TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

The IRS Reduced Earned Income Tax Credit Examinations in Fiscal Year 2024, but the Process to Mitigate Racial Disparity Needs to Be Defined

May 9, 2025

Report Number: 2025-308-020

HIGHLIGHTS: The IRS Reduced Earned Income Tax Credit Examinations in Fiscal Year 2024, but the Process to Mitigate Racial Disparity Needs to Be Defined

Final Audit Report issued on May 9, 2025 **Report Number 2025-308-020**

Why TIGTA Did This Audit

In August 2022, the Secretary of the Treasury issued a memorandum (2022 Treasury Directive) to the IRS Commissioner directing the IRS not to use resources provided by the Inflation Reduction Act of 2022 to increase audit rates on small businesses or households earning below $400,000 per year. In May 2023, the IRS Commissioner acknowledged the existence of racial disparities in its methodologies for selecting examinations of tax returns claiming the Earned Income Tax Credit (EITC).

The overall objective of this audit was to assess changes to the EITC examination strategy relating to both the 2022 Treasury Directive and the fair and equitable selection of EITC returns for examination.

Impact on Tax Administration

The law requires the IRS to follow the fair and equitable treatment of taxpayers as a standard. Racial disparities in audit selection compromise the fair and equitable standard. To achieve this result, the IRS Commissioner rebalanced the IRS's EITC enforcement efforts by increasing outreach and education efforts and modifying how it selects EITC cases for audit. The IRS also reduced the number of correspondence audits focused specifically on refundable credits, including the EITC, in Fiscal Year (FY) 2024.

What TIGTA Found

After acknowledging publicly that there were racial disparities in its EITC examination case selection methodologies, the IRS began working toward correcting the problem by: (1) developing and testing two new EITC case selection models, and (2) rebalancing enforcement activities by examining fewer EITC cases and shifting resources to non-EITC workstreams. While the IRS does not yet have results from its efforts, we found that the IRS has not yet established goals to measure success in addressing racial disparities in case selection.

The IRS will also consider the racial disparities noted in external and internal studies as quantifiable measures against which they will compare future results. Without established measurable goals, the IRS will be unable to evaluate how its efforts have made a difference reducing disparity issues with selected examinations of taxpayers claiming the EITC.

Although we did not assess whether the IRS satisfied the 2022 Treasury Directive for Tax Year 2023 tax returns, we found that the IRS significantly decreased EITC audits, increasing the likelihood of meeting the goals of the Directive since fewer tax returns of taxpayers with incomes under $400,000 were audited. We also found that planned starts for some FY 2024 workstreams did not completely align with those listed in the IRS's FY 2024 Draft Enterprise-wide Examination Plan. Given the importance of monitoring EITC disparity issues, it is especially important when measuring results by workstream that there is consistency between the planned examination starts and the FY 2024 Examination Plan to avoid reporting different outcomes.

The IRS has started to monitor compliance with the 2022 Treasury Directive and developed a draft template to monitor completed examinations by tax year against a comparative baseline measure. However, it has not finalized its methodology for the audit coverage calculation.

What TIGTA Recommended

We recommended that the Chief, Taxpayer Services Division: (1) define measures and establish monitoring activities to assess its success in mitigating racial disparities related to the EITC examination selection process; and (2) establish a monitoring process to ensure that revisions to "planned examination starts" are communicated and aligned at both the division and enterprise levels.

The IRS agreed with both recommendations, stating that it plans to annually monitor audit selection demographics and establish a log to provide real-time updates and document changes.

TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

U.S. DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20024

May 9, 2025

MEMORANDUM FOR: COMMISSIONER OF INTERNAL REVENUE

FROM: Diana M. Tengesdal
Acting Deputy Inspector General for Audit

SUBJECT: Final Audit Report – The IRS Reduced Earned Income Tax Credit Examinations in Fiscal Year 2024, but the Process to Mitigate Racial Disparity Needs to Be Defined (Audit No.: 2024308026)

This report presents the results of our review to assess changes to the Earned Income Tax Credit examination strategy relating to both the 2022 Treasury Directive and the fair and equitable selection of Earned Income Tax Credit returns for examination. This review is part of our Fiscal Year 2025 Annual Audit Plan and addresses the major management and performance challenge of *Tax Compliance and Enforcement.*

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

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Background

In August 2022, the Secretary of the Treasury issued a memorandum (2022 Treasury Directive)[1] to the Commissioner of Internal Revenue directing the Internal Revenue Service (IRS) not to use resources provided by the Inflation Reduction Act of 2022 to increase audit rates on small businesses or households earning incomes below $400,000 per year.[2] In May 2023, the IRS Commissioner acknowledged the existence of racial disparities in the IRS's methodologies for selecting examinations of tax returns claiming the Earned Income Tax Credit (EITC). In response, TIGTA initiated three audits to review the IRS's implementation of the directive. The first two audits focused on:

- The IRS's approach for ensuring that Inflation Reduction Act funds are not used to increase the percentage of audits of taxpayers with incomes below $400,000.[3]
- The IRS's plans to increase examinations on high-income taxpayers while not increasing audit rates for taxpayers with incomes below $400,000.

This audit focuses on the portion of the Fiscal Year (FY) 2024 Draft Enterprise-wide Examination Plan (hereafter referred to as the FY 2024 Examination Plan) related to the Taxpayer Services Division and the IRS's overall efforts to substantially reduce the number of audits on EITC-related returns and address the unintentional effects of racial disparity in the selection process.[4] The EITC helps low to moderate-income workers and families who qualify get a tax credit that can reduce or eliminate taxes owed and potentially increase their refund. In general, low to moderate-income workers who meet qualifying rules such as having earned income and a qualifying child may be eligible to claim the EITC.

There are numerous requirements for taxpayers to qualify for the EITC, including the following basic requirements:[5]

- Earned income test - Provides for an EITC phaseout for adjusted gross incomes above certain thresholds depending on the marital status of the taxpayer and number of qualifying children. For example, for Tax Year 2024, the maximum adjusted gross income is $66,819 for taxpayers married filing jointly with 3 or more qualifying children.
- Relationship test - The qualifying child must have a relationship to the taxpayer of child, stepchild, brother, sister, stepbrother, stepsister, half brother, half sister, grandchild, niece, nephew, adopted child, or foster child.
- Residency test - The qualifying child must reside in the taxpayer's residence for more than half of the tax year.

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[1] We discussed the current status of the 2022 Treasury Directive with the IRS, and they indicated that the directive remains in effect.

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

[3] TIGTA, Report No. 2024-308-043, *The IRS Has Made Limited Progress Developing the Methodology to Comply With the Treasury Directive to Not Increase the Audit Rate for Taxpayers With Incomes Below $400,000 Due to Planning and Implementation Challenges* (August 2024).

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

[5] IRS Publication 596, *Earned Income Credit* (2024).

Over the last several years, stakeholders have raised concerns about a possible racial bias in EITC case selection. In FY 2021, we issued a report confirming a geographical examination selection bias, finding that significantly more EITC examinations occurred pro rata in five southern states.[6] In January 2023, a Standford University study concluded there was an inherent racial bias present in the IRS's EITC case selection methodology.[7] In September 2023, the IRS Commissioner sent a letter to members of Congress acknowledging that there were unintended racial disparities present in EITC case selection models and committed to study the causes of the problem and make changes. In March 2024, the Commissioner reiterated that any indication of racial bias in IRS work is unacceptable. The law requires the IRS to follow the fair and equitable treatment of taxpayers as a standard, and racial disparities in EITC case selections compromise that standard.[8] The Commissioner communicated the IRS's commitment to understand any potential systemic bias in compliance strategies and treatments in their ongoing evaluation of the EITC audit selection process.

In September 2023, the Commissioner highlighted the IRS's efforts to rebalance its enforcement activities by increasing outreach and education efforts and modifying EITC case selection methods. The IRS planned to reduce the number of correspondence audits focused specifically on certain refundable credits, including the EITC in FY 2024. Correspondence audits (as opposed to field audits that may entail detailed reviews of taxpayers' books and record) are tax examinations conducted by mail that are limited in scope. The Commissioner also noted that initial testing suggests that changes to the EITC case selection processes would increase the expected return on investment for cases selected while simultaneously reducing disparities. Furthermore, the Commissioner confirmed that the IRS is devoting more resources to address unscrupulous preparers who lead their customers to underreport income or overclaim credits, such as the EITC.

In FY 2024, the IRS implemented a single examination plan to create a more agile organization and make centralized resource allocation decisions. Previously, the business operating divisions (BOD) created individual examination plans. The Taxpayer Services Division is one of the BODs that contributed to the IRS's new enterprise plan approach and provides program oversight for refundable credits, such as the EITC. Historically, its Refundable Credits Examination Operations (RCEO) function has dealt with most of the IRS's examinations related to the EITC and related issues. Due to the type of taxpayers that the Taxpayer Services Division serves, nearly all of its approximately 251,000 planned individual income examinations for FY 2024 relate to taxpayers with total positive income (TPI) below $400,000, such as those claiming the EITC.

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[6] TIGTA, Report No. 2021-30-051, *The Earned Income Tax Credit Examination Compliance Strategy Can Be Improved* (September 2021), found that significantly more audits pro rata occurred in Alabama, Georgia, Louisiana, Mississippi, and Tennessee.

[7] Hadi Elzayn, et al, *Measuring and Mitigating Racial Disparities in Tax Audits*, Stanford Institute for Economic Policy Research (January 30, 2023).

[8] Section 1204(b) of the Internal Revenue Service Restructuring and Reform Act of 1998 requires that all IRS employees be evaluated annually on the fair and equitable treatment of taxpayers as one of the standards. Pub. L. No. 105-206, 112 Stat. 685, 722 (codified as amended in scattered sections of 2, 5, 16, 19, 22, 23, 26, 31, 38, and 49 U.S.C.).

Results of Review

The IRS Changed the Earned Income Tax Credit Selection Process, but Has Not Defined Measurable Goals to Address Racial Disparities

After acknowledging publicly that there were racial disparities in its EITC examination case selection methodologies, the IRS began working toward correcting the problem by developing and testing two new EITC case selection models. The IRS is working toward, but has not defined, measurable goals outlining how it will monitor and determine its success in reducing racial disparities that may be inherent in the EITC selection process. As part of their strategy to rebalance enforcement activities, the Taxpayer Services Division developed an action plan to address issues related to refundable credits including the EITC. The action plan includes the implementation of a new scoring model for Processing Year 2024, and testing of two new EITC case selection models, among other planned actions related to refundable tax credits. The IRS plans to review the results of these models for racial disparities using a process applied in academic studies. Their action plan also includes activities related to communication, education, and outreach, as well as increasing return preparer compliance at tax filing. We limited our review to the actions specific to the process and models used to select EITC related returns for examination.

The IRS implemented changes but is still evaluating the EITC selection process

Starting in Processing Year 2024, the IRS implemented a new scoring model to select tax returns claiming the EITC for examination. The new scoring model uses the existing Dependent Database (DDB) process for case selection and largely replaced the old selection model. The DDB was introduced in Processing Year 2001 and uses a sophisticated set of rules and scoring models along with internal and external data to validate taxpayers' entitlement to refunds and credits and identifies taxpayers who claim the EITC in error.

In Calendar Year 2024, the IRS developed two pilot studies to select EITC cases for potential examination and will conduct pilot tests of post-refund audits for these models. Specifically:

- Pilot 1 – A machine learning model designed to compete with the DDB program in selecting EITC returns based on refundable credit eligibility. This is a different process that would replace the existing rules as well as the residency and relationship check, and filters used by the existing models. The machine learning model is expected to better identify EITC compliance issues of all kinds including invalid residency and the relationship status of the dependents. Pilot 1 is expected to start in FY 2025 with results expected about a year later.
- Pilot 2 – A machine learning model designed to select returns for audit related to Schedule C (Form 1040), *Profit or Loss From Business (Sole Proprietorship)*, expenses for returns claiming the EITC or other refundable credits. The pilot started in August 2024 and is limited to correspondence audits for Schedule C expenses on returns claiming the EITC. This pilot is currently in process and is exploring the Stanford Institute for Economic Policy Research finding from their published work paper titled *Measuring and Mitigating*

Racial Disparities in Tax Audits (hereafter referred to as the Stanford study).[9] The study found that an audit strategy focused on audits of more complex returns with potentially larger amounts of total underreported tax would generate higher revenue while reducing disparity. Preliminary results are not expected until June 2025. However, the IRS believes results may show that prioritizing larger Schedule C businesses reduces the share of Black taxpayers in the audit-eligible population.

The IRS should define a racial disparity monitoring process for EITC selected returns

Although the Commissioner has referenced the IRS's commitment to address potential systemic bias including racial bias, the IRS has not fully defined how it will measure its efforts to mitigate racial disparities in the EITC examination selection process. For EITC audits, the IRS plans to wait until all examinations are completed before analyzing results and estimating the racial makeup of audited taxpayers. However, once that information is available, the IRS has not determined how it will use the information to reduce racial disparities. According to IRS management they plan to make appropriate adjustments to their case selection processes based on the results of those tests.

The Stanford study, which was also published as an article in The Quarterly Journal of Economics,[10] reviewed the differences in IRS audit rates between taxpayers whose potential race was inferred as Black and non-Black and found that Black taxpayers were audited three to five times the rate of non-Black taxpayers. The disparity was noted to be primarily among taxpayers claiming the EITC. In January 2023, an IRS cross-functional team found that there were possibilities to improve the model and some evidence that it might produce a lower disparity rate. The team sought to create and improve upon existing models such as recommending the previously mentioned pilot programs. The two pilot programs have a joint goal of improving audit outcomes and reducing racial disparity.

The IRS does not collect data on taxpayer race.[11] Instead, the Research, Applied Analytics and Statistics Division infers potential race by using the Bayesian Improved First Name Surname Geocoding method. This method assigns each taxpayer a probability of belonging to one of each of the six race/ethnicity categories by matching taxpayers' names and addresses to race/ethnicity distributions drawn from public sources. The IRS stated that historically, data limitations such as missing parental Social Security Numbers particularly for Black and Hispanic fathers and Hispanic mothers in third-party data, have made it difficult to determine the eligibility of dependents claimed for EITC. IRS stated that racial differences in the effects of these limitations have likely raised the relative audit rate for Black taxpayers. The IRS worked with the Social Security Administration to backfill missing parental Social Security Numbers and reduced the missing values considerably, particularly for mother's Social Security Numbers. However, according to the IRS, missing data rates remain high for fathers and are still higher for Black and Hispanic fathers than for White fathers claiming EITC with dependents.

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[9] Hadi Elzayn, et al., *Measuring and Mitigating Racial Disparities in Tax Audits*, Stanford Institute for Economic Policy Research (January 30, 2023).

[10] Hadi Elzayn, et al., *Measuring and Mitigating Racial Disparities in Tax Audits*, The Quarterly Journal of Economics (September 26, 2024).

[11] Government Accountability Office, GAO-24-106126, *IRS Audit Selection Processes for Returns Claiming Refundable Credits Could Better Address Equity*, p. 26 (April 2024).

IRS management developed an action plan and acknowledged that they do not have results yet to measure their success in addressing the racial disparities in audit rates identified by the Stanford study and their own research. However, they clarified that they consider the reported disparities from these studies as a quantifiable measure against which the IRS would compare future results. Management added that the IRS's goal is to fairly select taxpayers for audit based solely on the taxpayers' noncompliance risk.

The *Standards for Internal Control in the Federal Government* identifies "monitoring" as one of the five components for internal control.[12] Monitoring provides that management should establish and operate monitoring activities to assess the quality of performance and promptly take corrective actions to achieve objectives. This includes establishing a baseline and incorporating ongoing monitoring that is responsive to change.

The IRS stated that it has performed a preliminary analysis of racial disparities in audits selected using the new scoring model. However, the IRS said that it would be premature to report any findings until most audits have closed. Their proposal is to apply the Bayesian Improved First Name Surname Geocoding to estimate the racial makeup of audited taxpayers once the bulk of the audits have closed. This evaluation will consider both the demographic and the economic outcomes of the new audit selection algorithms in the scoring model. When evaluating the audit outcomes, the IRS considers the dollars assessed, revenue protected, and no change rate. However, there are no set goals for reducing audit disparities by race or any other attribute. In April 2024, the Government Accountability Office (GAO) also found limitations in the IRS's oversight of the Taxpayer Services Division's audit selection systems, and consequently, the IRS's ability to address equity, racial and otherwise, in audit selection.[13]

IRS officials stated they believe that taxpayers with similar levels of noncompliance should face similar audit risk, regardless of their demographic characteristics. However, it is unclear how the IRS will measure the population of taxpayers claiming the EITC to identify noncompliance by race. We believe that the IRS would benefit from defining clear measurable goals to ensure fairness across all taxpayers. Without established measurable goals, the IRS will be unable to evaluate how its efforts have made a difference in reducing disparity issues with selected examinations of taxpayers claiming the EITC.

Recommendation 1: The Chief, Taxpayer Services Division, should define measures and establish monitoring activities to assess its success in mitigating racial disparities related to the EITC examination selection process.

> **Management's Response:** The IRS agreed with this recommendation stating it will adopt a standard annual process for monitoring the demographics of audit selection that is consistent with law and regulation.

[12] Government Accountability Office, GAO-14-704G, *Standards for Internal Control in the Federal Government*, p. 64 (September 2014). The *Standards for Internal Control in the Federal Government* known as the "Green Book" sets the standards for an effective internal control system for federal agencies. Internal control helps an entity run its operations efficiently and effectively, report reliable information about its operations, and comply with applicable laws and regulations.

[13] GAO, GAO-24-106126, *IRS Audit Selection Processes for Returns Claiming Refundable Credits Could Better Address Equity*, p. 26 (April 2024).

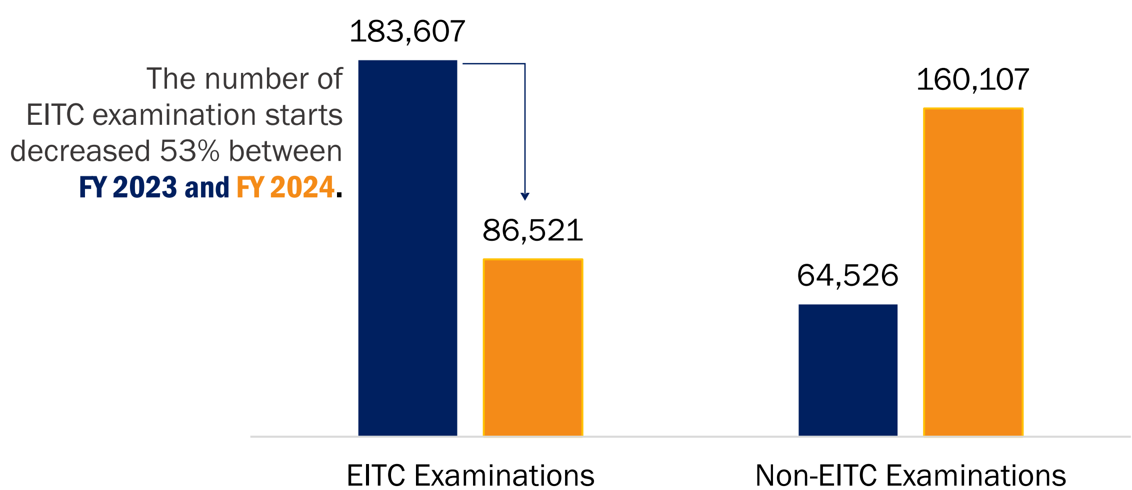
In Fiscal Year 2024, the IRS Significantly Decreased Earned Income Tax Credit Audits; However, the Planned Examinations Did Not Align With the Taxpayer Services Division's Internal Monitoring Report

The IRS continued to address racial disparities in the EITC case examination process by rebalancing enforcement activities. Specifically, the Taxpayer Services Division decreased the number of EITC examinations and shifted their workload and resources to non-EITC workstreams. Additionally, we found the division's planned starts in their revised FY 2024 internal monitoring report did not align for some workstreams with the planned starts included in the FY 2024 Examination Plan.

In FY 2024 the IRS significantly decreased EITC audits

The Taxpayer Services Division reduced actual EITC examination starts by 53 percent from FY 2023 to FY 2024. As shown in Figure 1, in FY 2023, the majority of the actual examination starts were EITC workstreams. However, by FY 2024, the majority were non-EITC workstreams. While this review did not assess whether the IRS satisfied the 2022 Treasury Directive for Tax Year 2023 tax returns, by significantly decreasing EITC examinations the IRS increased the likelihood of achieving the goal to audit fewer tax returns of taxpayers with income under $400,000.[14]

Figure 1: Taxpayer Services Division EITC and Non-EITC Examination Starts for FYs 2023 and 2024



Source: Analysis of the RCEO FY 2023 Rollup Exam Planned Starts Compared to Actual September, and EITC/Non-EITC Starts through Quarter 4.

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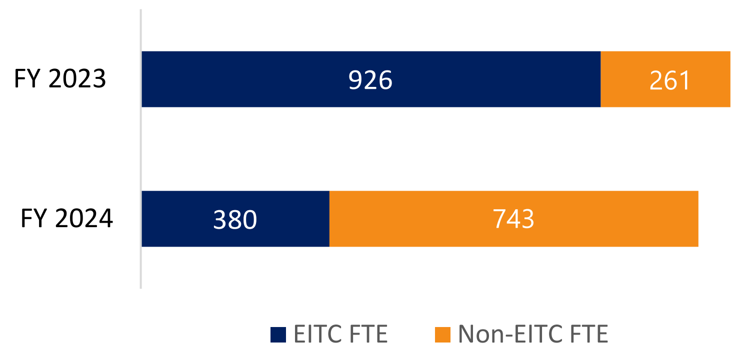
[14] As discussed in a 2024 TIGTA audit, the IRS is using Tax Year 2018 as a base year for comparison purposes to assess the percentage of individual taxpayers with incomes below $400,000 who were audited by dividing that number by the total number of tax returns with individual taxpayers reporting incomes of less than $400,000. TIGTA, Report No. 2024-308-043, *The IRS Has Made Limited Progress Developing the Methodology to Comply With the Treasury Directive to Not Increase the Audit Rate for Taxpayers With Incomes Below $400,000 Due to Planning and Implementation Challenges* (August 2024).

As previously mentioned, the IRS changed its annual examination planning process to an enterprise based approach beginning with FY 2024. Part of these efforts include monitoring EITC planned and actual examination starts across all BODs. In the IRS's FY 2024 Examination Plan, monitoring of planned EITC examinations expanded from the Taxpayer Services Division to include the Small Business/Self-Employed (SB/SE) and Large Business and International (LB&I) Divisions.[15] Prior to FY 2024, the SB/SE and LB&I Divisions did not separately monitor EITC starts or completions in their respective BOD plans. The majority of collective planned EITC examinations across these three divisions fall under the Taxpayer Services Division.

The number of employees assigned to conduct EITC examinations shows a similar trend. In Figure 2, planned full-time equivalents (FTE) decreased by 59 percent in FY 2024 when compared to FY 2023. There was also a 185 percent increase in planned FTEs assigned to non-EITC related work for the same period.

Figure 2: Taxpayer Services Division Resource Allocations for Planned Examination Starts During FYs 2023 and 2024



The IRS staffing plan reflects a shift in prioritizing employees on non-EITC examinations.

Source: Analysis of the Taxpayer Services Division's assumptions for its FY 2023 Workplan and its FY 2023 Workplan, and the FY 2024 Examination Plan.

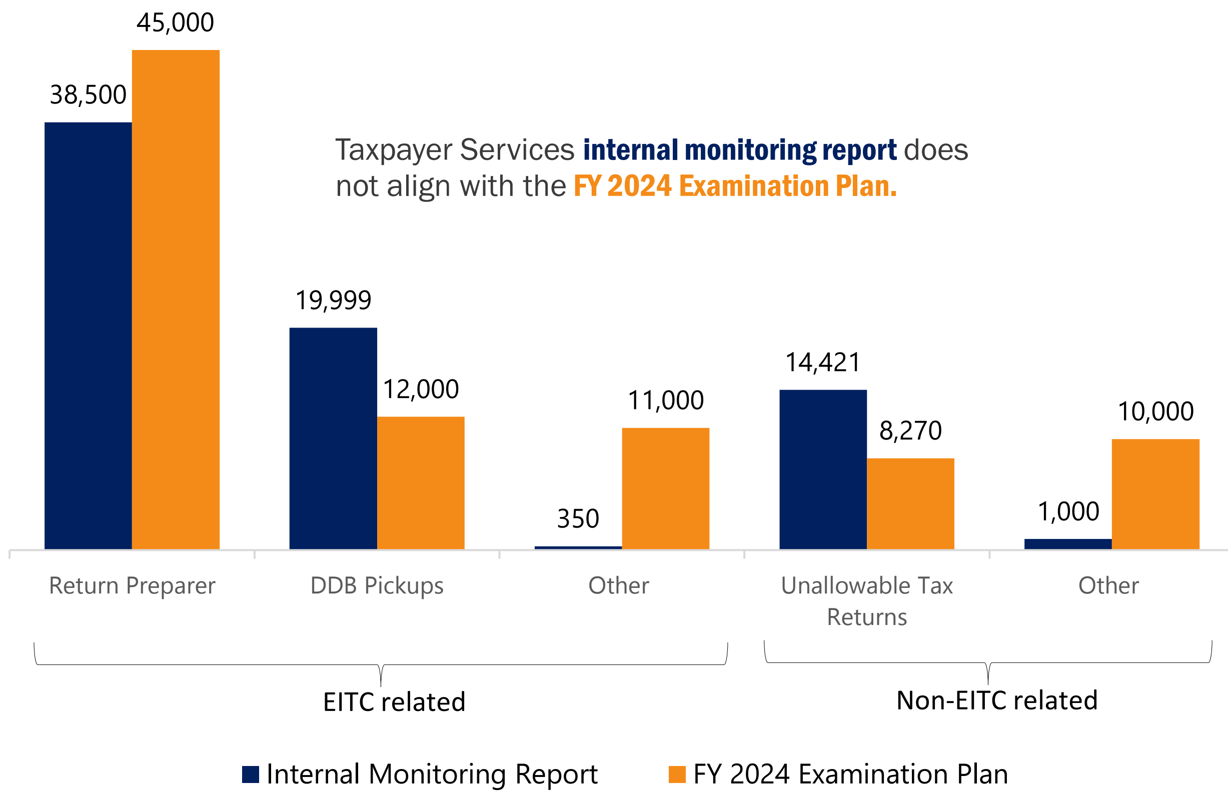
RCEO staff performing EITC audits do not dedicate 100 percent of their time to EITC-related audits and may also work on non-EITC audits, programs, and support activities. Additionally, in FY 2024, the planned RCEO FTEs allocated to EITC type audits represented approximately 34 percent of FTEs, decreasing significantly compared to an allocation of 78 percent of FTEs in FY 2023. Conversely, FTEs allocated to non-EITC audits increased from 22 percent of FTEs in FY 2023 to 66 percent in FY 2024.

The Taxpayer Services Division's internal monitoring report did not align with the FY 2024 Examination Plan

The Taxpayer Services Division's planned examination starts listed by workstream in their internal monitoring report as of February 2024 for FY 2024 did not align with those in the IRS's November 2023, FY 2024 Examination Plan. New examination starts are monitored to ensure that they do not exceed the number of planned starts listed in the FY 2024 Examination Plan. Figure 3 highlights the planned starts for only those workstreams with differences between the internal monitoring report and the FY 2024 Examination Plan.

[15] Withholding Exchange and International Individual Compliance works EITC examinations where the taxpayer resides in a U.S. Territory.

Figure 3: Workstreams Where the Planned Examination Starts Did Not Align for FY 2024



Source: Analysis of the Taxpayer Services RCEO FY 2024 Rollup Exam Planned Starts Compared FY 2023 To Actual February 2024 report and the FY 2024 Examination Plan (dated November 2023).

As previously noted, the "monitoring" component of the *Standards for Internal Control in the Federal Government* provides that management should establish and operate monitoring activities to assess the quality of performance and promptly take corrective actions to achieve objectives. Therefore, planned examination starts associated with the Taxpayer Services Division's segment of an enterprise plan should parallel the same examination starts included in their own division's internal monitoring reports.

In April 2024, Taxpayer Services Division management agreed that the planned starts for some FY 2024 workstreams in their internal monitoring report as of February 2024 did not completely align with those listed in the IRS's November 2023, FY 2024 Draft Examination Plan as reflected in Figure 3. However, we found that the total planned examination starts across all workstreams, approximately 251,000, was consistent in both reports. In response, the IRS stated that there may be minor discrepancies between the two documents after corrections were made. The Taxpayer Services Division's internal plan does not traditionally change during the fiscal year. Selections may be adjusted based on the cases available, but when selections are adjusted, the IRS substitutes within the available workstreams.

In August 2024, the IRS provided a revised FY 2024 Examination Plan with updates through the end of May 2024. However, the IRS did not officially finalize their FY 2024 Examination Plan and does not consider any FY 2024 plan as a final version. Subsequently, in November 2024, IRS management confirmed the number of planned examination starts as of the end of FY 2024. Additionally, IRS management informed us that these revisions were never memorialized in a reissued enterprise level FY 2024 Examination Plan.

We believe that any revisions to planned examination starts made at either the BOD or enterprise level must be communicated and monitored so that the planned examination starts contained in either report are aligned. Given the importance of monitoring EITC disparity issues, it is especially important when measuring results by workstream that there is consistency between the planned examination starts listed in the Taxpayer Services Division's internal monitoring report and the FY 2024 Examination Plan to avoid reporting different outcomes when measuring results against planned targets.

Recommendation 2: The Chief, Taxpayer Services Division, should establish a monitoring process between the division and the enterprise level to ensure that revisions to "planned examination starts" at either level are communicated and aligned so that there is consistency when measuring actual results at both the division and enterprise levels.

> **Management's Response:** The IRS agreed with this recommendation stating that it will establish a change log to provide real-time updates and document all changes made at both the division and enterprise levels.

The IRS Has Started to Monitor Compliance With the 2022 Treasury Directive, but Has Not Finalized Its Methodology to Establish Baseline Audit Rates

The IRS has started to monitor compliance with the 2022 Treasury Directive. The IRS developed a draft template to monitor completed examinations by tax year against a comparative baseline measure, but the report has not been finalized.

The GAO's *Standards for Internal Control in the Federal Government* provides "control activities" as one of the five components for internal control.[16] Control activities require management to design control activities to achieve objectives and respond to risks. This includes creating a monitoring process to measure the IRS's success meeting the 2022 Treasury Directive that directs the IRS not to use any additional resources to increase audits on small businesses or households earning $400,000 per year or less.

To determine how the IRS will monitor the audit rates, we obtained and reviewed a draft monitoring report template and an agency-wide quarterly report. The IRS stated that there are two different monitoring reports. The first report monitors the 2022 Treasury Directive (to not increase audit rates for households with income under $400,000) by tax year. The second report monitors EITC and non-EITC income driven examinations by fiscal year included in the FY 2024 Examination Plan.

In August 2024, we reported that the IRS had not finalized its methodology for the audit coverage calculation required to assess its compliance with the 2022 Treasury Directive.[17] Subsequently, the IRS shared a draft of their tax-year based monitoring report to assess its compliance with the 2022 Treasury Directive which included all open and closed Tax Year 2023

[16] GAO, GAO-14-704G, *Standards for Internal Control in the Federal Government*, p. 44 (September 2014).

[17] TIGTA, Report No. 2024-308-043, *The IRS Has Made Limited Progress Developing the Methodology to Comply With the Treasury Directive to Not Increase the Audit Rate for Taxpayers With Incomes Below $400,000 Due to Planning and Implementation Challenges* (August 2024).

examinations as of the end of FY 2024. However, the IRS clarified that this report is considered a draft, because the methodology to calculate the audit coverage is still not finalized.

While the IRS works to complete the methodology to establish baseline audit rates, as recommended by our August 2024 report, it is equally important that the IRS also establish its monitoring process to include the frequency and method by which actions will be taken to address issues. According to Taxpayer Services Division management, almost all of its examinations fall under $400,000. Therefore, it is important to develop a monitoring tool at the agencywide level that can be communicated to the BOD to avoid exceeding the baseline once it is established. If these processes are not in place, the IRS risks potential delays with implementing actions that may impact multiple business units and the potential to exceed the established 2022 Treasury Directive threshold.

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this audit was to assess changes to the EITC examination strategy relating to both the 2022 Treasury Directive and the fair and equitable selection of EITC returns for examination. To accomplish our objective, we:

- Determined the Taxpayer Services Division's processes and procedures to update the IRS's overall FY 2024 Examination Plan.
- Reviewed the Taxpayer Services Division's planned examination starts to determine compliance with not increasing audits of households with TPI of $400,000 or less.
- Assessed the IRS's processes and procedures for selecting EITC returns for examination by reviewing the Internal Revenue Manual and programming guides, and interviewing IRS management.

Performance of This Review

This review was performed with information obtained from the Taxpayer Services Division located in Atlanta, Georgia, the SB/SE Division located in Lanham, Maryland, and the LB&I Division's Withholding Exchange and International Individual Compliance function located in Atlanta, Georgia, during the period January 2024 through February 2025. 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.

Data Validation Methodology

We performed tests to assess the reliability of information included in the following IRS prepared examination plan and monitoring reports for FY 2023 and FY 2024:

- RCEO FY 2023 Rollup Exam Planned Starts Compared to Actual September.
- RCEO FY 2024 Rollup Exam Planned Starts Compared FY 2023 To Actual February 2024.
- EITC/Non-EITC Starts through Quarter 4.
- Taxpayer Services Division FY 2023 Workplan.
- FY 2024 Examination Plan.

These reports were prepared at the division and enterprise levels. We relied on IRS assumption documents that estimated resources for their FY 2023 and FY 2024 planning efforts. We evaluated the data by analyzing required data elements for missing data, outliers, or obvious errors, reviewing existing information about the data and the system that produced them, and interviewing agency officials knowledgeable about the data. We determined that the data were sufficiently reliable for purposes of this report.

Internal Controls Methodology

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined that the following internal controls were relevant to our audit objective: the IRS's policies, procedures, and practices related to the selection of EITC returns for examination by the Taxpayer Services, SB/SE, and LB&I Divisions. We evaluated these controls by reviewing reports to evaluate any significant trends. We also interviewed IRS management and reviewed relevant sections of the Internal Revenue Manual and internal and external studies pertaining to EITC case selection.

Appendix II

The 2022 Treasury Directive

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

August 10, 2022

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

Dear Commissioner:

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

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

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

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

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

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

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

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

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

Sincerely,

Janet L. Yellen

Janet L. Yellen

Appendix III

Management's Response to the Draft Report

CHIEF
TAXPAYER SERVICES

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

April 14, 2025

MEMORANDUM FOR DANNY VERNEUILLE
ACTING DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Kenneth C. Corbin
Chief, Taxpayer Services Division

Digitally signed by Kenneth C. Corbin
Date: 2025.04.14 12:40:18 -04'00'

SUBJECT: Draft Audit Report – The IRS Reduced Earned Income Tax Credit Examinations in Fiscal Year 2024, but the Process to Mitigate Racial Disparity Needs to be Defined (Audit No.: 2024308026)

Thank you for acknowledging our work and the opportunity to review and provide comments on the draft report. The report cites academic research that states IRS audit processes may have unintentionally resulted in differences in audit selection rates by demographics. The IRS mission seeks to provide America's taxpayers top-quality service by helping them understand and meet their tax responsibilities and enforce the law with integrity and fairness to all. Taxpayer demographics are not considered in our case selection and audit processes.

As outlined in our letter to the Senate Committee on Finance, dated September 18, 2023, the IRS has already taken significant steps to address some of these observations. Starting in fiscal year 2024, as directed by the Department of the Treasury, we substantially reduced the number of correspondence audits focused specifically on certain refundable tax credits, including the Earned Income Tax Credit (EITC), the American Opportunity Tax Credit, the Health Insurance Premium Tax Credit and the Additional Child Tax Credit. We are also increasing our efforts to address unscrupulous preparers who are leading their customers to underreport income or overclaim credits and deductions. We created a team of subject matter experts from across the IRS to study and address the issues reported in the external research study. We are also assessing how recent Executive Orders may influence this work.

We follow data science best practices to evaluate enforcement model performance across the IRS, in terms of fairness, transparency, and replicability. We are testing new case selection models, including one initially developed and tested between 2020 and

2022. A full evaluation of this model will be completed in fiscal year 2025. We continuously evaluate our case selection processes, data quality, and testing of new approaches to improve overall results.

It is crucially important to understand that patterns of taxpayer noncompliance evolve dynamically over time. The problem of emerging forms of noncompliance, and the potential for changes in the demographics of noncompliance, pose significant challenges for bias detection and mitigation. Given those challenges, it follows that fixed demographic benchmarks for audit selection rates are not appropriate.

We are taking additional steps to reduce noncompliance and increase payment accuracy in two key ways: first, by helping taxpayers prepare accurate returns through improved service, outreach and education, and other tools; and second, by increasing our enforcement activities directed toward unscrupulous return preparers and other bad actors. We anticipate it will take several months after the end of the filing season to determine the effect of these changes, but we are committed to monitoring results, sharing our findings, and making additional improvements. It is important to note, there is no 'end state' to this work. We must remain vigilant in our efforts to ensure fairness in the tax system, to continue to test new models and address emerging areas of non-compliance. There is no metric that would describe a state of completeness for this work.

The introduction of the Enterprise-Wide Examination Plan (Examination Plan) in fiscal year 2024 marked a shift in monitoring practices for IRS audit activities and was intended to be a high-level view of inventory across all the compliance functions of IRS. For the Taxpayer Services Division, the Examination Plan represented its inventory into the broad categories of EITC, Non-EITC, Income-Driven Credits, and Non-Income Driven Credits. There were some limited category breakdowns in those broader categories in the Examination Plan. One objective of the Examination Plan was to allow IRS management to monitor commitments such as the Treasury commitment not to increase audits of Americans making less than $400,000. The internal monitoring report[1] referenced in the report contains more line items than the Examination Plan to give division management the ability to break down the inventory into more specific project types. This enables managers to address emerging areas of non-compliance and redeploy resources accordingly.

The Taxpayer Services Division monitors real-time progress using data that is pulled weekly. The data is then analyzed, and adjustments to case selections are made on a weekly basis. For this reason, there will always be variations between these operational level reports and the enterprise level plan. These variations are necessary to enable the most efficient use of resources and to adjust to emerging issues, but the Examination Plan numbers were unaltered, and the overall objective represented by the top line goal

[1] Report name: RCEO FY 24 Rollup Exam Planned Starts Compared to Actual February.

Attachment

Recommendations

RECOMMENDATION 1
The Chief, Taxpayer Services Division, should define measures and establish monitoring activities to assess its success in mitigating racial disparities related to the EITC examination selection process.

CORRECTIVE ACTION
We agree with this recommendation in principle, and we will adopt a standard annual process for monitoring the demographics of audit selection that is consistent with law and regulation.

IMPLEMENTATION DATE
October 15, 2025

RESPONSIBLE OFFICIAL
Director, Refundable Credits Program Management, Return Integrity and Compliance Services, Taxpayer Services Division

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

RECOMMENDATION 2
The Chief, Taxpayer Services Division, should establish a monitoring process between the division and the enterprise level to ensure that revisions to "planned examination starts" at either level are communicated and aligned so that there is consistency when measuring actual results at both the division and enterprise levels.

CORRECTIVE ACTION
We agree with the recommendation. We will establish a change log to provide real-time updates and document all changes made at both the division and enterprise levels.

IMPLEMENTATION DATE
October 15, 2025

RESPONSIBLE OFFICIAL
Director, Refundable Credits Program Management, Return Integrity and Compliance Services, Taxpayer Services Division

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

Appendix IV

Glossary of Terms

Term	Definition
Business Operating Division	A title for major IRS organizations such as the Independent Office of Appeals, Taxpayer Services, Office of Professional Responsibility, and Information Technology.
Dependent Database	A risk-based audit selection tool used to identify tax returns for audit. This tool includes information databases with birth certificate information and court documents used to establish a relationship and residency between a taxpayer and the qualifying children claimed on a tax return.
Earned Income Tax Credit	A refundable tax credit for low-income to moderate-income workers.
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.
Full-Time Equivalent	A measure of labor hours in which one full-time equivalent is equal to eight hours multiplied by the number of compensable days in a particular fiscal year.
Internal Revenue Manual	The primary, official source of IRS "instructions to staff" related to the organization, administration, and operation of the IRS.
Processing Year	The calendar year in which the IRS processes a tax return or document.
Standards for Internal Control in the Federal Government	Sets the standards for an effective internal control system for federal agencies and provides the overall framework for designing, implementing, and operating an effective internal control system. An entity uses these standards to help achieve its objectives related to operations, reporting, and compliance.
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

BOD	Business Operating Division
DDB	Dependent Database
EITC	Earned Income Tax Credit
FTE	Full-Time Equivalent
FY	Fiscal Year
GAO	Government Accountability Office
IRS	Internal Revenue Service
LB&I	Large Business and International Division
RCEO	Refundable Credits Examination Operations
SB/SE	Small Business/Self-Employed Division
TIGTA	Treasury Inspector General for Tax Administration
TPI	Total Positive Income

To report fraud, waste, or abuse,
contact our hotline on the web
at https://www.tigta.gov/reportcrime-misconduct.

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

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