tax compliance programs relative to conducting Federal tax examinations. A GS-13 revenue agent in the Large Business and International Division will work on cases involving individuals and business organizations that may include extensive subsidiaries with operations of national and/or international scope, while a GS-13 revenue agent in the Small Business/Self-Employed Division will work on cases involving returns filed by individuals, small businesses, organizations, and other entities.

[7] TIGTA, Report No. 2023-30-054, *The IRS Needs to Leverage the Most Effective Training for Revenue Agents Examining High-Income Taxpayers,* p. 10 (Aug. 2023). At the end of Fiscal Year (FY) 2020 there were 4,215 revenue agents in SB/SE and 3,062 in LB&I. As of March 31, 2023, there were 4,227 revenue agents in SB/SE and 2,908 in LB&I.

[8] Pub. L. No. 117-169, 136 Stat. 1818.

[9] Congress subsequently rescinded approximately $1.4 billion in IRA funding with Section 251 of the Fiscal Responsibility Act of 2023, Pub. L. No. 118-5, and an additional $20.2 billion with Sections 530 and 640 of the Further Consolidated Appropriations Act, 2024, Pub. L. No. 118-47; *i.e.*, a total $21.6 billion reduction in funding and allocation to enforcement activities.

> *This means that ... small businesses 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.*[10]

At the initiation of this audit in December 2022, the acting Deputy Commissioner for Services and Enforcement informed TIGTA that the IRS was no longer going to pursue the 2020 Treasury Directive because the examinations were unproductive. For example, many of the cases examined under the directive had high "no-change" rates (meaning that there was a high percentage of examinations that did not result in a change to the amount of tax due).

Results of Review

The IRS Achieved Compliance With the 2020 Treasury Directive for Three Tax Years Until Compliance Was Terminated

Both the SB/SE and LB&I Divisions were responsible for completing and monitoring audits to reach the targeted audit rate; however, the SB/SE Division was responsible for preparing the official audit rate reports for the 2020 Treasury Directive.[11] Due to the statute of limitations issues previously cited, the IRS started to address the 2020 Treasury Directive audit goal with TY 2018. However, since the 2020 Treasury Directive requested the IRS to apply the audit rate goal starting with TY 2016, we included TYs 2016 and 2017 in our review. As such, the IRS provided TIGTA its monitoring reports including information on the in-process and completed audits through September 30, 2023, for TYs 2018 through 2021. Figure 1 presents the audit rate metrics for TYs 2016 through 2021.[12]

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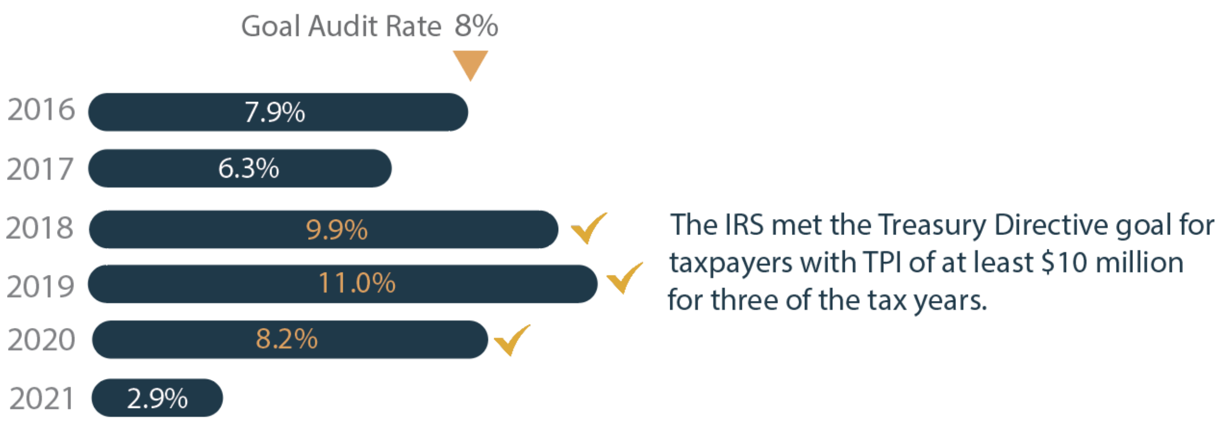
[10] Correspondence, Secretary of the Treasury Janet Yellen to IRS Commissioner Charles Rettig. (Aug. 10, 2022). See Appendix IV.

[11] The SB/SE Division was responsible for preparing the *Audit Rate $10M Monitoring Report*, which monitored the IRS's agencywide opened and closed examinations against the total filed returns by tax period for individual taxpayers with TPI of $10 million or more. The IRS used this report to monitor the 2020 Treasury Directive 8 percent audit rate goal.

[12] The IRS did not provide a breakdown of the audits in process or closed for TYs 2016 and 2017, so this information was obtained from Table 17 of the IRS Data Book, 2022.

Figure 1: IRS Audit Rates for Individual Tax Return Examinations With TPI of $10 Million or More for TYs 2016 Through 2021[13]



Source: TIGTA's analysis of closed and open tax return examinations as of September 30, 2023, per IRS Monitoring Reports and the IRS Data Book, 2022.

As illustrated in Figure 1, the IRS did not meet the 2020 Treasury Directive goal for TYs 2016 or 2017. As of September 30, 2023, the audit rate for TY 2016 was slightly under 8 percent (exceeding the then Commissioner's estimated 6.5 percent audit rate for TY 2016) and approximately 6 percent for TY 2017. However, the IRS exceeded the 8 percent audit rate goal (based on the 2020 Treasury Directive) for TYs 2018 through 2020. As of September 30, 2023, it was still too early to determine the TY 2021 audit rate for the $10 million or more income earning taxpayers since the tax year is considered open.

In response to the 2020 Treasury Directive, the IRS established additional activity codes used to track taxpayers earning $10 million or more. In January 2022, the IRS created additional activity codes to track returns with TPI of $10 million or more. Prior to January 2022, Activity Code 281 was used to track Forms 1040, *U.S. Individual Income Tax Return*, with TPI of $1 million or more. As part of the activity code revisions, the TPI range covered by Activity Code 281 was split into three activity codes. One of the three, was Activity Code 284 that was created to track Forms 1040 (individual taxpayers) with TPI of $10 million or more.

As of September 30, 2023, the IRS completed 7,688 examinations of individual returns with TPI of $10 million or more for TYs 2016 through 2021.

The IRS no longer has a target audit rate in place for examinations of individual returns with TPI of $10 million or more

In February 2023, IRS executives informed TIGTA that the IRS would continue to audit high-income individual returns with TPI of $10 million or more but would not aim to achieve the 8 percent audit rate in the future. IRS executives stated at that time that they considered the 2020 Treasury Directive obsolete. The executives explained that the IRS's new focus will be on compliance with the 2022 Treasury Directive to expand examinations of individuals with incomes of $400,000 or more. In November 2023, the SB/SE Division informed TIGTA that it would no

[13] The SB/SE and LB&I Divisions are currently in the process of auditing returns for TYs 2016 through 2021, so values for these TYs are subject to change. Furthermore, the IRS did not provide a breakdown of the audits in process or closed for TYs 2016 and 2017 and applied the 2020 Treasury Directive audit rate goal starting with TY 2018.

longer generate the agencywide *Audit Rate $10M Monitoring Report* and that the last report prepared was through the end of FY 2023. Therefore, the IRS no longer monitors whether it has met or needs to put in process additional examinations to meet, the 8 percent audit rate goal established by the 2020 Treasury Directive for high income individuals with TPI of $10 million or more.

On April 5, 2023, the IRS issued Publication 3744, *Inflation Reduction Act Strategic Operating Plan* (hereafter referred to as Strategic Operating Plan) for FYs 2023 to 2031. IRS management stated that the Strategic Operating Plan was designed to be a framework on how the IRS will meet the new 2022 Treasury Directive. While the Strategic Operating Plan includes the expansion of enforcement surrounding high-income high-wealth individuals, the elimination of its 2020 Treasury Directive audit rate makes it unclear the extent to which the IRS plans to audit these high-income individual tax returns.

The Strategic Operating Plan includes initiatives to address high-dollar compliance issues, such as those related to high-income individuals, however, the initiatives do not define high-income individuals or establish any target audit rates or goals. While the SB/SE Division confirmed that it would no longer monitor and report the $10 million or more high-income audit rates, it did communicate that certain case metrics can be evaluated to determine performance of audits, regardless of whether a target audit rate is provided, *i.e.*, no change rate, dollars recommended per return/hour, average returns per case, average hours per case, days per return, average case length, and return pick-up rate. However, goals are not associated with these measures.

IRS management informed TIGTA that their FY 2024 Enterprise-wide Examination Plan outlines the planned starts for return examinations including those for individuals with TPI of $10 million or more, which they consider are clear and measurable goals. However, according to the IRS, the FY 2024 Enterprise-wide Examination Plan has not been finalized and the planned return examination starts are subject to change. IRS management informed us they are reviewing FY 2024 first and second quarter examination data to help determine the number of starts they will need for the rest of the fiscal year.

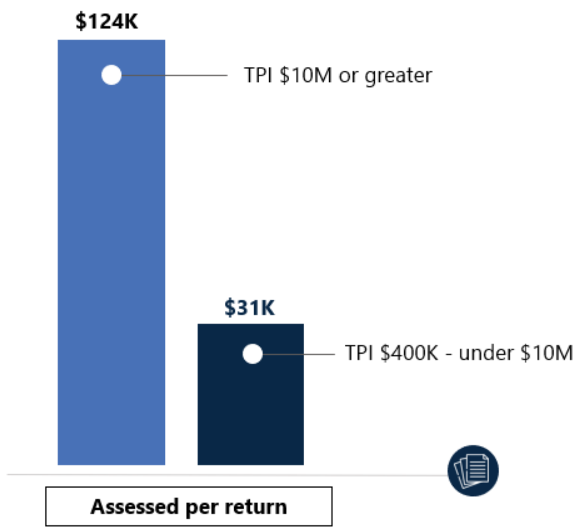
Achieving a goal of planned new examination "starts" alone, may not allow for the IRS to identify and work the most egregious highest income returns and could cause Inflation Reduction Act funds for audits of high-income individual returns to be used inefficiently. For example, achieving 100 percent of planned examination starts may satisfy the goal; however, if most of these examinations were closed as no-change, the limited IRS resources would be expended examining returns of compliant taxpayers who would be unnecessarily burdened.

The Small Business/Self-Employed Division's Examinations of Individual Returns of Taxpayers Earning $10 Million or More Have Generally Been More Productive Than Returns Examined at Lower Income Levels

The SB/SE Division's management established a Compliance Initiative Project (CIP) to comply with the 2020 Treasury Directive and at the end of the CIP found that the results justified the time and resources spent on auditing high-income returns. Furthermore, our analysis of the SB/SE Division's closed examinations of individual taxpayers with TPI of $10 million or more, for TYs 2016 through 2021, as of June 30, 2023, were more productive than TPI ranges of $400,000 to under $10 million. For the six years, the SB/SE Division assessed over $574 million, averaging approximately $124,389 per return and approximately $2,220 per hour for individual returns with TPI of $10 million or more.[14]

The Government Accountability Office's, *Standards for Internal Control in the Federal Government*, provides "monitoring" as one of the five components for internal control.[15] Monitoring provides that management should establish and operate monitoring activities to assess the quality of performance and promptly take corrective actions to achieve objectives.

Figure 2: Examinations of Returns with TPI $10 Million or More Yield 4 Times More Dollars Assessed per Return.



Source: TIGTA's analysis of closed tax return examinations as of June 30, 2023, per A-CIS data provided by the IRS.

To monitor and evaluate noncompliance, the IRS typically uses productivity measures including, but not limited to, the average dollars assessed per return and the average dollars assessed per hour. The IRS calculates the average dollars assessed per return by dividing the sum of the total positive dollars recommended for each audit by the number of closed audits. Similarly, the IRS calculates the average dollars assessed per hour by dividing the sum of the total positive dollars recommended for each audit by the number of hours spent on these audits. All audits that result in a refund would be reported as zero when calculating the total dollars assessed. We used the IRS's methodology in analyzing the data, and the results of our analysis are presented in Figures 2 and 3.

Using the Audit Information Management System – Centralized Information System (A-CIS) closed case data for TYs 2016 through 2021 returns, we calculated and analyzed the average dollars assessed per return and the average dollars assessed per hour for the SB/SE Division, as of June 30, 2023.[16]

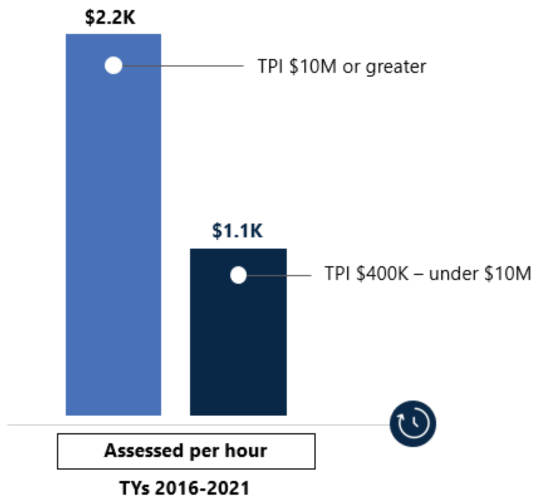
For TY 2016 through 2021, Figure 2 compares the average dollars assessed per return for returns with TPI of $10 million or more to returns with TPI of $400,000 to under $10 million. Examinations of returns with TPI of $10 million or more yielded four times more dollars assessed per return for TYs 2016 through 2021 when compared to the dollars assessed per return for returns with TPIs of $400,000 to under $10 million.

[14] The amount assessed is the sum of the total positive dollars recommended. Therefore, all return examinations that result in a refund would be reported as zero. The average assessment was calculated using the cumulative total positive dollars divided by the total returns examined, including returns resulting in a no change or refund.

[15] Government Accountability Office, GAO-14-704G, *Standards for Internal Control in the Federal Government*, p.64 (Sept. 2014).

[16] SB/SE Division has active exams open/in process for TYs 2016 through 2021, so values for those tax years are subject to change.

Figure 3: Examinations of Returns with TPI $10 Million or More Yield 2 Times More Dollars Assessed per Hour



Source: TIGTA's analysis of closed tax return examinations as of June 30, 2023, per A-CIS data provided by the IRS.

For TYs 2016 through 2021, Figure 3 compares the average dollars assessed per hour for examinations of returns with TPI of $10 million or more to returns with TPI of $400,000 to under $10 million. Examinations of returns with TPI of $10 million or more yielded two times more dollars assessed per hour for TYs 2016 through 2021 when compared to the dollars assessed per hour for returns with TPIs of $400,000 to under $10 million. These productivity measures are indicators that audits of individual returns with TPI of $10 million or more are more productive than the TPI ranges shown below $10 million.

Our analysis of the average dollars assessed per return and per hour at the various TPI ranges shows that the SB/SE Division examinations of returns with TPI of $10 million or more are more productive than returns with the lower TPI ranges reviewed by TIGTA. SB/SE management stated that this is because returns with TPI of $10 million or more tend to have larger issue adjustments and therefore higher recommended tax amounts.

The SB/SE Division's CIP for the 2020 Treasury Directive was open for approximately three years and ended in June 2023. The CIP covered selections for TYs 2018 through 2020 and assisted the SB/SE Division in meeting its share of the 2020 Treasury Directive audit rate requirement, not covered by examinations selected under other workstreams.[17] On September 26, 2023, the SB/SE Division issued the CIP Termination Report, detailing the results of the audits of high-income tax returns. The report stated that there was a total of 1,761 returns examined under this CIP, of which approximately 25 percent (442 returns) resulted in a no change. Revenue agents averaged 68 hours to complete each return examination with an average deficiency of $65,483 and an average of $957 dollars per hour. The IRS has determined that, based on the results of the CIP, it will continue to address the noncompliance of taxpayers who filed high-income returns. The IRS believes that the CIP results justified the time and resources spent on auditing high-income returns. Additionally, the SB/SE Division has partnered with the Research, Applied Analytics, and Statistics Division to analyze the population of taxpayers who file these high-income returns to identify areas of noncompliance, so that it can better determine how to address noncompliance in this population. By selecting returns that are more productive, *i.e.*, returns resulting in a tax assessment and therefore non-compliant, the SB/SE Division will also reduce the burden placed on the taxpayers who are more compliant.

In response to an earlier TIGTA audit, the IRS agreed to establish an enterprise examination plan rather than having the four IRS Operating Divisions establish their own goals, each with their

[17] A workstream is a type or category of work, such as the Discriminant Index Function, where returns are selected for audit based on their computer-scored examination potential.

own priorities.[18] The IRS is currently in the process of developing a unified examination plan for the first time. The IRS has also announced a new organizational structure which will further impact accountability for examination operations.[19]

The Strategic Operating Plan does not address the 2020 Treasury Directive required audit rate, but it does state that the IRS intends to increase enforcement activities to help ensure tax compliance of high-income high-wealth individuals. However, the Strategic Operating Plan does not define "high-income" or "high-wealth" individuals. As outlined in Initiative 3.4 of its Strategic Operating Plan, the IRS intends to use data and analytics to improve their understanding of tax filings of high-wealth individuals and to pursue noncompliance through a variety of mechanisms, including audits and non-audit contacts. Success for this initiative includes an increase in the audit coverage rates and other types of enforcement of high-income high-wealth taxpayers to improve voluntary compliance. The IRS informed TIGTA that it is in the process of working on definitions related to Initiative 3.4 of the Strategic Operating Plan. Until the IRS completes its new process on high-income individual taxpayers at all levels including taxpayers with TPI of $10 million or more, TIGTA will continue to direct recommendations pursuant to the existing IRS structure.

Recommendation 1: The Deputy Commissioner, Services and Enforcement, should include a separate category for taxpayers with TPI of $10 million or more when evaluating the compliance of high-income individual taxpayers for Initiative 3.4 of the IRS Strategic Operating Plan to ensure the productivity of examinations on these high-income individual returns is tracked and analyzed in comparison to examinations of taxpayers at other income levels.

> **Management's Response:** The IRS partially agreed with this recommendation stating it has already categorized taxpayers at multiple TPI amounts and monitors productivity measures related to high-income high-wealth taxpayers, including those with TPI of $10 million or more, to ensure the most productive returns are selected for examination. The IRS agrees with TIGTA's goal of evaluating the compliance of all high-income high-wealth taxpayers; however, the IRS disagreed that it should compare specific levels of TPI.
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> > **Office of Audit Comment:** As part of its commitment to the 2022 Treasury Directive to not increase audit rates for taxpayers making under $400,000, the IRS should review and compare the productivity for high-income taxpayers exceeding this threshold at various ranges. The factors used to identify the most productive returns at the lower end ($400,000 level) may be quite different than those related to the highest income taxpayers including those with TPI of $10 million or more.

[18] TIGTA, Report No. 2023-30-008, *Opportunities Exist for the IRS to Develop a More Coordinated Approach to Examination Workplan Development and Resource Allocation* (Feb. 2023).

[19] IR-2023-237, *New Structure Features Single Deputy IRS Commissioner, Four Chief Executive Positions to Cover Taxpayer Service, Compliance, IT and Operations* (Dec. 13, 2023).

The Large Business and International Division's Selection Methods for Returns Examined as Part of the 2020 Treasury Directive Need Improvement

LB&I case selection methods in place prior to the 2020 Treasury Directive resulted in better productivity metrics when compared to post-Treasury Directive results. Like the SB/SE Division, the LB&I Division started to address the 2020 Treasury Directive audit goal with TY 2018. For TYs 2016 and 2017, an individual return would be opened as part of a related business return examination, when known adjustments were required to be made at the individual return level. For the LB&I Division to achieve their designated portion of the 2020 Treasury Directive audit rate going forward, management needed to use other selection methods.

Prior to the 2020 Treasury Directive, the LB&I Division's individual returns were generally either: 1) international returns where the taxpayers generally had reported income under $200,000, or 2) returns that were picked up for review based on an associated business return that was already selected for examination as part of the Global High Wealth (GHW) program.[20] As a result of the 2020 Treasury Directive, the LB&I Division modified its GHW selection methodology to identify individual taxpayers with TPI of $10 million or more.[21] The modified GHW model, is referred to as the High-Income Individual (HII) model and was used by the division for TYs 2018 through 2020.[22] LB&I management explained that in addition to the GHW and HII models, their division used other selection methods to select individual returns for the 2020 Treasury Directive audits.

To monitor and evaluate noncompliance, the IRS typically uses productivity measures including the no change rate, the average dollars assessed per return and the average dollars assessed per hour. Using the A-CIS closed case data for individual returns as of June 30, 2023, we calculated and analyzed the three productivity measures for the LB&I Division using the same TPI ranges applied to the SB/SE Division. We found that there was no TPI range consistently more productive, including individual returns with TPI of $10 million or more.

As a result of this inconclusive analysis, we further analyzed the LB&I Division's TY 2016 through TY 2021 closed case data for individual returns with TPI of $10 million or more, as of June 30, 2023, by selection method and compared the productivity measures for cases selected by:

- GHW Model – Returns selected under this model impacted TYs 2016 through 2020 return case selections.
- HII Model – This model was implemented because of the 2020 Treasury Directive and impacted TYs 2018 through 2020 return case selections.

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[20] TIGTA, Report No. 2023-30-019, *The IRS Large Business and International Division Should Consider Shifting Individual Examination Resources to More Productive Examinations* (May 2023). In this report, TIGTA found that most LB&I individual returns are taxpayers with reported incomes below $200,000. The GHW program takes a holistic view of an individual income tax return by looking at their entire financial picture and the enterprises they control.

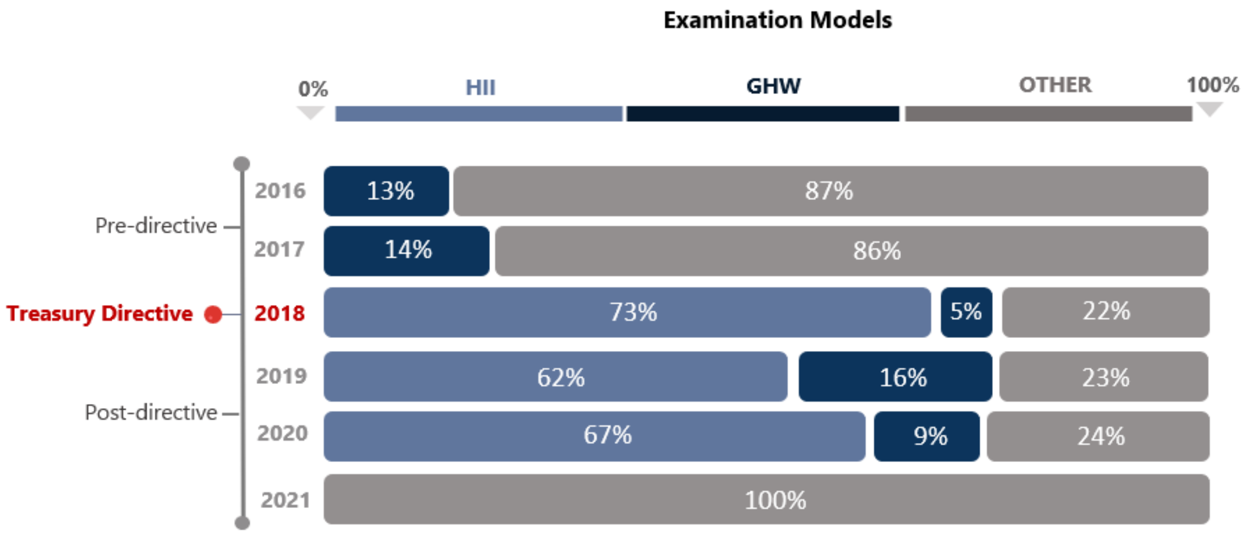
[21] In December 2019, the LB&I Division used the GHW model to select individual TY 2018 returns for examination. However, in response to the 2020 Treasury Directive, the LB&I Division reselected its TY 2018 individual returns in March 2020 using the modified GHW model.

[22] For TY 2021, the LB&I Division moved to a selection method called the Artificial Intelligence Risk model to identify individual taxpayer returns with TPI of $10 million or more. However, as of our analysis on June 30, 2023, there were no closed returns from this selection method.

- Other – All other selection methods were combined under this category.[23]

As of June 30, 2023, for TYs 2016 through 2021, the LB&I Division assessed over $715 million, averaging approximately $329,257 per return and approximately $2,157 per hour.[24] Figure 4 shows the percentage of closed examinations in the LB&I Division, for individual taxpayers with TPI of $10 million or more selected by the HII model, the GHW model and all other methods for TYs 2016 through 2021, as of June 30, 2023.

Figure 4: LB&I Division Closed Examinations of Individual Tax Returns with TPI of $10 Million or More by Selection Method for TYs 2016 Through 2021[25]



Source: TIGTA's analysis of closed tax return examinations as of June 30, 2023, per A-CIS Data provided by the IRS.

As previously stated, the IRS began addressing the 2020 Treasury Directive starting with the TY 2018 audit rate goal, primarily due to statute of limitation issues. Therefore, we consider examinations of individual tax returns with TPI of $10 million or more for TYs 2016 and 2017 as pre-Treasury Directive. As shown in Figure 4, prior to the 2020 Treasury Directive, *i.e.*, TYs 2016 and 2017, LB&I Division's selection of individual tax returns with TPI of $10 million or more for examination primarily came from selection methods outside of the GHW program. A definite shift in LB&I's selection of these high-income returns is apparent beginning with TY 2018 (the first tax year impacted by the 2020 Treasury Directive) where the HII model was responsible for most of the returns selected.

Across these selection methods, we found that LB&I examination results were better in TYs 2016 and 2017, before modifications were made to the selection methodology based on the issuance

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[23] For TYs 2016 through 2021, the "other" category includes selection methods for various work streams such as Joint Committee, captive insurance, and S Corporation distribution.

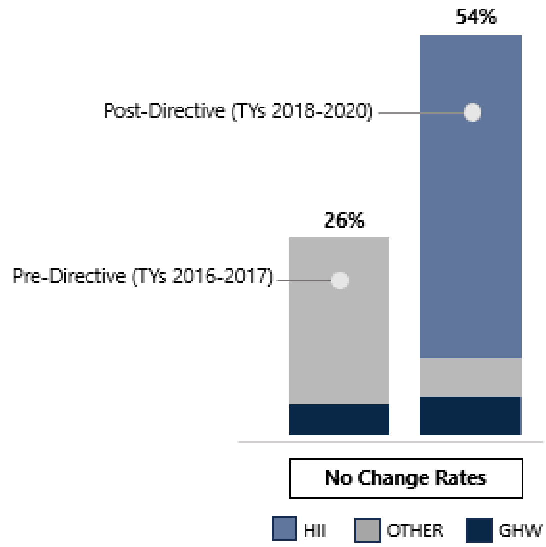
[24] The amount assessed is the sum of the total positive dollars recommended. Therefore, all audits that result in a refund would be reported as zero.

[25] LB&I is currently in the process of auditing returns for TYs 2019 through 2021, so values for these TYs are subject to change.

of the 2020 Treasury Directive, than in subsequent tax years.[26] Figure 5 compares the no change rate by case selection method for individual returns with TPI of $10 million or more for TYs 2016 and 2017 (pre-directive) to TYs 2018 through 2020 (post-directive).[27]

The no change rate for the GHW selection model and the HII selection model (used in TYs 2018 through 2020) has increased since TY 2016. The no change rate for audits selected through "other" methods has decreased. It is possible that the no change rate for TYs 2019 through 2020 may decrease, as audits are still in process for these tax years. IRS management stated that no change examinations typically take less time to complete than examinations requiring adjustments. As the examination cycle progresses for a particular tax year, the no change rate will typically decrease as audits requiring adjustments are completed.

Figure 5: Examinations of Returns with TPI $10 Million or More Were Less Productive After Selection Method Modifications Were Made in Response to the 2020 Treasury Directive



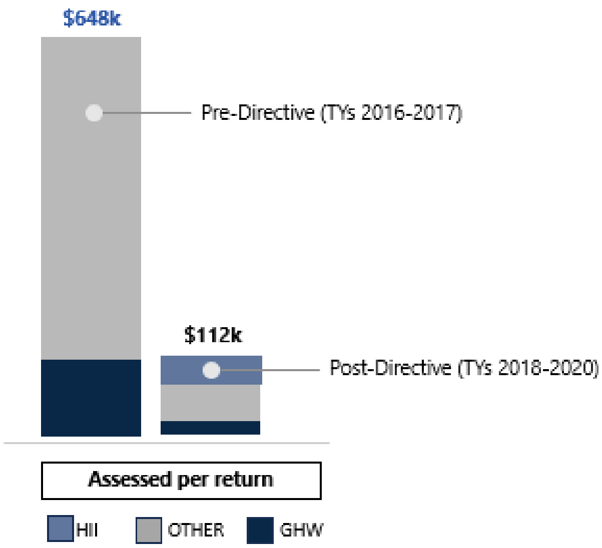
Source: TIGTA's analysis of closed tax return examinations as of June 30, 2023, per A-CIS data provided by the IRS.

[26] As of June 30, 2023, the LB&I Division had closed only four examinations of individual taxpayers with TPI of $10 million or more for TY 2021, therefore, due to limited data, we excluded this tax year from our analysis as shown in Figures 5 through 7.

[27] After June 30, 2023, the LB&I Division continues to audit returns for TYs 2019 through 2020, therefore the values for those tax years, as shown in Figures 5 through 7, are subject to change.

Figure 6 compares the average dollars assessed per return by case selection method for individual returns with TPI of $10 million or more for TYs 2016 and 2017 (pre-directive) to TYs 2018 to 2020 (post-directive).

Figure 6: The Average Dollars Assessed per Return with TPI of $10 million or more were Nearly 6 Times More Productive Prior to the 2020 Treasury Directive



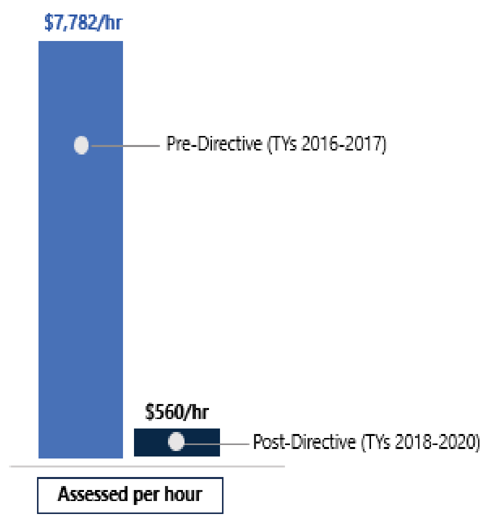
Source: TIGTA's analysis of closed tax return examinations as of June 30, 2023, per A-CIS data provided by the IRS.

As Figure 6 shows, the average dollars assessed per return with TPI of $10 million or more was nearly six times more productive prior to the 2020 Treasury Directive.

Figure 7 compares the average dollars assessed per hour by case selection method for individual returns with TPI of $10 million or more for TYs 2016 and 2017 (pre-directive) to TYs 2018 to 2020 (post-directive) in the LB&I Division.

As shown in Figure 7, the average dollars assessed per hour on returns with TPI of $10 million or more were nearly 14 times more productive prior to the 2020 Treasury Directive. Overall, we found that the no change rate was lower and average dollars assessed per return and the average dollars assessed per hour were higher in TYs 2016 and 2017 prior to the 2020 Treasury Directive.

Figure 7: The Average Dollars Assessed per Hour with TPI of $10 million or more were Nearly 14 Times More Productive Prior to the 2020 Treasury Directive



Source: TIGTA's analysis of closed tax return examinations as of June 30, 2023, per A-CIS data provided by the IRS.

LB&I Division management stated that factors such as attrition and workforce played a role in the no change rate, citing significant attrition of 5 to 10 percent per year with less agents available to open new cases to meet goals. Management added that cases changed hands many times as agents left, adding to high cycle times and a higher likelihood of cases closing due to statute of limitation issues. The Division's FY 2022 and third quarter FY 2023 Key Stat reports noted that the number of staff years applied to all LB&I returns went from approximately 1,616 staff years in FY 2018 to approximately 937 as of June 2023, suggesting that their workforce has decreased during that time. Additionally, according to a TIGTA report released in August 2023, at the end of FY 2019 there were 3,040 revenue agents in LB&I and as of

March 31, 2023, there were 2,908 in LB&I, which is a 4.3 percent decrease.[28] Management also shared that the new Bipartisan Budget Act of 2015 centralized partnership audit regime procedures were not always clear and resulted in premature closures for a variety of issues thereby contributing to the increased no change rate.[29]

The IRS's primary objective in selecting returns for examination is to promote the highest degree of voluntary compliance on the part of taxpayers. This requires the exercise of professional judgement in selecting sufficient returns of all classes to assure taxpayers receive equitable consideration by using available experience and statistics indicating the probability of substantial error, and in making the most efficient use of examination staffing and other resources.[30]

As detailed above, there are multiple factors influencing the LB&I Division's increasing no change rates and lower productivity measures.[31] Ultimately, all factors should be considered in reviewing the methods used by the LB&I Division to select returns for examination to promote the highest degree of voluntary compliance and efficient use of limited resources. Also, if the IRS continues to select returns of taxpayers who are compliant, this imposes an unfair burden on those taxpayers.

Recommendation 2: The Commissioner, Large Business and International Division, should identify the potential causes for the low productivity examination results and monitor the productivity measures related to the highest income individual taxpayers including those with TPI of $10 million or more, ensuring the most productive returns are selected for examination.

Management's Response: The IRS partially agreed with this recommendation with respect to the need to identify potential causes for the low productivity examination results and stated that it had already taken steps to identify the causes. The IRS plans to use enhanced data and analytics to select cases based on the highest risk of noncompliance.

Office of Audit Comment: Although the IRS partially agreed with this recommendation, it did agree to monitor productivity measures related to high-income high-wealth taxpayers, including those with TPI of $10 million or more, to ensure the most productive returns are selected for examination. In combination with the IRS's response to Recommendation 1 and this recommendation that includes identifying the potential causes for the low productivity examination results, the collective actions taken should fully address this recommendation.

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

[29] Pub. L. No. 114-74, § 1101, 129 Stat. 625.

[30] Internal Revenue Manual 1.2.1.5.10(2) (June 1, 1974).

[31] LB&I management stated that other factors including workload may also impact the increasing no change rates and lower productivity measures. We did not review workload levels in this audit.

The IRS Overstated the Opportunity Costs Associated With the 2020 Treasury Directive

On March 13, 2020, the then IRS Commissioner responded to the then Secretary of the Treasury citing the resource needs of at least 400 full-time revenue agents, with the majority being at General Schedule Grade 13 level. The then Commissioner also cited the following opportunity costs associated with complying with the 2020 Treasury Directive:

- Approximately 900 fewer audits of large and mid-size business returns.
- 600 fewer audits of small corporate returns.
- 850 fewer audits of individual returns with TPI under $10 million.

The then Commissioner was stating that a total of 1,500 business returns and 850 individual returns could not be worked if the 2020 Treasury Directive were undertaken, since resources would need to be reallocated to work the additional returns required to meet the Directive. Our review identified that these stated opportunity costs were based on the additional examinations (not including in process or planned examinations) required to collectively meet the 2020 Treasury Directive for TYs 2017 and 2018.

We reviewed the IRS's calculations to determine the opportunity costs for working on individual returns with TPI of $10 million or more. At the time of the IRS's response, the IRS had already started or planned to start about 45 percent of the audits it would need to complete to reach the 8 percent audit rate for TYs 2017 and 2018 combined.

The IRS provided us with the methodology used by the SB/SE Division to determine how it identified approximately 600 fewer small corporate returns and about 850 fewer audits of individual returns with TPI under $10 million would be conducted in TYs 2017 and 2018, for the IRS to complete the additional audits necessary to reach the 8 percent audit rate goal of audits over $10 million TPI. However, the IRS did not provide us with the methodology used by the LB&I Division to determine how it identified that about 900 fewer large and mid-size business audits would be conducted. The IRS stated that it did not have the exact computations that led to the figure. As a result, for our assessment, we used information from the FY 2019 LB&I Key Stats report to calculate how many large and mid-size business audits the IRS would need to forego to complete the additional audits necessary to achieve the 8 percent audit rate for TYs 2017 and 2018. We determined that the IRS would work approximately 710 fewer combined large and mid-size business audits, which is 190 less audits than the 900 audits documented in the then Commissioner's March response. Therefore, the opportunity costs appear to be overstated.

When we asked what the retention policy is for the calculations used in the Commissioner's memorandum, we were provided with the IRS General Records Schedule, which states that common office records or administrative records maintained by any agency office can be destroyed once there ceases to be a business use. However, according to Federal Records Management, records that are evidence of an agency's decisions must be managed properly for the agency to function effectively and to comply with Federal laws and regulations and as such, "the head of each Federal agency shall make and preserve records containing adequate and proper documentation of the organization, functions, policies, decisions, procedures, and essential transactions of the agency and designed to furnish the information necessary to protect the legal and financial rights of the Government and of persons directly affected by the agency's activities."[32] If the support for information reported in the Commissioner's memorandum is not maintained, then there is no way to determine if the data in the memorandum is accurate because there is no way to verify the accuracy of the calculations used to determine these figures.

[32] Records Management by Federal Agencies, Pub. L. 90–620, 82 Stat. 1297 (codified as amended in 44 United States Code Section 3101).

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this audit was to determine whether the IRS was meeting the Department of the Treasury's established goal of auditing a minimum of 8 percent of all high-income individual returns filed each year.[1] To accomplish our objective, we:

- Assessed the IRS's processes and procedures for selecting high-income returns for audit, including reviewing the Internal Revenue Manual, programming guides, and interviewing IRS Management to determine how the IRS selected high-income tax returns for audit, along with understanding any differences between the SB/SE and LB&I Divisions' processes.
- Determined if any changes were made to the process once the Treasury Directive was issued in February of 2020.
- Reviewed the IRS's calculations of audit rates for high-income tax returns for TYs 2016 through 2021.
- Reviewed the results of the audits performed to determine the productivity and manner of disposition for each audit. We also compared the productivity of high-income audits to audits of returns with TPI less than $10 million for both the SB/SE and the LB&I Divisions. Additionally, we compared the productivity measures of high-income audits conducted by the LB&I Division based on selection methods.
- Reviewed the IRS Strategic Operation Plan and interviewed management on their plans to monitor and evaluate examination results of the highest income individual taxpayers, including those with TPI of $10 million or more.
- Validated available IRS information supporting the then Commissioner's March 2020 response to the Secretary of the Treasury reflecting the opportunity costs of shifting resources to meet the 2020 Treasury Directive.

Performance of This Review

This review was performed with information obtained from the Headquarters offices of the SB/SE Division located in Lanham, Maryland and the LB&I Division located in Washington, D.C., during the period February 2023 through March 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); Michele Jahn, Director; Javier Fernandez,

[1] Our audit focused on IRS examinations of individual returns with total positive income of $10 million or more, which the IRS used to comply with the minimum 8 percent audit rate goal.

Audit Manager; Aranxa Delgado, Lead Auditor; Stephanie Finlay, Lead Auditor; Yancy Tam, Auditor; and Laura Christoffersen, Information Technology Specialist.

Data Validation Methodology

We performed tests to assess the reliability of data from the A-CIS. We evaluated the data by (1) performing electronic testing of required data elements, (2) reviewing existing information about the data and the system that produced them, (3) interviewing agency officials knowledgeable about the data, (4) reconciling selected data to the Integrated Data Retrieval System. 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 determined that the following internal controls were relevant to our audit objective: the IRS's policies, procedures and practices related to the selection of individual returns for examination by the SB/SE and LB&I Divisions. We evaluated these controls by interviewing management, reviewing reports, and analyzing closed examination data.

Appendix II

Secretary of the Treasury Steven Mnuchin's February 10, 2020, Directive to IRS Commissioner Charles Rettig

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

February 10, 2020

MEMORANDUM FOR INTERNAL REVENUE SERVICE COMMISSIONER CHARLES P. RETTIG

FROM: Steven T. Mnuchin, Secretary of the Treasury

SUBJECT: Importance of Audit Procedures

Robust enforcement of the tax laws is critical to ensuring fairness in our tax system. By pursuing taxpayers who fail to comply with their tax obligations, the Internal Revenue Service (IRS) treats compliant taxpayers fairly and incentivizes all taxpayers to voluntarily comply with the law.

You and I have recently reviewed the IRS's recent audit rates for high-income individual returns—*i.e.*, the returns of individual taxpayers with adjusted gross income above $10 million. I am concerned with the reduction in audit rates and as such, I have concluded that it is necessary and appropriate for the IRS to audit a minimum of at least 8% of all such returns filed each year.

Therefore, pursuant to 26 U.S.C. §§ 7801 and 7803 (a)(2), I direct you to take all steps necessary to ensure that the IRS audits a minimum of 8% of all high-income individual returns filed each year, starting with the 2016 tax year.

Although the IRS audited at least this percentage of high-income individual returns for the 2010 through 2015 tax years, the IRS's audit rate projections for subsequent tax years currently fall below this threshold. I understand that the IRS has operated under significant budgetary constraints throughout this period. In the event that you determine that the IRS will need to reallocate resources to implement this directive, please advise me of your resource needs within 30 days of this letter.

Appendix III

IRS Commissioner Charles Rettig's March 13, 2020, Response to Secretary of the Treasury Steven Mnuchin's February 10, 2020, Directive

COMMISSIONER

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

March 13, 2020

The Honorable Steven T. Mnuchin
Secretary
U.S. Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Dear Secretary Mnuchin:

We are responding to your letter dated February 10, 2020, directing the IRS to audit a minimum of 8% of high-income individuals returns (i.e., individual taxpayers with adjusted gross income above $10 million) filed each year, starting with the 2016 year.[1] We appreciate your acknowledgment that the IRS has operated under significant budgetary constraints for many years. We further appreciate your request to be advised of our resource needs that would be required for a reallocation of resources to implement your directive. We share your enthusiasm for ongoing, visible, robust tax enforcement efforts as one method of ensuring the fairness and integrity of our tax system.

Statute of Limitations:

As of now, we project that the 2016 coverage rate for taxpayers with total positive income of $10 million and above will be roughly 6.5%. Unfortunately, there is little time remaining on the 2016 statute of limitations to initiate additional examinations in a manner that might materially improve that percentage. In a typical cycle, examinations are opened with approximately 18 months remaining on the statute of limitations to allow sufficient time to review the return, meet with the taxpayer/representatives, request additional information from the taxpayer and possibly others supporting the positions set forth in the return, and, when appropriate, interview third parties.

As discussed below, given current resource limitations and the extensive training required for a Revenue Agent to become capable of examining a complex individual income tax return, we also face challenges with respect to timing on 2017 statutes. As stated, the amount of time needed to conduct an effective examination of taxpayers at this level of complexity is longer than what remains on the statute for timely filed 2017 returns. If a taxpayer under examination declined to voluntarily extend the typical 3-year statute of limitations, absent sufficient information to support the issuance of a Notice of

[1] While the memorandum refers to AGI, it is our understanding that we are to achieve an 8% coverage by looking at total positive income (TPI) and by tax year.

Deficiency (which typically must be issued within the 3-year statutory period), we would likely have to close the examination prematurely.

Reaching coverage targets and trade-offs:

For 2017 and beyond, we are not currently able to significantly increase the amount of open examinations without redeploying our most experienced employees from other priority work and also hiring and training additional employees to handle examinations of complex individual returns. Achieving and maintaining an 8% audit coverage rate of high-income individuals would require at least 400 full-time revenue agents, with the majority being at the grade 13 level for this work. In the two IRS divisions that audit high-income taxpayers, we have approximately 2,100 grade 13 revenue agents who conduct field audits of taxpayers. The redeployment of approximately 20% of this workforce will have a significant detrimental impact on other priority work. In addition to audits of individuals under the $10 million threshold, these employees typically perform complex business audits (both small and large business, including corporations, partnerships and other flow-through entities) as well as excise and employment tax audits. Their work also includes high-priority, impactful compliance issues such as syndicated conservation easements, micro-captive insurance, offshore noncompliance, promoter investigations, and ensuring TCJA compliance; as well as our stated objective of increasing partnership audits and our global high wealth program.

We are working to quickly quantify the full impact and identify which employees will be redeployed from other work. We must also acknowledge that increasing audits for high-income individuals (as well as our efforts to increase partnership coverage) will reduce the coverage rate in the categories of large business audits, small corporate audits and individuals under $10M total positive income (TPI). We expect the following reduction: approximately 900 fewer large and mid-size business returns, approximately 600 fewer small corporate returns, and approximately 850 fewer audits of individuals under $10M TPI. Finally, an ongoing commitment to this work will impact our ability to increase coverage in the large partnership area and some of our planned TCJA compliance activities. Note that the immediate impact may vary and is difficult to predict as we need to transition employees from other work and train additional employees currently focused on other areas to do this work (and such training often entails bringing experienced employees offline to train the employees in transition).

Impact of changes in partnership audit regime:

The change in partnership audit rules creates a headwind to achieving this audit rate, and past results are not comparable to future results. The IRS's historical audit numbers of high-income individuals reflect the TEFRA partnership auditing regime, whereby an audit of a partnership entailed several related audits and adjustments at the partner level. As such, one examination resulted in many different taxpayer touchpoints that are reflected in the coverage numbers. In prior tax years, TEFRA investor closures made up over one-third of examinations in the over $10M TPI category and required only a few hours of work per return from our campus employees. However, under the Bipartisan Budget Act's (BBA) centralized partnership auditing regime, audits and adjustments are generally made at the partnership level, and that will result in a reduced count of entities and individuals audited in connection with any one BBA exam.

Other required investments and considerations:

As noted above, significant training will be required for our existing employees who do not have Form 1040 or high wealth auditing expertise in order to position them to appropriately take on this work. The vast majority of revenue agents who currently focus on business audits do not have training or experience involving the examination of a complex individual income tax return. It would take approximately 3-4 months until these otherwise experienced grade 13 revenue agents are equipped to handle this work, in terms of getting the requisite training and completing or transitioning their existing inventory.

The foregoing estimates may change, as we are still in the process of identifying the employees who will need to be redeployed to this effort, how to transition their existing exam work, the best source for identification of cases meeting these criteria, and an overall timeline for this effort.

Resource request:

To avoid negative impacts to other priority work, the IRS requests additional resources to significantly increase the number of new grade 13 revenue agents and to appropriately train these new agents. Based on the resources required to complete the above, and noting continued attrition of grade 13 revenue agents at the annual rate of approximately 7%, the IRS would request additional resources to accommodate onboarding at least 428 additional revenue agent staffing. In addition to additional staffing resources, we also need a corresponding increase in operation support to provide necessary IT equipment.

Program Integrity Cap (PIC) Adjustment:

In closing, we'd be remiss if we failed to reference our strong, mutual support for the FY21 Budget proposal to fund an adjustment to the discretionary caps for program integrity activities to strengthen our enforcement efforts. It is important for the IRS to maintain appropriate levels of staffing at points of significant taxpayer contact. Compliant taxpayers deserve to know that non-compliant taxpayers are at risk.

The proposed initial $400 million cap adjustment for FY21 would fund additional enforcement staff, new and continuing activities, and expanded efficiency through the use of data analytics and artificial intelligence in our enforcement operations. Once the new PIC enforcement staff are trained and become fully operational these initiatives are expected to generate approximately five dollars for every dollar expended. The PIC is expected to return a net savings of $64 billion from 2021-2030 (before considering the significant deterrent effect associated with an expanded enforcement presence).

We appreciate your ongoing, direct engagement with and strong support of the Internal Revenue Service. We interact with more Americans than any other institution, public or private. In FY19, the IRS accounted for approximately 96% of the gross revenue received on behalf of the United States. In this regard, the continued success of our country depends, at least in part, upon a successful IRS. We want to do more and respect our responsibility to efficiently expend our limited resources in support of our country.

Sincerely,

Charles P. Rettig

Appendix IV

Secretary of the Treasury Janet Yellen's August 10, 2022, Directive to IRS Commissioner Charles Rettig

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.

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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

Appendix V

Management's Response to the Draft Report

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

COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

May 31, 2024

MEMORANDUM FOR MATTHEW A. WEIR
ACTING DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Lia Colbert Amalia C. Colbert Digitally signed by Amalia C. Colbert Date: 2024.05.31 10:03:24 -04'00'
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – *The IRS Ceased Compliance With the $10 Million Taxpayer Treasury Directive in Favor of an Overall Focus on High-Income Taxpayer Noncompliance* (Audit 202330020)

Thank you for the opportunity to respond to the above referenced report. In August 2022, Congress enacted the Inflation Reduction Act (IRA), giving the Internal Revenue Service (IRS) a historic opportunity to transform tax administration through improved taxpayer service and expanded compliance efforts. In April 2023, the IRS released the IRA Strategic Operating Plan (SOP) providing a vision for the future of federal tax administration – a vision that includes new capabilities, including specialized skills to understand and address the complex filings of high-income high wealth taxpayers and large corporations and partnerships so Americans have confidence that all taxpayers are doing their part to meet their responsibilities under our tax laws. The SOP identifies the highest priority opportunities to deliver transformational change for taxpayers and hundreds of IRS employees are serving on initiative and project teams to accomplish the SOP.

The IRA provided much-needed funding for the IRS to enforce the tax laws against those wealthy individuals, large corporations, and large, complex partnerships who today do not pay what they owe. The IRS will not use IRA resources to increase audit rates for small businesses and taxpayers making under $400,000. Accordingly, the IRS is focusing on high income, high wealth (HIHW) taxpayers, including those reporting $10 million or more, to ensure this population of taxpayers pays what they owe.

The efforts already underway to accomplish the SOP align with TIGTA's recommendations to improve high income and high wealth audits. Specifically, objective

3 of the SOP focuses expanded enforcement on taxpayers with complex tax filings and high-dollar noncompliance to address the tax gap. We are developing an enterprise-wide compliance strategic plan that will focus resources on the Secretary's 2022 directive concerning high-income high wealth taxpayers, larger corporations and complex partnerships.

On May 2, 2024, the IRS released a SOP update outlining future priorities and highlighting major accomplishments since the IRA's passage. It highlights our successes such as recovering $520 million as of January 2024 from taxpayers with more than $1 million income who have either not filed their taxes or failed to pay their recognized tax debt, creating a team to stand up a new organization to work complex partnerships and pass through entities, and increasing our number of revenue agents in the past year by approximately 9%, among other achievements. The outline also features our plan to build a 21st century tax agency which requires Congress maintain IRA funding levels for the IRS to modernize technology, use new enforcement staff to double audit rates on the wealthiest taxpayers, and continue ensuring fairness in pursuit of narrowing the tax gap.

Responses to your specific recommendations are enclosed. If you have any questions, please contact me or Rich Tierney, Director, Examination, Small Business/Self-Employed Division.

Attachment

Attachment

RECOMMENDATION 1:
The Deputy Commissioner for Services and Enforcement, should include a separate category for taxpayers with TPI of $10 million or more when evaluating the compliance of high-income individual taxpayers for Initiative 3.4 of the IRS Strategic Operating Plan to ensure the productivity of examinations on these high-income individual returns are tracked and analyzed in comparison to examinations of taxpayers at other income levels.

CORRECTIVE ACTION:
The IRS already has categorizations for taxpayers at multiple total positive income (TPI) amounts including $10 million or more. The SOP outlines how we will use IRA funding to enforce tax laws on high-income high wealth (HIHW) taxpayers, larger corporations, and complex partnerships who do not pay what they owe. We monitor productivity measures related to HIHW taxpayers, including those with TPI of $10 million or more, to ensure the most productive returns are selected for examination as part of our commitment to the 2022 Treasury Directive to not increase audit rates for small businesses or taxpayers making under $400,000. While we disagree that the IRS should compare specific levels of TPI, we share TIGTA’s goal of evaluating the compliance of all HIHW taxpayers.

IMPLEMENTATION DATE:
N/A

RESPONSIBLE OFFICIAL:
N/A

CORRECTIVE ACTION MONITORING PLAN:
N/A

RECOMMENDATION 2:
The Commissioner, Large Business and International Division, should identify the potential causes for the low productivity examination results and monitor the productivity measures related to the highest income individual taxpayers including those with TPI of $10 million or more, ensuring the most productive returns are selected for examination.

CORRECTIVE ACTION:
We partially agree with the need to identify potential causes for the low productivity examination results as we have already taken steps to identify the causes. We will use enhanced data and analytics to select cases based on the highest risk of noncompliance.

IMPLEMENTATION DATE:
March 15, 2025

RESPONSIBLE OFFICIAL
Director, LB&I Pass Through Entities Practice Area

CORRECTIVE ACTION MONITORING PLAN:
We will monitor this corrective action as part of our internal management system of controls.

Appendix VI

Glossary of Terms

Term	Definition
Activity Code	A code that identifies the type and condition of returns selected for audit.
Audit Information Management System – Centralized Information System	A database that provides monthly Audit Information Management System data on both open and closed cases.
Discriminant Index Function	A mathematical technique used to computer-score income tax returns as to examination potential. Examination potential is indicated by a numeric score that is assigned to each return by examination class; the greater the score, the greater the examination potential within each examination class.
Fiscal Year	Any yearly accounting period, regardless of its relationship to a calendar year. The Federal Government's fiscal year begins on October 1 and ends on September 30.
General Schedule	The classification and pay system established under 5 United States Code Chapter 51 and Subchapter III of Chapter 53. It is a rate of basic pay for professional, technical, administrative, and clerical professionals working for the Federal Government.
Revenue Agent	Employees in the Examination function who conduct face-to-face examinations of more complex tax returns, such as businesses, partnerships, corporations, and specialty taxes.
Tax Year	A 12-month accounting period for keeping records on income and expenses used as the basis for calculating the annual taxes due. For most individual taxpayers, the tax year is synonymous with the calendar year.
Total Positive Income	The sum of all positive amounts shown for the various sources of income reported on the individual tax return and, therefore, excludes losses.

Appendix VII

Abbreviations

A-CIS	Audit Information Management System – Centralized Information System
CIP	Compliance Initiative Project
FY	Fiscal Year
GHW	Global High Wealth
HII	High-Income Individual
IRS	Internal Revenue Service
LB&I	Large Business and International
SB/SE	Small Business/Self-Employed
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.