TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

The IRS Continued Compliance Efforts for High-Income Taxpayers After Disbanding the High Income High Wealth Strategy, but With Less Effective Outcomes

July 7, 2021

Report Number: 2021-30-041

HIGHLIGHTS: The IRS Continued Compliance Efforts for High-Income Taxpayers After Disbanding the High Income High Wealth Strategy, but With Less Effective Outcomes

Final Audit Report issued on July 7, 2021 **Report Number 2021-30-041**

Why TIGTA Did This Audit

This audit was initiated to evaluate the IRS Small Business/Self-Employed (SB/SE) Division's High Income High Wealth (HIHW) strategy for compliance of high-income individual taxpayers.

Impact on Taxpayers

The IRS's primary objective in selecting returns for examination is to promote the highest degree of voluntary compliance. When some taxpayers do not report their correct income and pay what they owe, other taxpayers will ultimately have to pay more to make up the difference. High-income taxpayers generally have more opportunities to engage in planning to avoid taxes. Between Fiscal Years (FY) 2015 and 2019, the SB/SE Division Examination function used 10 or 11 strategic priorities (depending on the fiscal year) to group similar examination work for reporting purposes. SB/SE Division management stated that high-income individual tax returns are worked in each of the SB/SE Division strategies, but they also stated that each strategy has a purpose that may or may not be focused on high-income return coverage.

The HIHW strategy started in 2010, and the IRS defines high-income taxpayers as those whose total positive income (TPI) was at least $200,000 on Form 1040, *U.S. Individual Income Tax Return*. The HIHW strategy consisted of two subcategories: filed returns for High Income Underreported (HIU) taxpayers and High Income Nonfiler (HINF). The HIU acronym referenced in this report was created by TIGTA for reporting purposes and represents high-income filers within the HIHW strategy. The HIHW strategy continued until it was disbanded at the end of FY 2017. The primary focus of this review was specific to the HIHW strategy before and after disbanding.

What TIGTA Found

The SB/SE Division's high-income examinations increased as a percentage of all closures from 20 percent in FY 2015 to 26 percent in FY 2019. However, total closures continued to drop during this time based on a reduction in available resources and resulted in actual high-income return closures dropping from 47,024 for FY 2015 to 29,610 for FY 2019 resulting in potential lost assessments totaling $1.9 billion.

The HIHW strategy closures with TPI of less than $200,000 represented the majority (73 percent) of the individual returns closed from the strategy for FYs 2015 through 2017. The examination case selection and assignment process for HIHW strategy returns does not appear to have been focused on the selection of returns with TPI of at least $200,000. For example, the HIHW strategy included HINF examinations selected based on TPI over $100,000 and, per the IRS, also included related return closures. HIHW strategy examinations that did focus on high-income taxpayers resulted in more dollars per hour on average than any of the other SB/SE Division strategies during FYs 2015 through 2017. Additionally, the overall HIHW strategy dollars per hour were diluted with the inclusion of closures with TPI of less than $200,000. The examination plan for high-income taxpayers with TPI over $1 million fell short of planned examinations for FYs 2016 and 2017.

When the HIHW strategy was disbanded, the SB/SE Division moved the HINF inventory to a nonfiler strategy that started in FY 2018 and moved the HIU inventory to the Other Priority Programs strategy. The dollars per hour for HINF remained steady after disbanding while the HIU dollars per hour fluctuated. After disbanding the HIHW strategy, the IRS increased examinations of high-income taxpayers using the discriminant function rather than maintaining or increasing HIU examinations. This change resulted in $121.5 million in potential lost assessments for FYs 2018 and 2019, affecting 1,534 tax returns. The outcome of $121.5 million does not consider examiner attrition, resource limitations by location, or the diminishing returns of examining additional tax returns. The IRS has requested three new activity codes but has no plans to create additional activity codes.

What TIGTA Recommended

TIGTA recommended that the IRS improve the monitoring of the results of high-income taxpayer examinations by: 1) creating a dedicated work stream focused on high-income taxpayer underreporting; 2) increasing the monitoring of closures by income categories to ensure that planned examination closures are met; 3) developing Compliance Initiative Projects to address the high-income taxpayer underreporting segment of the Tax Gap; and 4) adding additional activity codes similar to income categories for high-income taxpayers in the IRS Data Book. IRS management disagreed with three of the four recommendations because they believe the current processes to monitor the examination results of high-income taxpayers are sufficient. For Recommendation 2, the IRS noted planned changes were already made independent of TIGTA's audit.

TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

U.S. DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

July 7, 2021

MEMORANDUM FOR: COMMISSIONER OF INTERNAL REVENUE

FROM: Michael E. McKenney
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – The IRS Continued Compliance Efforts for High-Income Taxpayers After Disbanding the High Income High Wealth Strategy, but With Less Effective Outcomes (Audit # 201930026)

This report presents the results of our review to evaluate the Internal Revenue Service Small Business/Self-Employed Division's efforts to ensure the compliance of high-income individual taxpayers. This review is part of our Fiscal Year 2021 Annual Audit Plan and addresses the major management and performance challenge of *Improving Tax Reporting and Payment Compliance.*

Management's complete response to the draft report is included as Appendix III.

Copies of this report are also being sent to the Internal Revenue Service managers affected by the report recommendations. If you have any questions, please contact me or Matthew A. Weir, Assistant Inspector General for Audit (Compliance and Enforcement Operations).

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Background

The Tax Gap's largest component, $314 billion, is individual income taxes, of which $245 billion is attributable to underreporting and $31 billion to nonfiling.

The average annual gross Tax Gap for Tax Years 2011 through 2013 is estimated to be $441 billion.[1] The largest component, $352 billion, is attributable to underreporting of taxes, with amounts attributable to nonfiling and underpayment of taxes at $39 billion and $50 billion, respectively. These Tax Gap estimates are also segmented by the type of tax. The largest segment, $314 billion, is individual income taxes, which is composed of underreporting ($245 billion), underpayment ($38 million), and nonfiling ($31 billion). The net Tax Gap is estimated to be $381 billion.[2] Sustaining and improving taxpayer compliance is important because small declines in compliance cost the Nation billions of dollars in lost revenue and shift the tax burden away from those who do not pay their taxes onto those who pay their fair share on time every year. High-income taxpayers generally have more opportunities to engage in planning to avoid taxes. To address underreporting by taxpayers, the Internal Revenue Service (IRS) examines tax returns.

The IRS's Small Business/Self-Employed (SB/SE) Division examines individual tax returns and business tax returns with assets under $10 million. The 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 judgment in making the most efficient use of staffing resources and in selecting returns to assure all taxpayers of equitable consideration. The Performance, Planning, and Analysis function in the SB/SE Division's Examination function prepares the annual SB/SE Division Examination Plan. In implementing the plan, the strategy is to have coverage across return categories that fall within the purview of the SB/SE Division.[3] The IRS uses a variety of sources to select returns for audit and strives to select those for which its examiners are likely to find areas of noncompliance and recommend changes to one or more items reported on the return.[4]

Between Fiscal Years (FY) 2015 and 2019, the SB/SE Division Examination function used 10 or 11 strategic priorities depending on the fiscal year, to group similar examination work.[5] Each strategy provides the results of examinations of a different type of inventory and includes taxpayers across income categories. IRS management defined these examination strategies as follows:

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[1] See Appendix IV for a glossary of terms.

[2] IRS, Publication 1415, *Federal Tax Compliance Research: Tax Gap Estimates for Tax Years 2011–2013*, pp. 1–2 and 8 (Sept. 2019).

[3] Internal Revenue Manual 4.1.1.2.3(1) (Oct. 25, 2017).

[4] Unless otherwise stated, the scope of this review was limited to SB/SE Division examinations of individual income tax returns conducted by revenue agents and tax compliance officers in field offices in the seven SB/SE Division Field Examination Areas. References to the "examination plan" throughout this report are to the SB/SE Division Field Examination Plan. The SB/SE Division's seven Field Examination Areas, based on geographical location, are Central, Gulf States, Midwest, North Atlantic, South Atlantic, Southwest, and Western.

[5] Hereafter referred to as "strategy" when used singularly or as "strategies" when used in the plural.

- The National Research Program (NRP) strategy provides a statistically valid random sample of filed returns representative of the compliance characteristics of taxpayers. Returns in this strategy are assigned to examiners as quickly as possible, and surveys before or after assignment are limited.
- The Promoters and Return Preparer (P&RP) strategy includes examining returns of clients of return preparers, examining returns of clients of promoters who also prepare returns, examining promoter returns, examining return preparer tax returns, assessment of preparer penalties, and pursuing injunctions against abusive preparers and promoters.
- The Offshore (OFF) strategy addresses returns that appear to have abusive issues related to offshore accounts or international issues.
- The Abusive Transactions and Technical Issues (ATTI) strategy focuses on domestic abusive transactions and tactics.
- The High Income and High Wealth (HIHW) strategy addresses taxpayers with total positive income (TPI) of at least $200,000 and high-income high wealth taxpayers who use techniques, such as flow-through entities, to significantly reduce TPI.[6]
- The Claims strategy focuses on Innocent Spouse, disaster, and similar claims in addition to taxpayer requests and Taxpayer Advocate Services operation assistance requests.
- The Nonfiler (NF) strategy addresses taxpayers who have been identified through various IRS selection processes as not filing required tax returns.
- The Unreported and Underreported Income (U&UI) strategy involves indications of unreported income.
- The Special Enforcement and Fraud Programs (SEP&F) strategy addresses unreported income that may be criminal in nature.
- The Other Priority Programs (OPP) strategy contains specific work streams and important projects that are specifically coded and do not fit into the other strategies.
- The Discriminant Function (DIF) strategy contains returns selected based on algorithms. The results of NRP strategy examinations are used to update the algorithms.
- The All Other (AO) strategy includes all other work that is not included in the other strategies but does not contain specific work streams.

The development of the SB/SE Division's Examination Plan involves allocating available time to the strategies. IRS management stated that the DIF strategy is built into the examination plan after allocations have been made to the other strategies. This direct correlation of the other strategies compared to the DIF and AO (DAO) strategies, specifically the DIF strategy, is subsequently discussed. Figure 1 shows the trends in resource allocation by Direct Examination

[6] For FY 2018, projects under the HIHW High Income Nonfiler subcategory were moved to Strategy Number 6 (Nonfiler), which was previously a placeholder, and projects under the High Income Underreported subcategory were moved to Strategy Number 9 (Other Priority Programs) with other national Compliance Initiative Projects. The former HIHW strategy became a placeholder containing no projects.

Staff Years (DESY) planned for strategies for FYs 2015 through 2019.[7] A DESY is generally equal to 2,000 direct examination hours.

Figure 1: Planned DESYs of Individual Returns by Strategy for FYs 2015 Through 2019[8]

Strategy	FY 2015 DESY % of Total	FY 2016 DESY % of Total	FY 2017 DESY % of Total	FY 2018 DESY % of Total	FY 2019 DESY % of Total
NRP	15%	16%	16%	17%	1%
P&RP	5%	4%	4%	4%	5%
OFF	5%	6%	4%	6%	2%
ATTI	2%	2%	2%	2%	2%
HIHW	3%	3%	3%	N/A	N/A
Claims	N/A	N/A	N/A	10%	16%
NF	N/A	N/A	N/A	2%	4%
U&UI	5%	5%	4%	1%	0%
SEP&F	1%	2%	2%	2%	2%
OPP	11%	15%	20%	12%	13%
DAO[9]	53%	47%	45%	44%	55%
Totals	100%	100%	100%	100%	100%
Total DESYs	2,453	2,144	1,866	1,706	1,383

Source: Treasury Inspector General for Tax Administration (TIGTA) analysis of SB/SE Division Examination's U.S. Program Monitoring Reports for FYs 2015 through 2019.

As noted in Figure 1, the total planned DESYs (time allocated) to the strategies decreased overall from 2,453 in FY 2015 to 1,383 in FY 2019, resulting in an overall decline in available resources of 44 percent. Between FYs 2015 and 2017, the planned percentage of DESYs for most of the strategies remained relatively consistent, with the exception of OPP (which increased from 11 percent to 20 percent) and DAO (which decreased from 53 percent to 45 percent). As the IRS shifted its resources towards more OPP strategy work streams and projects, this resulted in a decrease in the DAO strategy, specifically the DIF strategy. During FY 2017, a decision was made to disband the HIHW strategy.

Figure 1 reflects two new strategies that the SB/SE Division started in FY 2018 for Claims and NF. While these two strategies started in FY 2018, the resources came from the OPP and HIHW strategies, respectively. IRS management stated these examinations were moved to a separate strategy to provide more attention to these types of examinations. Because the resources

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[7] We relied on the closed Field Examination data from the HIHW, NF, and OPP strategies provided by the IRS, including the U.S. Program Monitoring Reports, the SB/SE Division's Director Field Exam Briefings, or the SB/SE Division's Director Exam Briefings, and did not independently validate the IRS's information.

[8] Figures in the U.S. Program Monitoring Reports are as of September of the applicable fiscal year. The percentages are calculated by dividing the strategy DESY to the total DESYs.

[9] The DAO is the combined figure for the DIF and AO strategies. The source of the data for this figure, the U.S. Program Monitoring Report, does not report individually the planned DESYs for the DAO strategies.

moved within the other strategies, this resulted in a minimal change from 45 percent to 44 percent to the DAO, DIF strategy.

After the HIHW strategy was disbanded in FY 2017, the DAO and Claims strategies increased significantly, from 44 percent to 55 percent, and 10 percent to 16 percent, respectively, while other strategies dropped (*i.e.*, NRP, OFF, and U&UI) for FY 2019, including a significant decrease for the NRP strategy from 17 percent in FY 2018 to 1 percent in FY 2019. NRP returns were not supplied to the field between February and September 2018 while SB/SE Division executives decided whether to continue examining returns for the NRP strategy. In September 2018, approximately 1,200 returns related to the Improper Payments and Recovery Elimination Act of 2010 were sent to Planning and Special Programs offices for classification, and another 1,200 were released to Planning and Special Programs offices in February 2019.[10] Overall, Figure 1 shows the SB/SE Division's Examination Plan allocated resources to the DAO, which ranged from 44 percent to 55 percent, specifically the DIF strategy within the DAO, after the resource allocations were made to the other strategies for FYs 2015 through 2019.

Once the total planned DESYs by strategy is determined, then Performance, Planning, and Analysis determines the examination planned closures by strategy. Figure 2 shows the SB/SE Division Examination planned closures for selected strategies of individual tax returns for FYs 2017 and 2018.

Figure 2: SB/SE Division Field Examination Planned Closures for Selected Strategies of Individual Tax Returns for FYs 2017 and 2018[11]

Strategy	FY 2017		FY 2018		Change in Planned Examinations
	Planned	% of Plan	Planned	% of Plan	
HIHW	5,822	3%	N/A	N/A	(5,822)
Claims	N/A	N/A	13,283	9%	13,283
NF	N/A	N/A	3,272	2%	3,272
U&UI	7,792	4%	1,839	1%	(5,953)
OPP	27,393	14%	11,972	8%	(15,421)
DAO	90,649	47%	71,096	47%	(19,553)
Subtotals	131,656	68%	101,462	67%	(30,194)
Total Planned Examination Closures	194,261	100%	152,340	100%	(41,921)

Source: TIGTA analysis of September U.S. Program Monitoring Reports for FYs 2017 and 2018.

Figure 2 shows that the total planned examination closures for all the strategies decreased by 41,921 individual income tax examinations from FY 2017 to FY 2018, resulting in an overall decline in examinations of 22 percent. This was due to the decline in available resources previously reflected in Figure 1. Figure 2 also shows the impact on planned examinations based

[10] Pub. L. No. 111-204, 124 Stat. 2224. Under the Improper Payments and Recovery Elimination Act of 2010 the heads of Federal agencies are required to produce a statistically valid estimate, or an estimate that is otherwise appropriate using a methodology approved by the Director, Office of Management and Budget, of the improper payments made by each program and activity and include those estimates in the accompanying materials to the annual financial statement of the agency.

[11] Combined revenue agent and tax compliance officer individual income tax return planned examination closures. These percentages are calculated by dividing the strategy examination planned closures by the total planned examination closures.

on the changes with the strategies and placement of the available resources for selected strategies. For example, Figure 2 reflects:

- A decision to disband the HIHW strategy, which represented 3 percent of the planned examinations in FY 2017.
- Two strategies began in FY 2018, Claims and NF, which represent 9 and 2 percent, respectively, of the planned FY 2018 examinations. However, as previously stated, the resources came from the OPP and HIHW strategies, respectively.
- U&UI and OPP planned examination closures decreased from FY 2017 to FY 2018.
- The DAO represents the largest decrease, with over 19,000 fewer planned examination closures, but consistently represents 47 percent of the overall planned examinations for both FY 2017 and FY 2018.

SB/SE Division management stated that high-income individual tax returns (those with TPI of at least $200,000) are worked in each of the SB/SE Division strategies, but they also stated that each strategy has a purpose that may or may not be focused on high-income return coverage. Management mentioned the DIF strategy as part of the overall coverage level for high-income taxpayers and noted that the DIF coverage rate is higher for high-income returns than other returns.

This review focuses on combined revenue agent (RA) and tax compliance officer (TCO) examinations of individual tax returns within the HIHW strategy. The SB/SE Division HIHW strategy started in 2010. SB/SE Division Examination defines high-income taxpayers as those who report a TPI of at least $200,000 on Form 1040, *U.S. Individual Income Tax Return*.[12] The IRS started using the $200,000 threshold to categorize returns in 2005 and has not changed the threshold since implementation. Based on this review, the HIHW strategy did not consist exclusively of high-income individual taxpayers. According to SB/SE Division management, the HIHW strategy addresses some HIHW taxpayers with similar characteristics and behaviors, such as their involvement with flow-through entities. However, we found that the U.S. Program Monitoring Reports show that each of the strategies within the SB/SE Division Examination Plan includes flow-through entities.

The performance reports group the examination closures based on TPI

The U.S. Program Monitoring Report for the SB/SE Division summarizes some performance targets for each strategy within the SB/SE Division Examination Plan. For example, Figure 2 shows the total planned examination closures of 194,261 and the planned examination closures for the HIHW strategy of 5,822 for FY 2017. The U.S. Program Monitoring Report provides a breakdown of the HIHW examination planned closures (5,822 for FY 2017), as identified in Figure 3, into two levels for individual tax returns: 1) Individual Master File (IMF) returns with TPI of less than $200,000 and 2) IMF returns with TPI of at least $200,000, which are 3,970

[12] FY 2017 IRS Data Book (page 26) Footnote to Table 9a states, "In general, total positive income is the sum of all positive amounts shown for the various sources of income reported on the individual income tax return and, thus, excludes losses." The U.S. Program Monitoring Report uses the categories greater than $200,000 (">200K") and less than $200,000 ("<200K") to differentiate between low-income and high-income taxpayers.

(68 percent) and 1,852 (32 percent), respectively, for FY 2017. Figure 3 shows some performance targets for the HIHW strategy of individual tax returns for FYs 2015 through 2017.

Figure 3: SB/SE Division Field Examination Planned Closures for the HIHW Strategy of Individual Tax Returns for FYs 2015 Through 2017[13]

Type of Closure	FY 2015 Planned	FY 2016 Planned	FY 2017 Planned	Total FY 2015 to FY 2017
IMF TPI < $200,000	3,878	6,084	3,970	13,932
IMF TPI ≥ $200,000	2,041	2,631	1,852	6,524
Total HIHW Planned Closures	**5,919**	**8,715**	**5,822**	**20,456**
IMF TPI $200,000 to $1M	1,444	1,973	1,377	4,794
IMF TPI > $1M	597	658	475	1,730
Planned Closures > $200,000	**2,041**	**2,631**	**1,852**	**6,524**

Source: TIGTA analysis of September U.S. Program Monitoring Reports for FYs 2015 through 2017 and SB/SE Division Examination Plans for FYs 2016 and 2017.

The U.S. Program Monitoring Reports provide further breakdown of the HIHW planned closures for the subcategory of IMF returns with TPI of at least $200,000 into two independent measures for individual tax returns: 1) IMF returns with TPI of $200,000 to $1 million and 2) IMF returns with TPI greater than $1 million, which is 1,377 (24 percent) and 475 (8 percent), respectively, of the HIHW total examination planned closures for FY 2017. As reflected in Figure 3, the U.S. Program Monitoring Reports provide a breakdown of the HIHW planned closures for individual tax returns based on available resources and gives Performance, Planning, and Analysis and SB/SE Division management a tool to monitor the planned to actual results.

Congress has expressed interest in the IRS's approach to auditing high-income taxpayers.[14] We conducted this review to evaluate the IRS SB/SE Division's efforts to ensure the tax compliance of high-income individuals with a primary focus on the HIHW strategy before and after disbanding.

Results of Review

While High-Income Examinations Increased As a Percentage of All Closures, the Number of Closures Decreased From Fiscal Year 2015 to 2019

We used the U.S. Program Monitoring Reports to identify the examination return closures for FYs 2015 through 2019. Figure 4 shows the actual examination closures for 1) IMF returns with TPI less than $200,000 and 2) IMF returns with TPI of at least $200,000 as well as the subcategory of IMF returns with TPI of at least $200,000 into two independent measures for

[13] Combined RA and TCO individual income tax return planned examinations.

[14] On April 8, 2019, Senator Angus King of Maine sent a letter to the IRS Commissioner calling on him to reform the IRS's audit selection procedure and remedy that procedure's disproportionate focus on Earned Income Tax Credit claimants.

individual tax returns: 1) IMF returns with TPI of $200,000 to $1 million and 2) IMF returns with TPI greater than $1 million and percentages of return closures.

Figure 4: SB/SE Division High-Income Examination Actual Closures and Percentages of Closures for Individual Tax Returns by TPI for FYs 2015 Through 2019[15]

Type of Closure	FY 2015 Closures/%		FY 2016 Closures/%		FY 2017 Closures/%		FY 2018 Closures/%		FY 2019 Closures/%	
IMF TPI < $200,000	184,886	80%	169,705	80%	139,673	78%	110,383	77%	85,278	74%
IMF TPI ≥ $200,000	47,024	20%	42,258	20%	39,212	22%	33,515	23%	29,610	26%
Total IMF Closures	**231,910**	**100%**	**211,963**	**100%**	**178,885**	**100%**	**143,898**	**100%**	**114,888**	**100%**
TPI $200K to $1M	35,364	15%	32,341	15%	29,835	17%	24,403	17%	21,182	18%
TPI over $1M	11,660	5%	9,917	5%	9,377	5%	9,112	6%	8,428	7%
Total ≥ $200K	**47,024**	**20%**	**42,258**	**20%**	**39,212**	**22%**	**33,515**	**23%**	**29,610**	**26%**

Source: TIGTA analysis of September U.S. Program Monitoring Reports for FYs 2015 through 2019.

Figure 4 shows the compliance coverage percentage of high-income examinations increased overall from 20 percent in FY 2015 to 26 percent in FY 2019. The increase in high-income individual income tax returns examination closures came from both the $200,000 to $1M and over $1M categories that increased overall from 15 percent and 5 percent in FY 2015 to 18 percent and 7 percent in FY 2019, respectively.

However, the SB/SE Division increased percentage of high-income examinations did not result in an increase in actual high-income examinations. The IRS gradually closed 17,414 (47,024 – 29,610) fewer high-income examinations due to the reduction in available resources from FY 2015 to FY 2019 as discussed previously (see Figures 1 and 2). We calculated the impact from the drop in high-income examination closures using FY2015 as the base year. Figure 5 summarizes the drop in high-income examination closures for FYs 2016 through 2019.

Figure 5: Decrease in High-Income Examination Closures of IMF Returns With TPI of at Least $200,000 for FYs 2016 through 2019 and Potential Tax Assessments

FY	Return Closures	Difference With FY 2015	Average Dollars per Return	Potential Tax Assessments
2015	47,024	N/A	N/A	N/A
2016	42,258	4,766	$40,628	$193,633,048
2017	39,212	7,812	$41,363	$323,127,756
2018	33,515	13,509	$43,184	$583,372,656
2019	29,610	17,414	$47,387	$825,197,218
Totals	191,619	43,501	NA	$1,925,330,678

Source: TIGTA analysis of September U.S. Program Monitoring Reports for FYs 2015 through 2019.

As noted in Figure 5, the total high-income examination closures potentially dropped by a total 43,501 when using FY 2015 as the base year and shows the average dollars per return increased from $40,628 in FY 2016 to $47,387 in FY 2019. As a result, the potential increase in tax

[15] Percentages are rounded and may not reconcile to total.

assessments would have been over $1.9 billion if the IRS had continued with the same level of high-income coverage as FY 2015.

We are not making a recommendation to address this issue as the decrease in closures was a result of declining resources in the SB/SE Division. The purpose of calculating the potential lost assessments was to emphasize the negative trend that declining resources had on the number of closures of high-income examinations over the last five years and the impact on potential tax assessments.

The SB/SE Division has emphasized high-income examinations within available resources from FYs 2015 to 2019. The overall upward trend from 20 percent to 26 percent for high-income closures reflects the SB/SE Division's commitment to increasing coverage for high-income taxpayers within existing resources. We believe this positive trend in enforcement activity by the SB/SE Division should be continued and that additional efforts for increasing overall high-income examinations should be prioritized when possible.

The High Income High Wealth Strategy Was Not Primarily Focused on High-Income Taxpayers

SB/SE Division high-income individual tax return examinations are conducted across all of the SB/SE Division strategies. However, the primary focus of this review is specific to the HIHW strategy and the productivity of examinations before and after disbanding.

We previously stated that the IRS defines high-income taxpayers as those who report TPI of at least $200,000 and that the U.S. Program Monitoring Reports provide a breakdown of the HIHW total planned closures for FYs 2015 through 2017. Figure 6 shows the numbers and percentages of planned and actual closures for individual tax returns by TPI level in the HIHW strategy for FYs 2015 through 2017.

Figure 6: SB/SE Division HIHW Strategy Examination Numbers and Percentages of Closures for Individual Tax Returns by TPI for FYs 2015 Through 2017[16]

Type of Closure	Total Planned[17]	Planned Percentage	Total Actual[18]	Actual Percentage
IMF TPI < $200,000	13,932	68%	17,846	73%
IMF TPI > $200,000	6,524	32%	6,678	27%
Total HIHW Closures	**20,456**	**100%**	**24,524**	**100%**

Source: TIGTA analysis of September U.S. Program Monitoring Reports for FYs 2015 through 2017.

We determined the SB/SE Division exceeded its planned HIHW examination closures under the HIHW strategy by 20 percent ((24,524 - 20,456 = 4,068)/20,456) from FYs 2015 through 2017. As previously stated, the IRS defined the HIHW examination strategy as addressing HIHW taxpayers. We expected the HIHW strategy to primary focus on high-income taxpayers (a higher

[16] Figure 6 is TIGTA's analysis based on the U.S. Program Monitoring Reports' data as reported.

[17] The total planned closures is the sum of all fiscal years' planned closures. The percentages are calculated by type of closure divided by total planned closures.

[18] The total actual closures is the sum of all fiscal years' actual closures. The percentages are calculated by type of closure divided by total actual closures.

percentage than 27 percent) with TPI from at least $200,000. Instead, Figure 6 shows that individual tax return examinations with TPI of less than $200,000 represent the majority of the returns planned and closed from the HIHW strategy for FYs 2015 through 2017 (68 percent and 73 percent, respectively). The examination case selection and assignment process for HIHW returns was not specifically focused on the selection of returns with TPI of at least $200,000 and included methods of selection for returns with potential adjustments regardless of reported income levels. The identification of this strategy as HIHW is misleading. The SB/SE Division HIHW strategy consisted of two subcategories:

- High Income Nonfiler (HINF) coverage is focused on compliance for unfiled returns and is not specifically focused on taxpayers with TPI of at least $200,000. SB/SE Division planning documents noted coverage across all income levels and considers HINF examinations to be those with income over $100,000 rather than the $200,000 threshold.
- High Income Underreported (HIU) coverage is focused on high-income, high-wealth filed returns selected within the HIHW strategy (and the TPI is based on the IMF return filed).[19] "Underreported" includes both underreported income and overstated expenses. For example, if a taxpayer filed IMF returns with TPI of $150,000 and had potential unreported income of $100,000 (for a total of $250,000 TPI), this is classified as an IMF return with a TPI of less than $200,000 based on the tax return filed.

Although this work was not primarily focused on high-income individual tax return examinations, a document provided by the SB/SE Division to explain the examination planning process noted that SB/SE Division Field Examination, which includes RAs and TCOs, is best suited to address this portion of the Tax Gap (nonfilers with potential TPI over $100,000). As a result, the HIHW strategy was not focused on high-income individual tax return examination closures with TPI of at least $200,000 for FYs 2015 through 2017.

The IRS noted the HIHW examination closures include related returns as part of the examination process. The source code of each pickup/related return is determined by its relationship to the primary return. However, we found that the U.S. Program Monitoring Reports show that each of the SB/SE Division strategies include pickup/related returns.

IRS management stated that HIHW returns with TPI under $200,000 were a consequence of taxpayers who potentially could move into the high-income category based on examination results and were selected based on behaviors identified through case selection.

Finally, the IRS suggested that analyzing FYs 2015 through 2019 resulted in a narrow scope and that a full lifespan review starting with FY 2010 is needed to fully evaluate HIHW projects. We do not agree and believe that the most recent data available are the most relevant.

While each strategy includes high-income tax returns, there was no strategy dedicated to high-income tax returns for FYs 2015 through 2019

SB/SE Division management previously stated that high-income individual tax returns (those with TPI of at least $200,000) are also worked in other SB/SE Division strategies, but each strategy has a purpose that may not be focused on high-income examination issues. Figure 6

[19] The HIU acronym used throughout this report was created by TIGTA for reporting purposes. The acronym used on the Strategic Priority Coding Lists for the strategy is HIHW and the name of the subcategory on the Strategic Priority Coding Lists is HIGH INCOME/HIGH WEALTH.

shows how the HIHW strategy included both taxpayers with TPI of less than $200,000 and TPI of at least $200,000.

We used the U.S. Program Monitoring Reports to identify the high-income examination return closures (IMF returns with TPI of at least $200,000). Figure 7 shows the totals and percentages of return closures by strategy for IMF returns with TPI of at least $200,000. Given that only 29 percent of FY 2015 HIHW strategy closures were at this level (TPI of at least $200,000), 71 percent of FY 2015 HIHW strategy closures where for returns with TPI under $200,000.

Figure 7: SB/SE Division Field Examination Totals and Percentages of Closures of Individual Tax Returns With TPI of at Least $200,000 for FYs 2015 Through 2019

Strategy	FY 2015 Closures/%		FY 2016 Closures/%		FY 2017 Closures/%		FY 2018 Closures/%		FY 2019 Closures/%	
NRP	4,154	28%	5,900	25%	4,842	25%	3,850	25%	1,634	23%
P&RP	435	2%	409	2%	390	3%	361	3%	265	3%
OFF	5,816	33%	6,398	37%	6,225	40%	3,874	41%	1,918	39%
ATTI	1,045	27%	1,010	34%	797	45%	1,142	62%	1,130	65%
HIHW	2,392	29%	2,401	24%	1,885	30%	N/A		N/A	
Claims	N/A		N/A		N/A		3,749	33%	4,781	38%
NF	N/A		N/A		N/A		1,120	28%	855	24%
U&UI	1,612	16%	1,776	15%	1,515	20%	749	27%	224	25%
SEP&F	385	20%	397	23%	322	19%	248	19%	247	19%
OPP	4,754	19%	5,356	21%	7,044	23%	2,402	20%	2,114	20%
DIF	23,262	21%	15,795	18%	13,827	19%	14,330	22%	14,858	27%
AO	3,169	22%	2,816	23%	2,365	24%	1,690	16%	1,584	24%
Total	47,024	20%	42,258	20%	39,212	22%	33,515	23%	29,610	26%
Combined Total = 191,619										

Source: TIGTA analysis of September U.S. Program Monitoring Reports for FYs 2015 through 2019.

As reflected in Figure 7, the percentage of examination closures for which TPI was at least $200,000 generally represented 30 percent or less in most strategies. In fact, for the "at least $200,000" level, only the OFF, ATTI, and Claims examinations were generally more than 30 percent between FYs 2015 and 2019. Even when the HIHW strategy was in effect (during FY 2015 through FY 2017), the percentage of closures for which TPI was at least $200,000 was 30 percent or less for that strategy. While we acknowledge each strategy within the SB/SE Division includes a percentage of closures for which TPI was at least $200,000, the SB/SE Division had no strategy dedicated to high-income returns for FYs 2015 through 2019.

Figure 1 previously showed that the NF strategy was started in FY 2018 and that the resources came from the HIHW strategy. IRS management stated that these examinations were moved to a separate strategy to provide more attention to these types of examinations. Because the HIHW strategy included HINF coverage focused on compliance for unfiled returns and is not specifically focused on taxpayers with TPI of at least $200,000, it seems reasonable for nonfiler examinations to move to the NF strategy in FY 2018.

It appears the remaining HIU projects did not move to a new strategy. Additionally, examinations of individual taxpayers with TPI of less than $200,000 should have been moved to SB/SE Division's U&UI strategy because this strategy involves unreported income. The SB/SE

Division still needs a strategy (or purpose group) dedicated to issues that focus on unreported income and other examination issues of high-income taxpayers.[20]

Recommendation 1: The Director, Examination Case Selection, SB/SE Division, should create a dedicated work stream with the purpose of focused examinations of IMF returns with TPI of at least $200,000 to address the high-income taxpayer underreporting segment of the Tax Gap.

> **Management's Response:** The SB/SE Division disagreed with this recommendation and stated that the recommendation is redundant with its use of activity codes and return category groupings for IMF $200,000 and higher returns. The IRS also stated that the high-income taxpayer population is covered throughout the purpose groups and work streams, and the number of returns examined can be influenced within the DIF work stream.
>
>> **Office of Audit Comment:** This recommendation is important to ensure a strategic approach to high-income audit coverage in which resources are allocated to high-income examinations. It is true the high-income taxpayer population is covered through the purpose groups (or other strategies). However, tax returns examined within some purpose groups are not selected for examination based on indications of probable error. For example, returns selected for examination under the NRP work stream are randomly selected and others are examined in response to a taxpayer request such as a claim, innocent spouse, or voluntary disclosure. Similarly, random audits, such as NRP audits, do not effectively identify tax evasion issues for high-income taxpayers. Because the results of NRP audits are used to develop the DIF algorithms, we do not believe the DIF work stream is an effective mechanism for influencing the high-income taxpayer population. It is important for the IRS to have a HIHW work stream that focuses on taxpayers with TPI of at least $200,000 to address underreporting of high-income taxpayers.

The Examination Plan for the High Income High Wealth Strategy Was Not Met for High-Income Taxpayers With Total Positive Income Over $1 Million for Two Years, Which Diluted the Impact on Compliance

Figure 8 shows the high-income closures (IMF returns with TPI of at least $200,000) in the HIHW strategy (total and percentage of planned and actual closures for FYs 2015 through 2017).

[20] Strategies were replaced by purpose groups starting in FY 2021 and are discussed later in this report.

Figure 8: HIHW Strategy Examination Closures (Planned and Actual) by TPI for FYs 2015 through 2017

FY	HIHW Planned	HIHW Actual	% of Planned Closures[21]
IMF TPI < $200,000			
2015	3,878	5,858	151%
2016	6,084	7,509	123%
2017	3,970	4,479	113%
Total IMF TPI < $200,000	13,932	17,846	128%
IMF TPI $200,000 to $1M			
2015	1,444	1,720	119%
2016	1,973	1,988	101%
2017	1,377	1,646	120%
IMF TPI > $1M			
2015	597	672	113%
2016	658	413	63%
2017	475	239	50%
Total IMF TPI ≥ $200,000	6,524	6,678	102%

Source: TIGTA analysis of September U.S. Program Monitoring Reports for FYs 2015 through 2017 and SB/SE Division Examination Plans for FYs 2016 and 2017.

Figure 8 shows that the HIHW strategy overall closures for FYs 2016 and 2017 for IMF examinations with TPI of greater than $1 million were only 63 percent and 50 percent of planned closures, respectively, while in comparison the examinations with TPI less than $200,000 were 123 percent and 113 percent, respectively, of planned closures, which resulted in potential lost assessments. However, the actual outcome would have been dependent on the availability of returns with TPI over $1 million identified by projects within the HIHW strategy and available resources including locations of taxpayers and examiners. The variance between actual and planned examination for TPI greater than $1 million needs to be closely monitored and overages of examination for returns with TPI with less than $200,000 should be avoided.

The examination plan is an important tool to ensure that the SB/SE Division is selecting returns for examination to promote the highest degree of voluntary compliance on the part of taxpayers and providing those returns to the field. The examination plan provides the number of planned examinations of HIHW strategy returns for high-income taxpayers (those $200,000 to $1 million and over $1 million).

The U.S. Program Monitoring Reports do not segregate examination data for closed returns with TPI above $1 million into separate income categories. In order to monitor and evaluate the examinations of individual income tax returns with TPI above $1 million, additional income categories (discussed later) should be created on the U.S. Program Monitoring Reports. The additional income categories will allow the SB/SE Division to better monitor and evaluate compliance trends for examinations of returns with TPI above $1 million and provide adequate resources to ensure balanced coverage of HIU taxpayers. The decision of where to set the high-income TPI thresholds has a significant bearing on how IRS audit resources are used. It is critical for the IRS to determine the best use of its limited resources by identifying the income levels with the highest risk.

[21] The percentages are calculated from actual closures divided by planned closures.

The dollars per hour is diluted with the inclusion of taxpayers with TPI of less than $200,000

Figure 9 shows individual tax return closure dollars per hour and average dollars per hour by TPI in the HIHW strategy for FYs 2015 through 2017.

Figure 9: HIHW Strategy Examination Closure Dollars per Hour by TPI for FYs 2015 Through 2017

Type of Closure	FY 2015	FY 2016	FY 2017	Average[22]
IMF TPI < $200,000	$1,950	$1,985	$1,644	$1,888
IMF TPI ≥ $200,000	$4,837	$4,306	$4,111	$4,441
IMF TPI $200K to $1M	$2,436	$2,534	$2,939	$2,627
IMF TPI > $1M	$8,451	$8,018	$8,309	$8,290

Source: TIGTA analysis of September U.S. Program Monitoring Reports for FYs 2015 through 2017.

Figure 9 shows that the dollars per hour for individual tax returns with TPI of less than $200,000 ranged from $1,950 in FY 2015 to $1,644 in FY 2017, with a peak of $1,985 in FY 2016 and an average of $1,888 for all three years. However, the dollars per hour for individual tax returns with TPI greater than $200,000 ranged from $4,837 in FY 2015 to $4,111 in FY 2017 (with an average of $4,441 for all three years)—an increase of $2,553 ($4,441 - $1,888) per hour on average over tax returns with a TPI of less than $200,000.

Overall, the examinations of returns with TPI of at least $200,000 are substantially more productive than those of returns with TPI of less than $200,000, yielding more than double the average dollars per hour. The decline in the percentage of HIHW strategy closures for TPI over $1 million as identified in Figure 8 results in a lower per hour rate of return as the shortage results in more examinations with TPI under $1 million, which on average have a lower dollar per hour rate. This negative variance between actual and planned examination for TPI greater than $1 million needs to be closely monitored and overages of examinations for returns with TPI less than $200,000 should be avoided. As a result of the overage for examination closures with TPI under $200,000 in FYs 2016 and 2017, the HIHW strategy dollars per hour was diluted with the inclusion of IMF returns with TPI of less than $200,000, a consequence of the HIHW strategy not being limited to or primarily focused on high-income examinations.

Recommendation 2: The Director, Planning and Performance, should increase the monitoring of planned versus actual examinations for additional income categories such as taxpayers with TPI from $1 million to $5 million, $5 million to $10 million, and over $10 million and make adjustments to ensure that planned examination closures are met within an acceptable range each fiscal year for all high-income taxpayer subcategories.

Management's Response: The SB/SE Division agreed with this recommendation and noted that it had already planned to add three income levels, independent from this TIGTA audit, for individuals with TPI greater than $1 million starting in FY 2021.

Office of Audit Comment: While we acknowledge the implementation of this recommendation is in process, we emphasize the importance of ensuring that

[22] Average is calculated based on aggregated dollars assessed by total aggregated hours.

planned examination closures are met within an acceptable range each fiscal year for all high-income taxpayer subcategories.

High-Income Examinations Within the High Income High Wealth Strategy Were More Productive Than Any Other Strategy From Fiscal Years 2015 Through 2017

The performance of the HIHW strategy before the strategy was disbanded can be evaluated based on the U.S. Program Monitoring Reports for returns with TPI of at least $200,000. Figure 10 provides a trend analysis of the dollars per hour for each of the strategies in use for returns with TPI of at least $200,000 from FYs 2015 through 2019.

Figure 10: Dollars per Hour for Examinations of IMF Returns With TPI of at Least $200,000 for FYs 2015 Through 2019[23]

Strategy	FY 2015	FY 2016	FY 2017	FY 2018	FY 2019
NRP	$ 144	$ 166	$ 283	$ 206	$ 369
P&RP	$ 858	$ 1,214	$ 1,161	$ 4,142	$ 1,687
OFF	$ 2,742	$ 3,235	$ 2,046	$ 2,041	$ 1,020
ATTI	$ 2,466	$ 2,634	$ 3,853	$ 4,391	$ 5,705
HIHW	$ 4,837	$ 4,306	$ 4,111	N/A	N/A
Claims	N/A	N/A	N/A	$ 282	$ 171
NF	N/A	N/A	N/A	$ 3,500	$ 3,354
U&UI	$ 787	$ 878	$ 1,675	$ 1,886	$ 2,009
SEP&F	$ 3,175	$ 3,539	$ 2,358	$ 2,468	$ 2,430
OPP	$ 756	$ 887	$ 1,047	$ 2,131	$ 2,433
DIF	$ 877	$ 972	$ 1,072	$ 982	$ 981
AO	$ 1,689	$ 2,541	$ 2,515	$ 2,505	$ 3,359
IMF Total	**$ 1,179**	**$ 1,201**	**$ 1,229**	**$ 1,143**	**$ 1,170**

Source: TIGTA analysis of September U.S. Program Monitoring Reports for FYs 2015 through 2019.

As noted in Figure 10, the HIHW examination dollars per hour trended down from $4,837 in FY 2015 to $4,111 in FY 2017 for returns with TPI of at least $200,000. The overall trend for all IMF examinations with TPI income of at least $200,000 remained steady moving from $1,179 in FY 2015 to $1,170 in FY 2019. Even with this downward trend, examinations of high-income taxpayers within the HIHW strategy produced more dollars per hour on average than any other strategy between FYs 2015 and 2017. IRS management noted the higher HIHW strategy productivity may be a result of using productivity results from the end of the strategy.

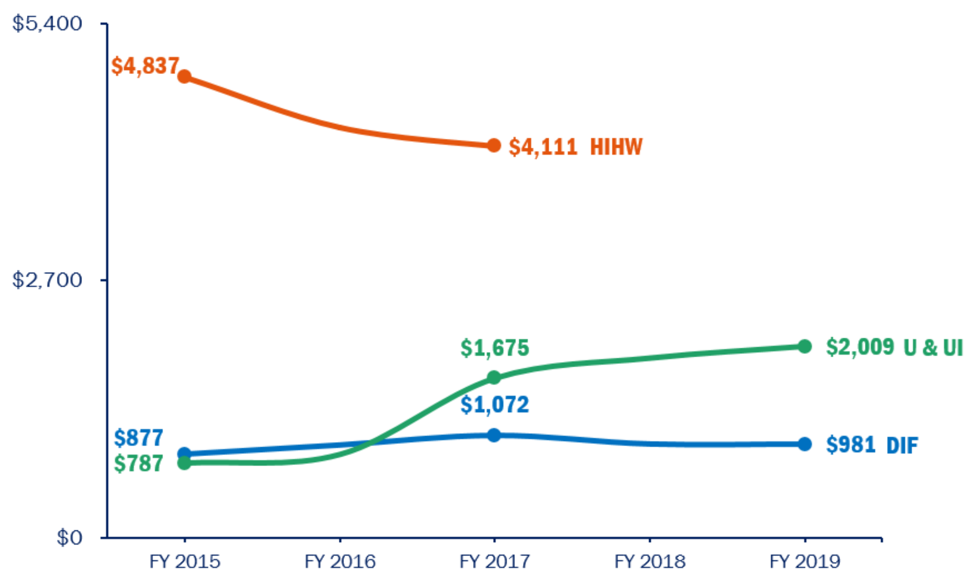
According to SB/SE Division management, the purpose of strategies is not based solely on whether they are productive in terms of dollars assessed. While we acknowledge each strategy

[23] The results show three years for the HIHW strategy because it was disbanded following FY 2017 and two years for the Claims and NF strategies because they commenced at the beginning of FY 2018. Figure 10 is TIGTA's analysis based on the U.S. Program Monitoring report's data as reported.

within the SB/SE Division includes a percentage of closures for which TPI was at least $200,000, the SB/SE Division had no strategy dedicated to high-income returns for FYs 2015 through 2019. For example, the P&RP strategy can be productive because it results in additional assessments; however, it is primarily designed to correct the actions of tax preparers who are not following proper tax preparation practices. While the purpose of some strategies is not based on productivity in terms of dollars assessed, other strategies that address the Tax Gap (which includes underreporting and nonfiling) are more focused on tax compliance and are generally more productive in terms of dollars assessed. FYs 2018 and 2019 performance numbers were included in Figure 10 for discussion later in the report.

IRS management stated that the DIF strategy was part of the overall coverage level for high-income taxpayers and that the DIF coverage rate is higher for high-income returns. IRS management also defined the U&UI strategy as involving indications of unreported income. Therefore, we compared the dollars per hour performance of examinations of high-income returns in these two strategies with the dollars per hour performance of examinations of high-income returns in the HIHW strategy. Figure 11 shows the dollars per hour results for the HIHW strategy for FYs 2015 through 2017 and the U&UI and DIF strategies over the five years for examinations of returns with TPI of at least $200,000.[24]

Figure 11: Audit Results of Individual Returns With TPI of at Least $200,000 for Selected Strategies



Source: TIGTA analysis of September U.S. Program Monitoring Reports for FYs 2015 through 2019.

As reflected in Figure 11, HIHW strategy examinations produced significantly more dollars per hour for examinations of individual income tax returns with TPI of at least $200,000 between FYs 2015 and 2017 compared to examinations under the DIF or U&UI strategies.

[24] There are only three years for the HIHW strategy because it was disbanded following FY 2017.

High-Income Underreporter Closures Within the High Income High Wealth Strategy Were Gradually Ended While Efforts Continued With Nonfiler Compliance

Because the SB/SE Division's U.S. Program Monitoring Reports did not report the HIHW strategy examination results after FY 2017, we could not use the U.S. Program Monitoring Reports to perform our analysis. We previously stated that the SB/SE Division HIHW strategy consisted of two subcategories, HIU and HINF. When the HIHW strategy was disbanded, the IRS moved HINF to the NF Strategy, and HIU moved to the OPP strategy. The OPP strategy includes several programs, not just HIU projects, for FYs 2018 and 2019. IRS management stated that HIU Compliance Initiative Projects were winding down because no new projects were being initiated and the decline in HIU closures after disbanding was expected. IRS management further noted that the SB/SE Division continued to examine HIHW returns across strategies with examples including syndicated conservation easements and micro-captive insurance cases.

In order to determine whether HINF and HIU cases selected for examination resulted in better examination results before or after the disbanding of the HIHW strategy, we used a combination of HIHW project and tracking codes assigned to the returns at the time of the examination to identify performance results for 32,328 examinations closed by RAs and TCOs during FYs 2015 through 2019.[25]

We analyzed data from 32,328 examinations of HIHW returns closed by RAs and TCOs in the SB/SE Division during FYs 2015 through 2019. This includes all individual tax return examination closures with HIHW project or tracking codes, whether the TPI was over or under $200,000. SB/SE Division management previously stated that: 1) HIU projects in the HIHW strategy had diminished and 2) HINF work was all that remained in the HIHW strategy. Figure 12 provides a summary of our analysis.

Figure 12: Numbers and Percentage of HIHW Return Closures for FYs 2015 Through 2019

	FY 2015	FY 2016	FY 2017	FY 2018	FY 2019	Totals
HINF Closures	7,306 89%	9,401 95%	6,087 96%	4,070 96%	3,514 98%	30,378 94%
HIU Closures	944 11%	509 5%	266 4%	150 4%	81 2%	1,950 6%
Total HIHW Closures	8,250 100%	9,910 100%	6,353 100%	4,220 100%	3,595 100%	32,328 100%

Source: TIGTA analysis of RA and TCO HIU and HINF examination results for FYs 2015 through 2019.[26]

As shown in Figure 12, the number of HIU tax returns examined by RAs and TCOs decreased from 944 in FY 2015 to 266 when the HIHW strategy was disbanded in FY 2017 (decreased from 11 percent to 4 percent, respectively). HIU returns then decreased to 150 in FY 2018 and 81 in FY 2019 when HIU projects were moved to the OPP strategy.

[25] Project and tracking codes aid in maintaining consistency across all SB/SE Division Examination offices and are specifically linked to each income tax return for tracking and reporting purposes.

[26] TIGTA's analysis later in this report includes minor changes to return closures for FY 2017 due to the IRS incorrectly categorizing returns. The IRS identified 11 returns incorrectly categorized and stated the returns would make little difference to the FY 2017 examination results summarized in the U.S. Program Monitoring Reports and concluded the reports would not be updated.

Over the five-year period we reviewed, HINF examinations comprised the vast majority of the 32,328 HIHW strategy examination closures.

As noted in Figure 12, the number of HINF individual income tax returns examined overall trended down, from FY 2015 (7,306) to FY 2019 (3,514), with a peak of 9,401 in FY 2016. HINF examination closures represented the majority of the HIHW examination closures based on the project or tracking codes from FY 2015 through FY 2019. The IRS stated that it started an NF strategy in FY 2018 because most of the work in the HIHW strategy was nonfiler examinations, and it wanted to track the results better and did not want NF strategy examination results buried in the HIHW strategy. We agree that the HIHW strategy work consisted primarily of HINF examination closures.

However, we stated previously that the largest segment of the gross Tax Gap, $314 billion, is attributable to individual income taxes, of which $245 billion (78 percent) is attributed to underreporting of taxes and $31 billion (10 percent) is attributable to nonfiling. As reflected in Figure 12, the HINF closures, which focus on nonfiling, represented the majority (94 percent) of the HIHW examination closures for FYs 2015 through 2019, while HIU closures, which focus on underreporting of taxes, represented (6 percent). The IRS moved HINF projects to a separate strategy in FY 2018; however, the IRS did not move HIU projects to their own separate strategy when the HIHW strategy disbanded.

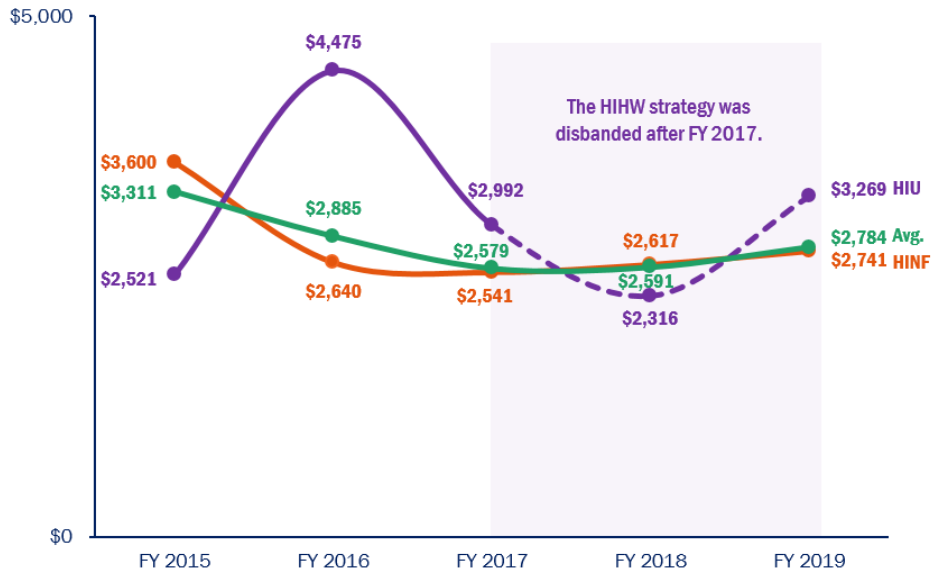
In a recent report, we found high-income nonfilers constitute a serious compliance risk. In that report, we identified 879,415 high-income nonfilers who did not have a satisfied filing requirement, with an estimated tax due of $45.7 billion. We identified that most of these cases would not likely be worked.[27] However, because the highest portion of the Tax Gap is attributable to underreporting of taxes (78 percent), the IRS needs to consider allocating some of its resources to a strategy that focuses on HIU taxpayers—specifically, a HIU strategy that focuses on HIU projects to address the underreporting segment of the Tax Gap.

The High Income High Wealth Examinations Were Productive

We analyzed the dollars per hour productivity of the 32,328 HIU and HINF examinations before and after the disbanding of the HIHW strategy. Figure 13 provides the trends in the HIU, the HINF, and the overall average of HIHW productivity using dollars per hour.

[27] TIGTA, Report. No. 2020-30-015, *High-Income Nonfilers Owing Billions of Dollars Are Not Being Worked by the Internal Revenue Service* pp. 7 and 12 (May 2020).

Figure 13: HIU and HINF Individual Income Tax Dollars per Hour Trends for FYs 2015 Through 2019



Source: TIGTA analysis of RA and TCO HIU and HINF examination results for FYs 2015 through 2019.[28]

As indicated by the orange (HINF) line in Figure 13, the performance of HINF examinations remained relatively consistent from FYs 2016 to 2019, ranging from a low of $2,541 dollars per hour in FY 2017 to a high of $2,741 in FY 2019. HIU examinations as indicated by the purple (HIU) line fluctuated but remained productive after disbanding ranging from a low of $2,316 dollars per hour in FY 2018 to a high of $3,269 in FY 2019.

We previously stated that HINF examination closures represented the majority of the closures from the HIHW strategy. According to SB/SE Division management, the purpose of moving the HINF inventory to a separate NF strategy was to provide more attention to HINF examinations, and they wanted to track the results better. As shown in Figure 12, the number of HINF closures declined from 9,401 in FY 2016 to 3,514 in FY 2019. Figure 1 reflects that the HIHW strategy accounted for 3 percent of the planned DESYs for FYs 2015 through FY 2017. When HINF projects moved to its own strategy, the planned DESYs were 2 percent and 4 percent, respectively, for FYs 2018 and 2019. As a result, the decrease in HINF closures is due to the decrease in total DESYs (resources available).

Figure 14 provides a trend analysis of closures by percentage for selected strategies for IMF returns with TPI of at least $200,000. The percentages are of the overall total for each year's examinations of individual returns with TPI of at least $200,000 and summarize the trend in how the IRS used each strategy over the years. For example, HIHW strategy closures as noted in Figure 14 for FY 2015 were 5 percent of the total examination closures for IMF returns with TPI of at least $200,000, while the DIF strategy made up 49 percent of the total examinations at that TPI level.

[28] The purple (HIU) dashed line represents the movement of the remaining HIU projects from the HIHW strategy at the end of FY 2017 to the OPP strategy.

Figure 14: Field Examination Closures of IMF Returns With TPI of at Least $200,000 for FY 2015 Through FY 2019[29]

Strategy	Before Disbanding			After Disbanding		Trend Since FY 2017
	FY 2015	FY 2016	FY 2017	FY 2018	FY 2019	
ATTI	2%	2%	2%	3%	4%	Up
HIHW	5%	6%	5%	N/A	N/A	N/A
Claims	N/A	N/A	N/A	11%	16%	Up
NF	N/A	N/A	N/A	3%	3%	Even
U&UI	3%	4%	4%	2%	1%	Down
OPP	10%	13%	18%	7%	7%	Down
DIF	49%	37%	35%	43%	50%	Up
Strategies Not Listed	30%	38%	36%	30%	19%	Down

Source: September U.S. Program Monitoring Reports for FYs 2015 through FY 2019.[30]

As noted in Figure 14, the SB/SE Division shifted some of its focus towards other strategies from FY 2017 (before disbanding the HIHW strategy) to FYs 2018 and 2019 (Claims and NF Strategies and more focus on ATTI and DIF returns), which impacted the number of returns examined in the OPP and U&UI strategies for IMF returns with TPI of at least $200,000. Specifically, the DIF closure percentage increased from 35 percent for FY 2017 to 50 percent for FY 2019. The SB/SE Division's approach for FY 2018 and FY 2019 compliance for high-income taxpayers has been focused on using DIF returns rather than returns from OPP, U&UI, or any other strategy.

Shifting Resources for High-Income Examinations to Discriminant Function Examinations Resulted in the Inefficient Use of Resources

IRS management explained that HIU returns have historically been addressed through Compliance Initiative Projects and that, due to difficulties with HIU Compliance Initiative Projects, they decided to implement a balanced approach to HIU return selection using DIF instead of having a new or separate HIU strategy. While high-income projects may be difficult to develop, the resources and efforts for identifying projects should not be abandoned in favor of DIF-selected returns. A recently released study from the National Bureau of Economic Research noted that random audits do not effectively identify tax evasion issues for high-income taxpayers and suggests using administrative resources and data beyond the conventional random audits to identify these high-risk cases.[31] NRP audits are the random audits that were used as part of this study. The results of NRP audits are used to develop DIF algorithms. While this report does not directly discuss DIF examinations, the recommendations of this report should still be considered as part of the approach to compliance for high-income taxpayers. We agree with this report and recommend that the SB/SE Division should prioritize resources to develop Compliance Initiative Projects focused on high-income taxpayers and that these efforts be established as a permanent function.

These resources could potentially come from DIF examination coverage because the DIF strategy is built into the examination plan after allocations have been made to the other

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[29] Combined RA and TCO examination closures.

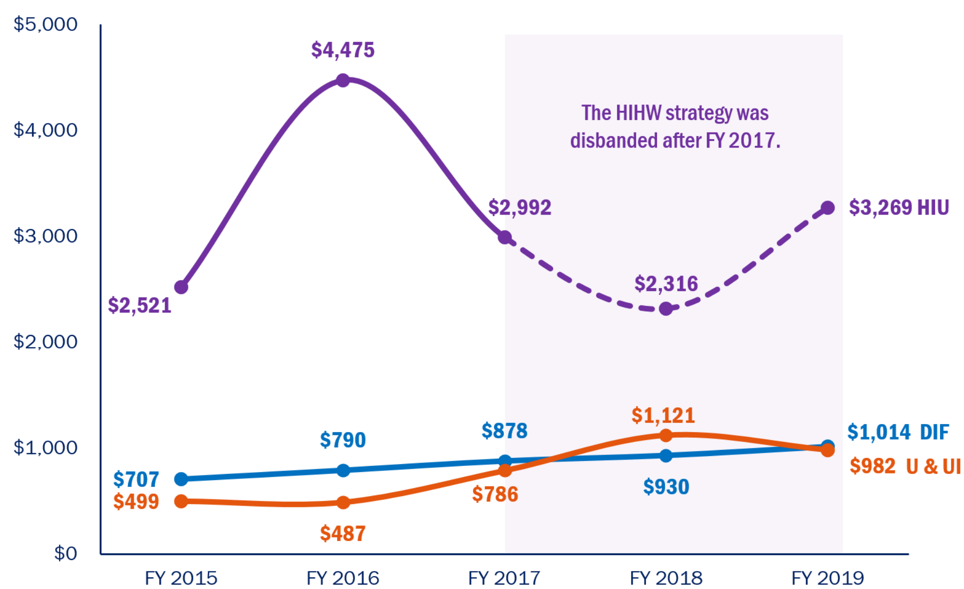
[30] Some columns may not add to 100 percent due to rounding.

[31] National Bureau of Economic Research - John Guyton, Patrick Langetieg, Daniel Reck, Max Risch, and Gabriel Zucman, *Tax Evasion at the Top of the Income Distribution: Theory and Evidence.*

strategies. Shifting resources to working DIF returns may not be an efficient use of resources. See Figure 7 for the increase in DIF examinations from FY 2017 to FY 2019 for IMF returns with TPI of at least $200,000. IRS management previously stated that the DIF strategy is built into the examination plan after allocations have been made to the other strategies.

IRS management clarified during our discussion that high-income taxpayer return coverage extends across all of the existing strategies, as previously reflected in Figures 7 and 10. Figure 15 provides a comparison of the DIF, U&UI, and HIU examinations of individual income tax returns. As we noted previously, IRS management stated the DIF strategy is part of the overall coverage level for high-income taxpayers and noted that the DIF coverage rate is higher for high-income returns compared to other returns. IRS management also defined the U&UI strategy as involving indications of unreported income. Figure 14 shows U&UI examinations have decreased from a 4 percent high in FY 2016 to 1 percent in FY 2019 as the IRS has shifted resources towards working more DIF returns. Figure 15 compares the dollars per hour performance for examinations of high-income returns with U&UI and DIF examination results.

Figure 15: SB/SE Division Individual Income Tax Dollars per Hour by Selected Strategies



Source: TIGTA analysis of RA and TCO HIU and HINF examination results for FYs 2015 through 2019.

As shown in Figure 15, HIU examinations as part of the HIHW strategy outperformed both DIF and U&UI examinations in dollars per hour in FYs 2015 through 2019. HIU examination results are based on TIGTA's analysis, and the methodologies supporting the analysis were reviewed by the IRS. The dotted purple (HIU) line represents the disbanding of the HIHW strategy at the end of FY 2017 and the beginning of the reporting of HIU results under the OPP strategy.

During FYs 2018 and 2019, SB/SE Division management preferred increasing DIF examinations rather than continuing with the HIHW strategy, as reflected by the increasing percentage of DIF closures of individual tax returns with TPI of at least $200,000 in Figure 7. The percentage of DIF closures of IMF returns with TPI of at least $200,000 increased consistently from 18 percent in FY 2016, to 19 percent in FY 2017, to 22 percent in FY 2018, and to 27 percent in FY 2019.

Figure 16 provides a summary of DIF compliance results from FY 2016 through FY 2019 for IMF returns with TPI of at least $200,000.

Figure 16: DIF Strategy Results for IMF Returns With TPI of at Least $200,000 for FYs 2016 Through 2019

FY	Hours per Return	Average Dollars per Hour	Return Closures
2016	37	$972	15,795
2017	35	$1,072	13,827
2018	37	$982	14,330
2019	41	$981	14,858

Source: September U.S. Program Monitoring Reports for FYs 2016 through FY 2019.

As noted in Figure 16, the average dollars per hour for DIF examinations have not been as productive in comparison to HIU examinations (see Figure 15). This approach of increasing the use of DIF rather than a more focused compliance approach for high-income taxpayer coverage resulted in potential lost assessments as the productivity of HIU examinations has been much higher than DIF examinations across all five years, as shown in Figure 15.

The impact of focusing resources on DIF rather than HIU examinations resulted in inefficient use of resources from conducting less productive DIF examinations after the disbanding of the HIHW strategy. As part of our review, we calculated the potential lost assessments from FYs 2018 and 2019 closures by applying the HIU productivity rates to the increased examination hours spent on DIF examinations of high-income returns. We calculated potential lost assessments of $121.5 million for FYs 2018 and 2019. Our calculations are limited to the data available and do not include adjustments for examiner attrition, resource limitations by location, or diminishing returns. See Appendix II for detailed calculations.

SB/SE Division management should consider dedicating resources to developing Compliance Initiative Projects for high-income taxpayers with TPI of at least $200,000 and provide SB/SE Division Examination management the ability to have a more focused compliance approach for of high-income taxpayers.

Recommendation 3: The Director, Examination, SB/SE Division, should dedicate some resources to developing Compliance Initiative Projects with the purpose of focused examinations of IMF returns with TPI of at least $200,000 to address the high-income taxpayer underreporting segment of the Tax Gap.

> **Management's Response:** The SB/SE Division disagreed with this recommendation and stated that the Compliance Initiative Projects are used to address specific areas of noncompliance or to test alternative workload selection methods. The IRS also stated that the use of several work streams allows for the results of the high-income taxpayer examinations to be compared using activity codes and return categories.
>
> > **Office of Audit Comment:** This recommendation is important to ensure a focused long-term approach to high-income audit coverage in which resources are allocated to develop and conduct focused high-income examinations. The implementation of this approach would be similar to the Compliance Initiative Project noted in management's response dedicated to taxpayers at the highest income categories. This same approach should be implemented for all high-income taxpayers.

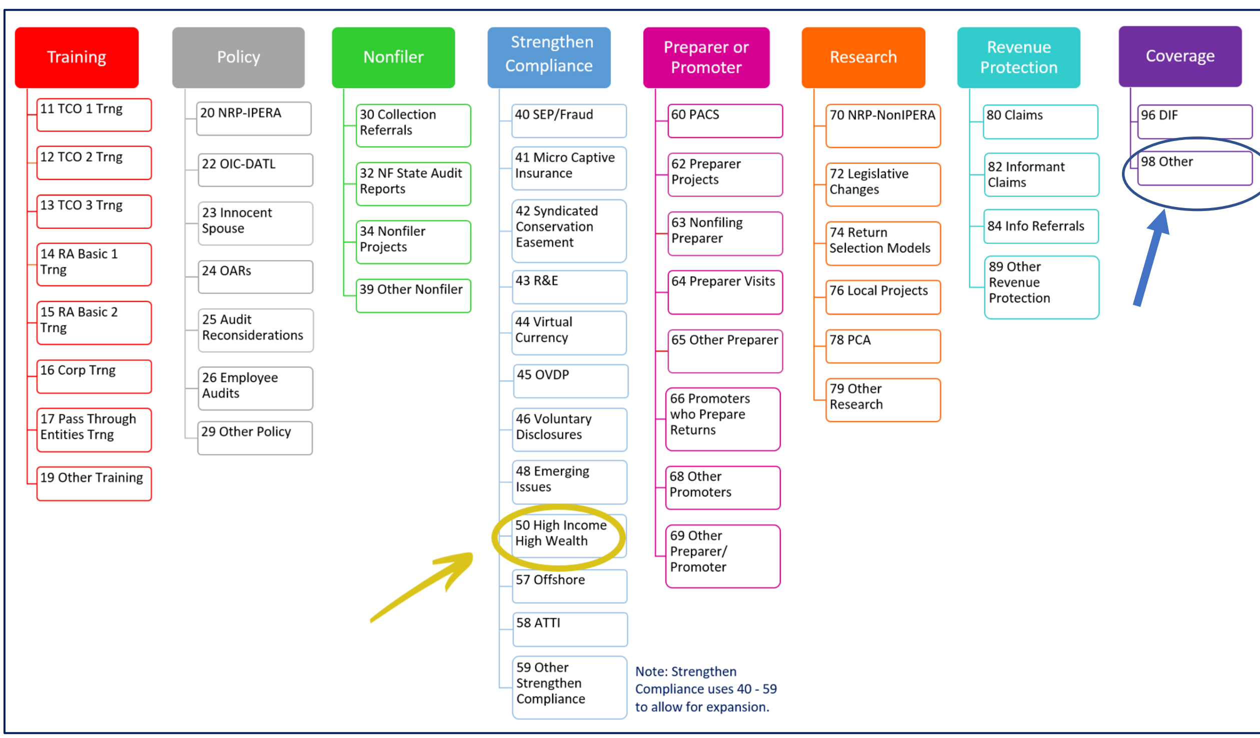
The Ability to Monitor High-Income Taxpayer Examinations Should Be Expanded to Include Additional Income Categories

IRS Policy Statement 4-21, *Selection of returns for examination*, states, in part, that "the primary objective in selecting returns for examination is to promote the highest degree of voluntary compliance on the part of taxpayers." In order to do so, the IRS has to be able to tell if the performance measures for a work stream are improving or deteriorating.

Standards for Internal Control in the Federal Government, published by the U.S. Government Accountability Office, provides the overall framework for establishing and maintaining an effective internal control system. It requires that management designs control activities to achieve an effective internal control system and states, "Control activities are the policies, procedures, techniques, and mechanisms that enforce management's directives to achieve the entity's objectives and address related risks." The establishment and review of performance measures and indicators is a control activity management establishes to monitor performance measures and indicators. Performance measures and indicators may include comparisons and assessments relating different sets of data to one another so that analyses of the relationships can be made and appropriate actions taken.[32]

During this review, TIGTA was made aware of a change by SB/SE Division Examination from using strategic priorities to using purpose groups starting in FY 2021. Figure 17 shows the new purpose groups methodology for FY 2021.

Figure 17: SB/SE Division Purpose Groups and Work Streams for FY 2021



Source: SB/SE Division Examination management.

[32] Government Accountability Office, GAO-14-704G, *Standards for Internal Control in the Federal Government* pp. 1, 45-46 (Sept. 2014).

As shown in Figure 17, "Nonfiler" (in green) is a purpose group, which remains a strategic focus, and the new "Strengthen Compliance" purpose group (in blue) includes HIHW as one of 12 work streams (additional streams not listed).

On February 10, 2020, the Secretary of the Treasury sent a memorandum to the IRS Commissioner directing the Commissioner to take all steps necessary to increase examinations for taxpayers with adjusted gross income above $10 million. The directive was based on reviewing audit reports detailing the trends in audit rate coverage such as the IRS Data Book.

The IRS initiated a new Compliance Initiative Project in response to the directive this year that includes 564 returns selected for examination. These examinations are being tracked under the Coverage (purple) purpose group work stream Other (98) rather than under the Strengthen Compliance purpose group HIHW work stream (50). As previously stated, while each of the strategies (or purpose groups starting in FY 2021) includes high-income taxpayers, there is no strategy (or purpose group) focused on the issues of high-income taxpayers. Figure 18 compares the IRS Data Book and U.S. Program Monitoring report income categories.

Figure 18: High-Income Taxpayer Examination Results Reporting Comparison for Individual Taxpayers[33]

Income Categories as Listed in the IRS 2018 Data Book and U.S. Program Monitoring Report	2017 Returns Filed	Returns Examined	Exam Rate	Income Categories as Listed in the IRS 2019 Data Book	2018 Returns Filed	Returns Examined	Exam Rate	Income Categories as Listed in the U.S. Program Monitoring Report
$200,000-$1,000,000	5,001,344	30,123	0.6%	$200,000 - $500,000	7,348,374	2,376	0.03%	$200,000-$1,000,000
				$500,000 - $1,000,000	1,166,863	400	0.03%	
Over $1,000,000	504,278	16,290	3.2%	$1,000,000 - $5,000,000	503,460	243	0.05%	Over $1,000,000
				$5,000,000 - $10,000,000	34,536	15	0.04%	
				$10,000,000 or more	23,456	7	0.03%	

Source: U.S. Program Monitoring Reports and 2018 and 2019 IRS Data Books

As noted in Figure 18, the IRS Data Book for 2019 expanded the income level categories for high-income individual taxpayers. Currently, SB/SE Division monitoring reports are not consistent with the categories used to report examination results in the IRS Data Book as noted in Figure 18. There are key examination coverage categories that should be monitored for both risk and coverage. SB/SE Division management noted that they have requested three new activity codes to be effective in January 2022, activity codes 282 ($1 million to $5 million TPI); 283 ($5 million to $10 million TPI), and 284 (over $10 million TPI), and that IRS management has no plans for new activity codes for the $200,000 to $500,000 or $500,000 to $1,000,000 income categories.

[33] The 2018 returns filed include all returns filed for Tax Year 2018 as of December 31, 2019. The 2018 returns examined include Tax Year 2018 return examinations that were closed as of September 30, 2019, and those that are in open examination status. Additional returns may be selected for examination in the future. Generally, the assessment statute expiration date is three years after the return was due, six years if the income on the return was understated by 25 percent of more, and there is no limit if the tax return was filed with the intent to commit fraud. Based on the aforementioned, the examination rate may increase in future years as additional Tax Year 2018 returns are selected for examination.

The revised U.S. Program Monitoring Report provides an extensive amount of data through the use of filters, and the three new activity codes have been included in the Return Category filter. The IRS Data Book provides the public a more detailed breakout of income levels than the U.S. Program Monitoring Report, which is used to provide purpose group-level data to SB/SE Division Examination management for decision-making purposes. SB/SE Division management should:

- Continue to pursue adding the three new activity codes activity codes 282 ($1 million to $5 million TPI), 283 ($5 million to $10 million TPI), and 284 (over $10 million TPI).
- Consider adding new activity codes for the $200,000 to $500,000 and $500,000 to $1,000,000 income categories which represents over 7 million and 1 million returns filed respectively, similar to the IRS Data Book, in order to provide SB/SE Division management and external stakeholders the ability to monitor the compliance of high-income taxpayers across specific income categories.

As TIGTA stated in its previous report, if high-income taxpayers believe the IRS's effort in this area is temporary or intermittent, those efforts are unlikely to have a long-term benefit on voluntary tax compliance.[34]

Recommendation 4: The Director, Examination, SB/SE Division, should add additional activity codes for the $200,000 to $500,000 and $500,000 to $1,000,000 income categories, similar to the IRS Data Book, to allow for a more focused approach to monitoring the compliance of specific income segments of the high-income taxpayer population.

Management's Response: The SB/SE Division disagreed with this recommendation and stated that adding additional activity codes, as suggested by TIGTA, is very costly, and the costs outweigh any additional benefits. In addition, with the data currently available, internal reports are easily generated to further breakdown categories into meaningful segments for management.

Office of Audit Comment: The IRS has been reluctant to add activity codes for many years and has finally started to add a few activity codes and should continue with adding the three suggested in this recommendation. We believe that a one-time cost to add additional activity codes would provide the SB/SE Division the ability over the long term to monitor segments of the high-income taxpayer population, which are comingled using the present activity codes. The additional activity codes would provide key planning metrics and a more focused examination plan, ensuring coverage equity across all high-income taxpayers.

[34] TIGTA Report No. 2020-30-015, *High-Income Nonfilers Owing Billions of Dollars Are Not Being Worked by the Internal Revenue Service* p. 18 (May 2020).

Appendix I

Detailed Objective, Scope, and Methodology

This audit was initiated to evaluate IRS SB/SE Division efforts to ensure the compliance of high-income individual taxpayers. To accomplish our objective, we:

- Determined whether the SB/SE Division had or still has a strategy in place to ensure the tax compliance of high-income individuals.
- Evaluated the controls and procedures used to select high-income tax returns for examination.
- Determined if SB/SE Division Examination has established activities to monitor and review the use of the DIF to select high-income tax returns for examination, and determined if the DIF strategy provided better returns for examination than the previous methods of selecting returns for examination.
- Determined whether monthly briefing documents provide management the information necessary to: 1) assure taxpayers of equitable consideration in the selection of high-income IMF returns for examination and 2) determine whether those methods identify returns with the probability of substantial error.

Performance of This Review

This review was performed with information obtained from the SB/SE Division during the period of November 2019 through January 2021. 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 Matthew A. Weir, Assistant Inspector General for Audit (Compliance and Enforcement Operations); Christina Dreyer, Director; Lee Hoyt, Audit Manager; David Hartman, Lead Auditor; and Matthew Schimmel, Information Technology Specialist (Data Analytics).

Validity and Reliability of Data From Computer-Based Systems

We verified the completeness of the counts of HIHW examinations conducted by the SB/SE Division by comparing the data provided by the SB/SE Division to the U.S. Program Monitoring Reports. We found no material variances. Additionally, we verified 95 records from closed examination data for FY 2015 through FY 2019 received from the IRS against examination documents and closed examination data on TIGTA’s Data Center Warehouse. We found no significant issues. We determined that the data are sufficient and 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 high-income IMF returns for examination by the SB/SE Division. We evaluated these controls by contacting management, reviewing Internal Revenue Manual guidance provided to managers and employees, reviewing reports, and analyzing closed examination data.

Appendix II

Outcome Measure

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. This benefit will be incorporated into our Semiannual Report to Congress.

Type and Value of Outcome Measure:

- Increased Revenue – Potential, total of $121.5 million in additional assessments for FYs 2018 and 2019 based on increasing HIU examination hours rather than DIF hours for 1,534 IMF returns with TPI of at least $200,000 (see Recommendation 2).

Methodology Used to Measure the Reported Benefit:

The HIHW strategy disbanded after FY 2017. The SB/SE Division increased examination closures of DIF IMF returns with TPI of at least $200,000 for FYs 2018 and 2019. This resulted in lost revenue based on less productive examination closures. We calculated the additional recommended assessments for FYs 2018 and 2019 as if the SB/SE Division had increased the HIU examination hours instead of increasing DIF hours. Figure 1 summarizes the increase in DIF examination closures for FYs 2018 and 2019.

Figure 1: Increase in DIF Examination Closures of IMF Returns With TPI of at Least $200,000 for FYs 2018 and 2019

FY	Return Closures	Difference With FY 2017
2017	13,827	0
2018	14,330	503
2019	14,858	1,031
Total		1,534

Source: TIGTA analysis of September U.S. Program Monitoring Reports for FYs 2017 through 2019.

As noted in Figure 1, DIF examination closures for IMF returns with TPI of at least $200,000 increased by 503 from FY 2017 to FY 2018 and by 1,031 from FY 2017 to FY 2019. Figure 2 summarizes the additional examination hours based on the increase in DIF examination closures for IMF returns with TPI of at least $200,000.

Figure 2: Increase in DIF Examination Hours for FYs 2018 and 2019

Description	FY 2018	FY 2019
Increase in Return Closures	503	1,031
Hours per Return	37	41
Total Increase in DIF Examination Hours	18,611	42,271

Source: TIGTA analysis of September U.S. Program Monitoring Reports for FYs 2018 and 2019.

Figure 2 shows that DIF examination hours increased by 18,611 for FY 2018 and 42,271 for FY 2019 with respect to FY 2017. Figure 3 summarizes the actual Dollars Recommended based on the additional examination hours expended on DIF examination closures during FYs 2018 and 2019.

Figure 3: DIF Examination Results for the Increase in Hours for FYs 2018 and 2019

Description	DIF Examination Hours	Average Dollars per Hour DIF	Dollars Recommended
FY 2018	18,611	$982	$18,276,002
FY 2019	42,271	$981	$41,467,851
Total			$59,743,853

Source: TIGTA analysis of September U.S. Program Monitoring Reports for FYs 2018 and 2019.

As noted in Figure 3, the increase in DIF examination closures resulted in an actual increase in total dollars recommended of $59,743,853. Figure 4 summarizes the potential Dollars Recommended based on applying the HIU Average Dollars per Hour rate to the additional DIF Hours.

Figure 4: Examination Results for the Increase in HIU Hours for FYs 2018 and 2019

Description	DIF Examination Hours	Average Dollars per Hour HIU	Dollars Recommended
FY 2018	18,611	$2,316	$43,103,076
FY 2019	42,271	$3,269	$138,183,899
Total			$181,286,975

Source: TIGTA analysis of September U.S. Program Monitoring Reports for FYs 2018 and 2019.

As shown in Figure 4, the increase in Dollars Recommended would have been $181,286,975 if the IRS had examined an additional 1,534 HIU returns.

The net difference as shown in Figure 5 is $121,543,122. The SB/SE Division's decision to use the DIF strategy rather than the HIHW strategy resulted in potential lost Dollars Recommended totaling $121,543,122.

Figure 5: HIU Examination Results With Dollars Recommended for FYs 2018 and 2019

Description	Dollars Recommended
Potential Dollars Recommended Based on the Increase in HIU Hours	$181,286,975
Actual Dollars Recommended	$59,743,853
Potential Lost Dollars Recommended	$121,543,122

Source: TIGTA analysis of September U.S. Program Monitoring Reports for FYs 2018 and 2019.

Management's Response: The SB/SE Division disagreed with the estimated monetary benefit. The IRS stated the outcome was based on an overstated productivity rate (dollars per hour) and FY 2018 and FY 2019 HIU results are not representative of additional HIU returns. The majority of the returns analyzed were from the end of strategy and were part of Tax Equity and Fiscal Responsibility Act of 1982 audits that are no longer available due to the implementation of the Bipartisan Budget Act of 2015.[1] The IRS stated that HIU productivity should be based on lifetime Compliance Initiative Project results, which are similar to DIF results. The IRS also stated that TIGTA did not remove outliers from the population and that the outcome measure ignored attrition of examiners and the decreased volume of examinations.

Office of Audit Comment: We acknowledge that the actual outcome would have been dependent on several variables including the availability of returns, locations of taxpayers, attrition, location of examiners, and changes from the implementation of the Bipartisan Budget Act. However, outliers are not the issue as the U.S. Program Monitoring Reports also do not consider outliers. We remain confident the actual outcome would have been similar to our potential outcome if a long-term approach to high-income examination coverage would have been implemented based on emphasizing Compliance Initiative Project examinations.

[1] Pub. L. No. 97-248, 96 Stat. 324 (codified as amended in scattered sections of 26 U.S.C.); Pub. L. 114-74.

Appendix III

Management's Response to the Draft Report

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

COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

June 8, 2021

MEMORANDUM FOR MICHAEL E. McKENNEY
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: De Lon Harris
Commissioner, Small Business/Self-Employed Examination Division

SUBJECT: Draft Audit Report – *The IRS Continued Compliance Efforts for High Income Taxpayers after Disbanding the High Income High Wealth Strategy, But With Less Effective Outcomes* (Audit # 201930026)

Thank you for the opportunity to review and comment on the subject draft audit report. At the IRS, we are committed to ensuring our enforcement efforts are fair. Taxpayers who underreport their tax liability undermine the integrity of our tax system. Compliant taxpayers deserve to know that noncompliant taxpayers are at risk of audit or other enforcement actions, and as a result may be assessed civil penalties, and where appropriate, criminal enforcement will be pursued. High-income taxpayers are no exception and are an enforcement priority.

The IRS must remain nimble in adapting to evolving risks and we have done the best we could with limited and shrinking resources confronting new and emerging risks. Tax advisors and promoters market increasingly sophisticated strategies causing us to adapt our compliance efforts for all taxpayer groups including high-income and high wealth taxpayers. Thus, we shifted resources from one category of work that TIGTA points to as a benchmark (the HIHW or High-Income High Wealth Strategy) to Abusive Transactions and Technical Issues (ATTI) projects. We adjusted to respond to evolving risks including virtual currency, syndicated conservation easement, Research and Experimentation Credit and micro-captive insurance issues. High-income individuals are engaged in substantially all of these transactions.

We also recently created an Office of Promoter Investigations focused on taxpayers and the promoters of these types abusive tax avoidance transactions. We have and will continue to focus on those major contributors to the tax gap whether we identify the work as "HIHW" or "Abusive Transactions".

It is important to point out that TIGTA's Review and this Report illustrate that regardless of the nomenclature used to identify the tranches of work undertaken while focused upon High Income High Wealth individuals, the examination results have remained stable at approximately $1,200 per hour across Fiscal Years 2015 – 2019.

Since 2018, we have shifted significant examination resources and technology to increase our focus on these taxpayers. Our specialized, most highly trained examination personnel are conducting audits of high-income and high-wealth taxpayers at an examination rate far higher than any other category of individual filers. As reported in the most recently published Data Book (2019), Tax Year 2015 audit rates for taxpayers with income of at least $10 million or more are 8.16%, while rates for individuals with income under $200,000 are 0.56%. We also initiated a Compliance Initiative Project to ensure that we continue to maintain a high rate of audit coverage of taxpayers at the highest income categories.

TIGTA correctly points out that reduced IRS resources have led to an overall decline in the number of examinations we are able to conduct. The amount of funding and staff allocated to enforcement activities has declined by about 30 percent since 2010, and an estimated 35 percent reduction in experienced revenue agents who handle complex enforcement cases such as examinations of high-income individuals. We used the HIHW strategy between 2010 and 2015 to gather information to improve workload selection and better understand behavior of taxpayers using complex transactions and inter-related entities to reduce taxable income reported on their returns. In fact, as TIGTA stated in the report, the percentage of all exam closures that involved high-income taxpayers increased from 20% in Fiscal Year (FY) 15 to 26% in FY 19 while taxpayers with over $200,000 of income represent less than 6% of the filing population. This fiscal year's audit plan and our year to date (April 2021) closures of Discriminant Index Function (DIF) returns of high-income taxpayers is over 62% of total individual taxpayer closures.

We understand TIGTA's point that not all returns audited in the HIHW strategy were focused on high-income taxpayers because certain activity codes included were not defined as high income. However, part of the HIHW strategy was to identify previously undetected high-wealth taxpayers as we consider a taxpayer's actual income, not just what was reported on the return. Further, TIGTA did not limit its evaluation to returns that were selected as part of the HIHW strategy but included returns that were examined because they were related to the original strategy returns. We expect examiners to verify that all returns within the taxpayer's sphere of influence are filed. Therefore, when a primary return (i.e., the return initially selected) is examined, related returns will be reviewed and considered for examination regardless of whether they fall within the parameters of the strategy. This may, and did, include returns below the HIHW threshold because, in the judgement of the revenue agent and their manager, there was noncompliance. TIGTA reports "[t]he identification of this strategy as HIHW is misleading," and does not take into account the impact on compliance from examining related returns.

We also take issue with the time period of the HIHW audits TIGTA evaluated. The majority of the HIHW strategy work began in the years 2010-2013, but TIGTA limited its review to years 2015-2017. As explained during the review, returns that close more quickly (prior to 2015) have higher no-change rates and are less productive, while returns with larger adjustments take much longer to resolve. By reviewing the results of the cases closing later (2015–2017) rather than the complete population, TIGTA skewed the results to the most productive cases which may cause the project results to be overstated by as much as 67%. Therefore, the results portrayed as potential revenue cannot be replicated.

The IRS is currently reviewing the organization of our Compliance operations following the Taxpayer First Act enacted in 2019. We are also considering the same in light of the Department of Treasury's May 2021 *American Families Plan Tax Compliance Agenda* and the FY2022 *Congressional Budget Justification & Annual Performance Report and Plan*. While much work remains to be done, we are devising an organizational structure for examination that will focus upon the major contributors to the Tax Gap to include an enterprise examination plan. We will share details with you as the design and plans are approved.

Attached is our detailed response to your recommendations. If you have any questions, please contact me or Scott Irick, Director, Examination Operations, SB/SE Division.

Attachment

Attachment

Recommendation 1:
The Director, Examination Case Selection, should create a dedicated work stream, with the purpose of focused examinations of IMF returns with TPI of at least $200,000 to address the high-income taxpayer underreporting segment of the Tax Gap.

Planned Corrective Action:
Adding a new workstream to identify Individual Master File (IMF) returns with TPI of at least $200,000 is redundant with our activity code usage and the return category groupings (IMF activity codes 279 and higher which are organized into the IMF $200,000 and higher return category). This population is covered throughout the purpose groups and workstreams, and the number of returns examined can be influenced within the DIF Workstream. We already monitor the results of high-income examinations overall and by purpose group or project.

Implementation Date:
N/A

Responsible Official(s):
N/A

Corrective Action Monitoring Plan:
N/A

Recommendation 2:
The Director, Planning and Performance should increase the monitoring of planned versus actual examinations for additional income categories such as taxpayers with TPI from $1 million to $5 million; $5 million to $10 million and over $10 million and make adjustments to ensure planned examination closures are met within an acceptable range each fiscal year for all High-Income taxpayer sub categories.

Planned Corrective Action:
Independent of TIGTA's audit, we had already planned to add the three income levels for individuals with Total Positive Income (TPI) greater than $1 million to the U.S. Program Monitoring report in FY 21. In FY 20, we also requested reprogramming to include these thresholds in IRS systems. The additional income thresholds enhance the data already available on high-income individual taxpayers and allows more flexibility in monitoring.

Implementation Date:
N/A

Responsible Official(s):
N/A

Corrective Action Monitoring Plan:
N/A

Recommendation 3:
The Director, SB/SE Examination, should dedicate some resources to developing Compliance Initiative Projects with the purpose of focused examinations of IMF returns with TPI of at least $200,000 to address the high-income taxpayer underreporting segment of the Tax Gap.

Planned Corrective Action:
CIPs are used to address a specific area of non-compliance or to test alternative workload selection methods. The goal of a CIP is to treat the specific noncompliance and terminate the CIP; or transition the identification methods and inventory from a CIP into a permanent workstream. Specific CIPs are not designed to be permanent workstreams. The IMF returns with at least $200,000 of income are monitored and tracked via activity codes and return categories. DIF can be utilized to focus on specific Activity Codes (direct allocations of planned starts to the desired Activity Codes) without the use of a CIP. As previously stated, coverage is obtained in other workstreams, as well. The use of several workstreams allows for the results of the high-income taxpayer examinations to be compared based on the source of the work using activity codes and return categories. Furthermore, Workstream 50 - High-Income High Wealth, is a workstream specific to this type of taxpayer (see Figure 17, p. 21, in report).

Implementation Date:
N/A

Responsible Official(s):
N/A

Corrective Action Monitoring Plan:
N/A

Recommendation 4:
The Director, SB/SE Examination should add additional activity codes for $200,000-$500,000 and $500,000 to $1,000,000 income categories similar to the IRS Data Book to allow for a more focused approach to monitoring the compliance of specific income segments of the high-income taxpayer population.

Planned Corrective Action:
SB/SE monitoring reports use the categories from the Data Book Table 17b, plus a breakdown of taxpayers reporting income of $1 million or more in the three categories from Table 17a. Adding additional activity codes, as suggested by TIGTA, is very costly, and we believe those costs far outweigh any additional benefits. With the data currently available, internal reports are easily generated to further breakdown categories into meaningful segments for management.

Implementation Date:
N/A

Responsible Official(s):
N/A

Corrective Action Monitoring Plan:
N/A

Outcome Measure 1
Increased Revenue – Potential: Total of $121.5 million in additional assessments for FYs 2018 and 2019 based on increasing HIU examination hours rather than DIF hours for 1,534 IMF returns with TPI of at least $200,000 (see Recommendation 2).

IRS Response:
TIGTA assigned a subcategory name of High-Income Under-reporter (HIU) to the filed returns in the HIHW strategy. HIU is not a term used in SB/SE and even though TIGTA states that this acronym was created by them, we believe this terminology does not accurately reflect the type of returns worked in this strategy and could mislead the reader regarding why those returns were selected. We disagree with this outcome measure. The methodology is using an overstated productivity rate (dollars per hour). The FY18 and FY19 "HIU" results are not representative of additional HIU returns. The majority of the returns analyzed were from the end of strategy and were part of TEFRA audits that are no longer available due to the implementation of BBA. The HIU productivity should be based on lifetime CIP results. We estimate that the lifetime CIP dollars per hour on returns with TPI of at least $200,000 are about 60% of the dollars per hour from the 2015 to 2017 period TIGTA analyzed. Using this approach, the HIU dollars per hour is similar to DIF results. Limiting the dollars per hour analysis to high income individual returns (IMF>$200,000 returns) ignores the associated time on other returns that may have been necessary to secure the IMF>200K results. Also, TIGTA did not remove outliers from the population.

The outcome measure ignores attrition of examiners and the decreased volume of examinations. The number of high-income examinations as a percentage of total examinations has actually increased in recent years. We strive to maintain balanced examination coverage, as stated in Policy Statement 4-21 “The 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 judgment in selecting sufficient returns of all classes of returns in order to assure all taxpayers of equitable consideration, in utilizing available experience and statistics indicating the probability of substantial error, and in making the most efficient use of examination staffing and other resources.”

Appendix IV

Glossary of Terms

Term	Definition
Compliance Initiative Projects	Authorized activity outside of planned strategies involving taxpayer contact to identify potential areas of noncompliance for correcting the noncompliance.
Data Center Warehouse	An online database maintained by TIGTA. The Data Center Warehouse pulls data from IRS system resources, such as IRS Collection and Examination files, for TIGTA access.
Direct Examination Staff Year	A DESY is generally equal to 2,000 direct examination hours. Staff years are the total number of RA or TCO hours divided by fiscal year total hours.
Discriminant 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.
Earned Income Tax Credit	A refundable tax credit for certain people who work and have earned income.
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.
Individual Master File	An IRS computer system that stores transactions or records of individual tax accounts.
Internal Revenue Manual	The primary, official source of instructions to staff related to the organization, administration, and operation of the IRS.
Revenue Agent	Employees in the Examination function who conduct face-to-face examinations of more complex tax returns such as those of businesses, partnerships, corporations, and specialty taxes.
Target	A goal to be achieved.
Tax Compliance Officer	Employees in the Examination function who primarily conduct examinations of individual taxpayers through interviews at IRS field offices.
Tax Gap	The estimated difference between the amount of tax that taxpayers should pay and the amount that is paid voluntarily and on time.
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 V

Abbreviations

AO	All Other
ATTI	Abusive Transactions and Technical Issues
DAO	Discriminant Function and All Other
DESY	Direct Examination Staff Year
DIF	Discriminant Function
FY	Fiscal Year
HIHW	High Income and High Wealth
HINF	High Income Nonfiler
HIU	High Income Underreported (Filed Return)
IMF	Individual Master File
IRS	Internal Revenue Service
NF	Nonfiler
NRP	National Research Program
OFF	Offshore
OPP	Other Priority Programs
P&RP	Promoters and Return Preparer
RA	Revenue Agent
SB/SE	Small Business/Self-Employed
SEP&F	Special Enforcement and Fraud Programs
TCO	Tax Compliance Officer
TIGTA	Treasury Inspector General for Tax Administration
TPI	Total Positive Income
U&UI	Unreported and Underreported Income

To report fraud, waste, or abuse,
call our toll-free hotline at:

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By Web:

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Or Write:

Treasury Inspector General for Tax Administration

P.O. Box 589

Ben Franklin Station

Washington, D.C. 20044-0589

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