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Report to the Chairman, Subcommittee on Oversight, Committee on Ways and Means, House of Representatives

April 2001

IRS AUDIT RATES

Rate for Individual Taxpayers Has Declined But Effect on Compliance Is Unknown

GAO

Accountability * Integrity * Reliability

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United States General Accounting Office
Washington, DC 20548

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The Honorable Amo Houghton
Chairman, Subcommittee on Oversight
Committee on Ways and Means
House of Representatives

Every year, the Internal Revenue Service (IRS) performs a variety of compliance checks to ensure the accuracy of information reported by taxpayers on their tax returns. These checks include verifying computations on returns, matching information reported by third parties to income reported by taxpayers on returns, and requesting more information about items on a tax return. Some of the checks were performed on virtually every one of the approximately 125 million returns filed in 1999; others were performed on a small subset of returns. IRS classified about 620,000 of these compliance checks as audits, which range from contacts with taxpayers that are simple enough to be audited through the mail to face-to-face contacts over items that are too complex to be audited through correspondence.[1]

In recent years, the audit rate—the proportion of tax returns that IRS audits each year—has drawn attention. The attention is due to a long-term decline in audit rates and the difference in audit rates for lower and higher income individuals. The decline in audit rates has raised concerns about whether this could lead to a decline in taxpayers accurately reporting their tax liabilities (i.e., their voluntary compliance). The 1999 audit rate for lower income taxpayers has raised concerns about whether taxpayers are being selected for audits in an equitable manner.

Because of the attention over audit rates, you asked us to (1) describe the changes in audit rates for individual income tax returns overall and for categories, such as major sources (i.e., nonbusiness versus business)[2] and levels of income for fiscal years 1996 through 2000; (2) obtain IRS' reasons

[1]Under Internal Revenue Code Section 7602, IRS can examine the taxpayer's books and records and solicit testimony from the taxpayer and relevant parties regarding the accuracy of a tax return.

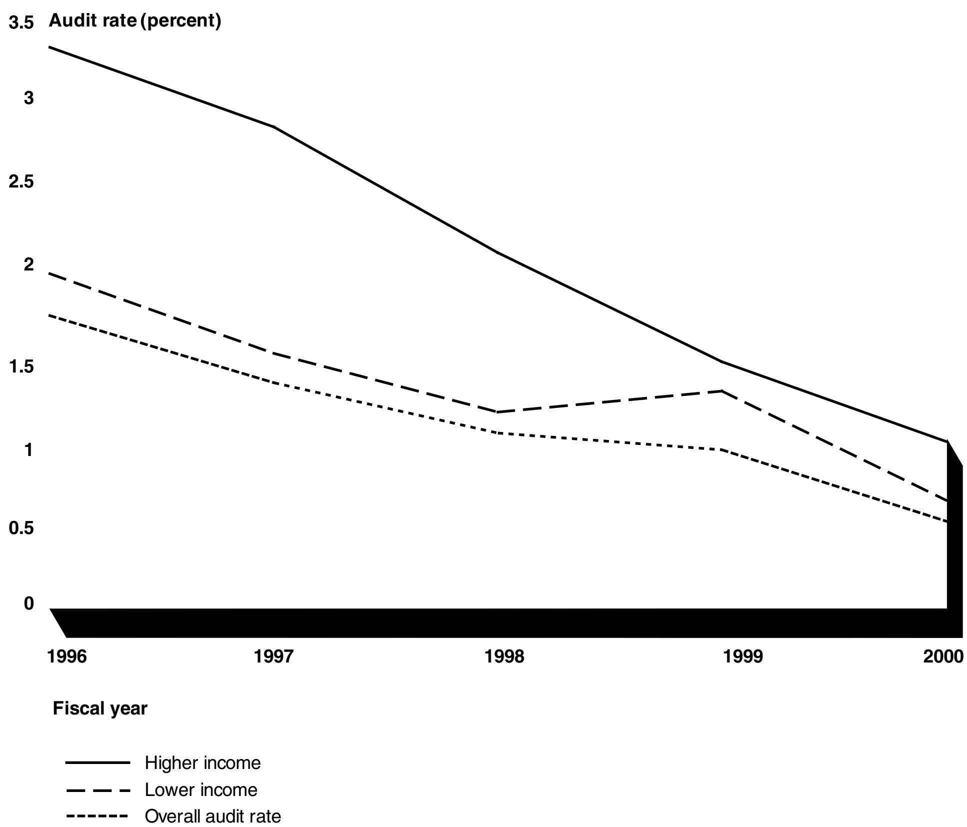
[2]Nonbusiness sources include wages, dividends, and interest. Business sources include self-employment income, such as income reported by individual sole proprietors on a schedule C, which is used to compute profit or loss.

and related data explaining the changes in the audit rates; and (3) describe what is known about the effects of changes in the audit rates on tax compliance.

Results in Brief

Comparing fiscal years 1996 and 2000, the overall income tax audit rate of individuals declined about 70 percent—from 1.67 percent to 0.49 percent as shown in figure 1. Rates declined regardless of the individual taxpayer's income level.

Figure 1: Audit Rates for Lower Income and Higher Income Individuals



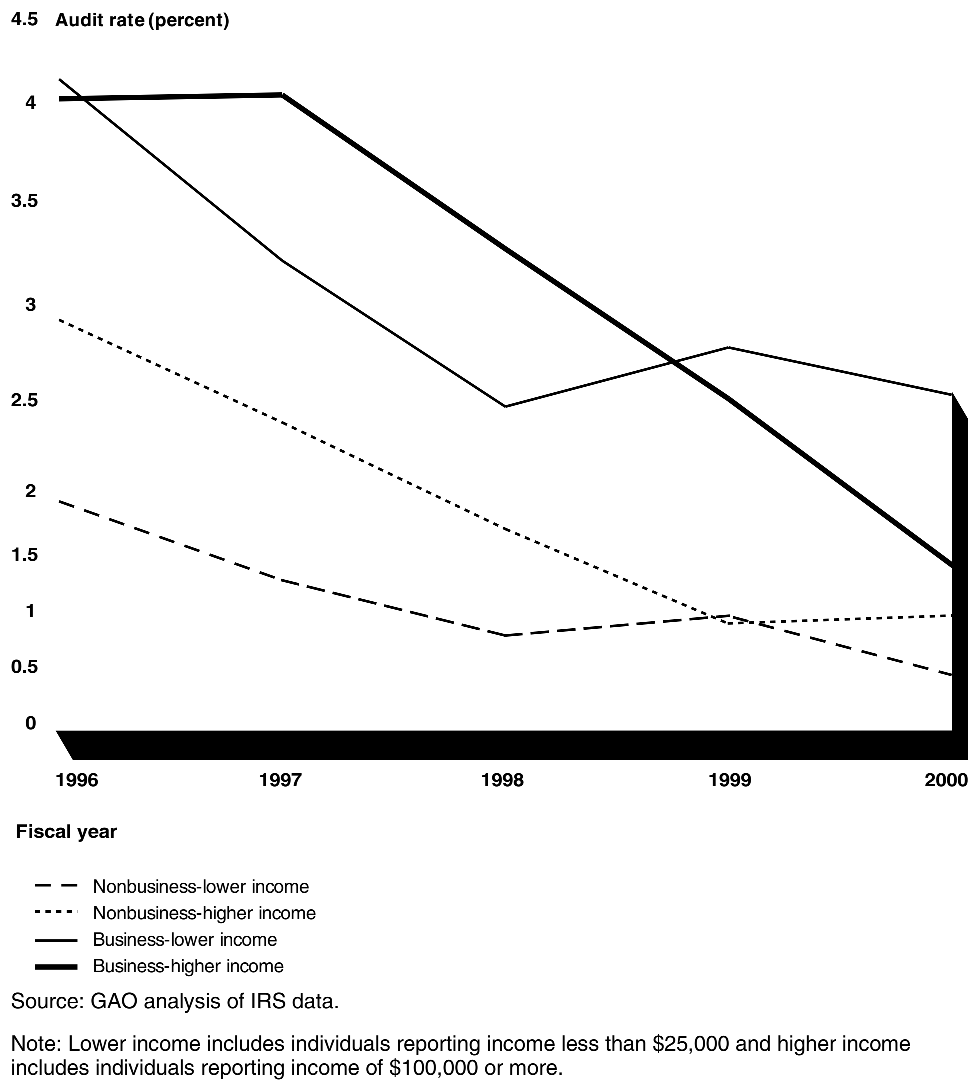
Note 1: Lower income includes individuals reporting income less than $25,000 and higher income includes individuals reporting income of $100,000 or more.

Note 2: The overall audit rate falls below the other two lines because it also includes audits of other individuals, such as those reporting moderate income on their tax returns.

Source: GAO analysis of IRS data.

In any given year, figure 1 also shows a greater audit rate for higher income individuals than for lower income individuals. When the higher and lower income groups are divided by major source of income, as shown in figure 2, some exceptions to this pattern are apparent. For individuals relying on nonbusiness income, those with lower incomes were audited at a greater rate in fiscal year 1999 than those with higher incomes. For individuals relying on business income, those with lower incomes were audited at a greater rate in fiscal years 1996, 1999, and 2000.

Figure 2: Audit Rates for Lower Income and Higher Income Nonbusiness and Business Returns



Source: GAO analysis of IRS data.

Note: Lower income includes individuals reporting income less than $25,000 and higher income includes individuals reporting income of $100,000 or more.

Comparing the type of audits and the income level of the audited individuals, most audits were correspondence audits and most lower income individuals were audited through correspondence. Most audited higher income individuals were audited through face-to-face audits.

According to IRS officials, audit rates declined for fiscal years 1996 to 2000 for three main reasons. First, over this period, the number of IRS auditors for individual returns declined by more than half for reasons such as a decline in total staff and decisions to change staffing priorities to better serve taxpayers before they file their returns. Second, IRS was more likely to use the remaining auditors in other duties, such as assisting taxpayers. Third, audits took longer due to additional audit requirements, such as more written communications with taxpayers about the status of their audit. To explain the changes in the audit rates by income levels, IRS officials cited increases in the number of high-income tax returns and an audit focus on noncompliance by earned income credit (EIC) claimants, who are usually lower income individuals. IRS' raw data were generally consistent with IRS' reasons. We could not establish the relative influence of each reason on the changes in the audit rate.

The specific effect of the recent decline in the audit rate on the level of voluntary compliance is not known for several reasons. First, IRS does not have current reliable information on levels of voluntary compliance. Even with this information, IRS would still need to take a number of steps to try to determine the specific link between compliance and audit rates. Second, because nonaudit and audit programs are designed to ensure tax compliance, it is possible that expansion of IRS' nonaudit compliance programs could compensate to some degree for declining audit rates. Third, improvements in assisting and educating taxpayers about their tax obligations could similarly compensate to some degree for declining audit rates. Because IRS does not have reliable, updated information on voluntary compliance, we do not know the net effects on tax compliance of the declining audit rates, changes in the volume of nonaudit checks, and any improvements in IRS' educational efforts.

Background

Annually, IRS audits some tax returns to determine whether taxpayers complied with the tax laws. IRS attempts to select returns for audit that have an indication of potential noncompliance based on, for example, its formula for flagging suspicious returns. IRS believes that a credible threat of being audited deters some noncompliance. IRS audits check compliance in reporting income, deductions, and other return items as well as in paying the correct tax liability. To conduct these compliance checks, IRS auditors ask taxpayers for documentation about specific items on their returns.

IRS conducts two types of audits, face-to-face and correspondence, using three classes of auditors—revenue agents, tax auditors, and tax examiners. Face-to-face audits can be either (1) field audits, in which an IRS revenue agent visits an individual who has business income or a complex return, or (2) office audits, in which an individual who has a less complex return visits a tax auditor at an IRS office. Correspondence audits, as the name suggests, are done by tax examiners who correspond with taxpayers through the mail. Correspondence audits usually involve one line item on a return. Because correspondence audits involve fewer and usually simpler tax return items, they are less likely to burden taxpayers in terms of time, contacts with IRS, and documentation provided to IRS.

IRS also checks compliance and contacts individual taxpayers through nonaudit enforcement programs. For example, IRS' math error program checks returns for math and consistency errors and contacts taxpayers if such errors are found. IRS' underreporter program matches the income reported on tax returns with the information returns (e.g., W-2 forms) filed by third parties, such as employers who pay wage income. If discrepancies are found, then taxpayers are mailed a notice. Although such contacts can be similar to correspondence audit contacts, IRS does not define them as audit contacts.[3] Over the years, IRS has shifted contacts between the audit and nonaudit categories. For example, in fiscal 1997, IRS shifted over 700,000 cases involving missing or invalid social security numbers on tax returns from the correspondence audit program to the math error program. Changes in the definition of an audit could contribute to decreases or increases in the audit rate.

Scope and Methodology

To describe changes in audit rates for individuals (as opposed to partnership or corporate taxpayers), we used IRS' method for computing audit rates. For all taxpayers and by taxpayer categories, the audit rate equals the proportion of IRS audits closed in a fiscal year compared to returns filed in the previous calendar year. We used data from IRS' Databook, Audit Information Management System, and Statistics of

[3]See *Tax Administration: IRS' Use of Nonaudit Contacts* (GAO/GGD-00-7, Mar. 16, 2000) for further discussion of nonaudit contacts and their relationship to audit contacts.

Income about individual income tax returns filed in calendar years 1995 through 1999 and audits of the returns that closed in fiscal years 1996 through 2000. This allowed us to describe the changes and update the audit rate trends in earlier reports.[4]

We also described audit rates by various categories. One category was the income reported on individual income tax returns, which IRS divides into broad groups. Under IRS' grouping, lower income individuals report income under $25,000 and higher income individuals report $100,000 or more of income on their tax returns. Other categories included the types of IRS audit, IRS office locations, and the major income sources. Nonbusiness sources include individuals who generated most of their income from sources such as wages, dividends, and interest. Business sources include individuals who generated most of their income from self-employment and reported that income on a schedule C (nonfarm income) or schedule F (farm income). For comparisons of lower and higher income by source of income, we excluded schedule F income because IRS' data only split schedule F income into groups under and over $100,000. We did include Schedule F taxpayers in the overall audit rate.

We interviewed officials from IRS' Examination Division and the Brookhaven Service Center to discuss IRS' reasons for changes in the audit rates from fiscal years 1996 through 2000. We also obtained available IRS data related to the reasons given by IRS officials. For example, we obtained IRS data on changes in the number of auditors and number of hours spent doing audits. We checked for inconsistencies between the raw data and the reasons that IRS officials gave us. However, due to time constraints, we did not do any more detailed analyses to determine the extent to which IRS' reasons explained the changes in audit rates. Nor did we attempt to identify reasons beyond those offered by IRS.

To describe what is known about the potential effects of changes in the audit rates on tax compliance, we used our previous and ongoing work on IRS audits, other IRS enforcement programs, and tax compliance. We also used information from our discussions with IRS officials.

[4]See *Tax Administration: Audit Trends and Results for Individual Taxpayers* (GAO/GGD-96-91, Apr. 26, 1996), which discussed audit rates for individuals during fiscal years 1988-95. We issued a report (*Tax Administration: IRS' Audit and Criminal Enforcement Rates for Individual Taxpayers Across the Country,* GAO/GGD-99-19, Dec. 23, 1998) on geographic audit rates. Appendix III updates such audit rates for fiscal years 1996-99.

We did our work at IRS' national office in Washington, D.C., between September 2000 and March 2001 in accordance with generally accepted government auditing standards.

We requested comments on a draft of this report from the Commissioner of Internal Revenue. We received written comments from the Commissioner in a letter dated April 19, 2001. The comments are reprinted in appendix IV and discussed at the end of this letter.

Individual Audit Rates Have Been Declining Overall and Across Various Categories

From fiscal years 1996 through 2000, the overall income tax audit rate of individuals declined. As table 1 shows, IRS' annual audit rates for individuals declined from 1.67 percent to 0.49 percent—about 70 percent. The table also shows that the audit rates fell for all major sources of income—nonbusiness as well as schedule C and schedule F business returns—over the 5 years.

Table 1: Audit Rates for Individuals

Returns and audits in thousands

Individual taxpayers	1996	1997	1998	1999	2000	Percent change
Individual income tax returns	116,059.7	118,362.6	120,342.4	122,546.9	124,887.1	8
Individual audits	1,941.6	1,519.2	1,192.8	1,100.3	617.8	-68
Audit rates (percent)	1.67	1.28	0.99	0.90	0.49	-70
Nonbusiness	1.54	1.15	0.88	0.82	0.42	-73
Schedule C	3.60	3.15	2.35	2.03	1.55	-57
Schedule F	2.29	1.82	1.21	0.90	0.54	-77

Source: GAO analysis of IRS data.

Table 1 also shows that the audit rate patterns for each year changed little from fiscal years 1996 to 2000. Schedule C business returns were more than twice as likely to be audited than the nonbusiness returns in each year.

Table 2 shows that audit rates declined about equally—67 percent and 70 percent, respectively—for lower and higher income individuals. When taxpayers are separated into nonbusiness and business income groups, audit rates declined at least 42 percent from fiscal years 1996 to 2000 for lower and higher income individuals in the two groups.

Table 2: Audit Rates for Individual Taxpayers by Primary Income Source and Income Level

Primary income source and income level[a]	1996	1997	1998	1999	2000	Percent change
Nonbusiness and schedule C business incomes						
Lower income	1.91%	1.46%	1.12%	1.24%	0.63%	-67
Higher income	3.19	2.74	2.03	1.40	0.96	-70
Nonbusiness income						
Lower income	1.82	1.39	1.06	1.18	0.55	-70
Higher income	2.85	2.27	1.66	1.14	0.84	-70
Schedule C business income						
Lower income	4.21	3.19	2.37	2.69	2.43	-42
Higher income	4.09	4.13	3.25	2.40	1.48	-64

Note: See table 12 for an explanation of how audit rates were calculated for fiscal year 1999.

[a]Lower income includes individuals reporting income less than $25,000 and higher income includes individuals reporting income of $100,000 or more.

Source: GAO analysis of IRS data.

Table 2 also shows that higher income individuals were more likely to be audited than lower income individuals in each of the 5 years. However, exceptions to this pattern emerged when these audit rates by income level were analyzed by source of income. First, in the nonbusiness group, IRS was more likely to audit lower income individuals only in fiscal year 1999. Second, in the business group (schedule C), the rates fluctuated by income levels. IRS was more likely to audit lower income individuals in fiscal year 1996, higher income individuals in fiscal years 1997 and 1998, and lower income individuals in fiscal years 1999 and 2000.

Most audits of lower income individuals were correspondence audits, with the proportion of audits of lower income individuals that were correspondence audits ranging from 69 to 84 percent over the 5 years. Audits of higher income individuals were mostly face-to-face audits, ranging from 62 to 75 percent over the 5 years. (See table 13 in app. I for details.)

Correspondence and face-to-face audit rates also varied by taxpayer income. For example, in fiscal year 2000, the face-to-face audit rate (face-to-face audits divided by all returns filed) for higher income individuals was 0.60 percent compared with 0.13 percent for lower income individuals. For correspondence audits in fiscal year 2000, the audit rate for higher income individuals was 0.37 percent and for lower income individuals was 0.50 percent. (See table 14 in app. I for details.)

Table 3 shows that both types of face-to-face audits (field and office) and correspondence audits declined by similar rates from 1996 to 2000. Table 3 also shows that correspondence/tax examiner audits accounted for over half of all audits in each year (ranging from 54 percent to 67 percent) and that the number of audits declined each year for all types of audits/auditors except for correspondence audits in fiscal year 1999.

Table 3: Individual Returns Audited by Type of Audit and Auditor

	Individual returns audited					
Audit/auditor type	**1996**	**1997**	**1998**	**1999**	**2000**	**Percent change**
Field/revenue agents	252,430	209,781	168,054	124,518	91,586	-64
Office/tax auditors	509,420	505,834	383,366	235,625	145,975	-71
Correspondence/tax examiners	1,179,696	803,628	641,360	740,130	380,204	-68
Total	**1,941,546**	**1,519,243**	**1,192,780**	**1,100,273**	**617,765**	**-68**

Note: With very few exceptions, revenue agents do field audits, tax auditors do office audits, and tax examiners do correspondence audits. Tax examiner totals for fiscal years 1998, 1999, and 2000 also include service center totals from IRS' data.

Source: GAO analysis of IRS data.

The declines in audit rates were spread uniformly across IRS' four regions. However, audit rates varied by region. The audit rates declined about 50 percent in each of IRS' four regional offices from fiscal years 1996 to 1999.[5] For each of these 4 years, the range of audit rates was highest in the Western Region (1.09 to 0.47 percent) compared to the Northeast Region (0.44 to 0.23 percent), the Southeast Region (0.58 to 0.28), and the Midstates Region (0.62 to 0.32 percent). (See tables 18, 19, and 20 in app. III.)

IRS Officials Cited Several Reasons for the Changes in Individual Audit Rates

According to IRS officials, overall audit rates declined for fiscal years 1996 to 2000 for three main reasons. First, IRS had fewer auditors for individual returns for reasons that include a decline in staff and decisions to change staffing priorities to focus on customer service. Second, IRS was more likely to use the remaining auditors in other duties, such as assisting taxpayers. Third, audits took longer due to additional requirements, such as more written communications with taxpayers about the status of their audit. With respect to changes in the audit rate by income levels, IRS

[5] Fiscal year 1999 return filings by geographical location were not available for us to compute the related audit rates for fiscal year 2000.

officials cited an increase in the number of high-income tax returns and an audit focus on noncompliance by earned income credit claimants, who are usually lower income individuals. IRS' raw data were generally consistent with all these reasons. However, due to time constraints, we did not analyze the data to determine the extent to which IRS' reasons explained the changes in audit rates.

IRS Auditor Staffing Levels Declined

According to IRS officials, IRS did fewer audits between fiscal years 1996 and 2000, in part because it had fewer auditors. IRS officials explained that auditor staff levels declined for two reasons. First, tight budgets in the 1990s reduced overall staffing levels. Second, IRS put more staff in positions to serve taxpayers and generally has not hired revenue agents or tax auditors since 1995.

As shown in table 4, the number of revenue agent and tax auditor positions assigned to audit individual income tax returns declined steadily since 1996. By fiscal year 2000, the number of these positions declined about 54 percent for revenue agents and about 61 percent for tax auditors. This represents a loss of over 2,000 staff years for audit staff devoted to field and office audits. On the other hand, tax examiner positions, which do the simpler correspondence audits, increased 13 percent, or 200 positions, between fiscal years 1997 and 2000 (data for fiscal year 1996 were not available).

Table 4: Audit Staffing Levels for Individual Audits

	Fiscal year					Change	
Type of auditor	**1996**	**1997**	**1998**	**1999**	**2000**	**Number**	**Percent**
Revenue agents	2,441	2,121	1,751	1,407	1,116	-1,325	-54
Tax auditors	1,173	1,045	797	621	461	-712	-61
Tax examiners	[a]	1,515[b]	1,772[b]	1,740	1,715	200[c]	13[c]
Total	[a]	**4,681**	**4,320**	**3,768**	**3,292**	[a]	[a]

[a]IRS was not able to provide tax examiner data for fiscal year 1996.

[b]Tax examiner totals for fiscal years 1997 and 1998 are IRS estimates.

[c]Only covers change from fiscal year 1997 to 2000.

Source: GAO analysis of IRS data.

Auditors Spent More Time on Other Activities

IRS officials also said that its auditors spent less time auditing in fiscal years 1996 through 2000. Our analysis of IRS' data, as shown in table 5, indicates that for individual income tax returns, the average amount of direct audit time—actual time doing audit work—has declined in comparison to time spent on nondirect audit activities. Nondirect audit activities include taxpayer assistance, other details, and training.

Table 5: Direct and Nondirect Staff Years and Percent Change by Type of Auditor

Type of auditor	1996	1997	1998	1999	2000	Percent change
Revenue agents						
Direct audit	7,924	7,765	6,840	5,903	5,265	-34
Nondirect audit	7,159	6,634	6,807	7,158	7,285	2
Total staff years	15,083	14,399	13,647	13,061	12,550	-17
Direct audit percent	0.53	0.54	0.50	0.45	0.42	-20
Tax auditors						
Direct audit	1,280	1,164	906	725	566	-56
Nondirect audit	1,205	1,154	1,207	1,204	1,136	-6
Total staff years	2,485	2,318	2,113	1,930	1,702	-32
Direct audit percent	0.51	0.50	0.43	0.38	0.33	-35

Source: GAO analysis of IRS data.

Part of the reason for the decline in auditing is that revenue agents and tax auditors spent increasingly more time providing taxpayer assistance between fiscal years 1996 and 2000. The amount of time spent on taxpayer assistance by revenue agents increased from about 1.0 percent of available staff years in 1996 to about 4.4 percent of available staff years in 2000. The amount of time spent on taxpayer assistance by tax auditors increased from about 1.4 percent of available staff years in 1996 to about 12.3 percent of available staff years in 2000. IRS did not have comparable data for assistance provided by tax examiners who had been slated to do audits.

In addition, revenue agents and tax auditors had less time to audit because of increased time in training. (See table 17 in app. II for additional information on revenue agent and tax auditor training.) Considering the 54-percent decrease in the number of revenue agents, the training time per revenue agent increased about 227 percent. The training time per tax auditor over the same 5 years increased about 95 percent. IRS did not have comparable training data on tax examiners.

IRS Auditors Spent More Time to Finish Each Audit

Finally, IRS officials said that auditors generally took longer to finish audits during fiscal years 1996 to 2000. Our analysis of IRS' data for this period (see table 16 in app. II) showed that the average time to finish an audit increased for all types of auditors, including about

- 37 percent (20.2 hours to 27.6 hours) for revenue agents (field audits),
- 56 percent (4.6 hours to 7.1 hours) for tax auditors (office audits), and
- 153 percent (0.7 hours to 1.8 hours) for tax examiners (correspondence audits).

IRS officials told us that Internal Revenue Service Restructuring and Reform Act of 1998 requirements increased audit time.[6] Among other things, these requirements resulted in IRS auditors having to send more notices to taxpayers and third parties that provide information about the taxpayer being audited. New requirements to explain innocent spouse provisions and to protect taxpayers under audit have generated more review work. These officials said the act has created many new tasks during audits. Other factors, such as the experience level of the auditor and complexity of the audit, also affected audit time per return. For example, IRS officials said that they lost many experienced auditors to higher graded positions elsewhere in IRS. Because multiple factors affect audit time per return, determining the contribution of each factor to changes in audit time could be difficult. Because of time constraints, we did not attempt such an analysis.

IRS Cited Other Reasons for the Varying Individual Audit Rates by Income Levels

IRS officials offered two reasons why the audit rates for lower income individuals exceeded the rates for higher income individuals in selected years among the nonbusiness and business groups. First, as table 6 shows, the number of higher income returns filed in calendar years 1995 through 1999 that were subject to audits in fiscal years 1996 to 2000 significantly increased compared with the number of lower income returns filed. For nonbusiness returns, the number of higher income returns filed rose 80 percent compared with a 5-percent decrease for lower income returns filed. For business returns, the number of higher income individual returns increased about three times the rate of lower income business returns.

[6] P.L. 105-206.

Table 6: Returns Filed and Percent Change by Income Level

Income level[a]	Returns filed in calendar year 1995	1996	1997	1998	1999	Percent change
Nonbusiness returns						
Lower income	59,211,700	58,790,700	58,266,600	57,432,900	56,247,800	-5
Higher income	4,540,800	5,260,500	6,044,700	7,025,000	8,151,600	80
Schedule C business returns						
Lower income	2,436,300	2,464,700	2,530,100	2,546,800	2,541,000	4
Higher income	1,738,300	1,770,700	1,835,500	1,876,000	1,948,900	12

Note: Returns filed in calendar years1995 through 1999 are used to compute the audit rates for fiscal years 1996 through 2000.

[a]Lower income includes individuals reporting income less than $25,000 and higher income includes individuals reporting income of $100,000 or more.

Source: GAO analysis of IRS data.

Second, IRS' audits in fiscal years 1997 through 2000 have continued to focus on EIC noncompliance, usually by lower income individuals.[7] As table 7 shows, EIC audits, usually correspondence audits, accounted for a large percent of the audits of lower income taxpayers, regardless of their major source of income. In fact, the EIC portion of all audits for lower income taxpayers in fiscal year 2000 was more than double the fiscal year 1997 EIC portion of these audits.

Table 7: EIC Audits as a Percent of Total Audits of Lower Income Individuals

Audit type	Fiscal year 1997	1998	1999	2000
Total audits of lower income individuals[a]	895,625	679,088	745,614	369,912
Service center EIC audits[b]	360,101	290,010	572,594	325,654
EIC as percent of total audits	40%	43%	77%	88%

Note: IRS was unable to provide EIC data for fiscal year 1996.

[a]Excludes Schedule F filers because IRS data do not show how many of these filers reported less than $25,000.

[b]District office audits might cover EIC in part, but IRS does not uniformly capture that information.

Source: GAO analysis of IRS data.

[7]Congress enacted EIC in 1975, as a refundable tax credit available to lower income, working taxpayers, to offset the effect of social security taxes on lower income families and to encourage these taxpayers to seek employment rather than welfare.

IRS officials also said that a project to address noncompliance by schedule C filers who claimed EIC explained the greater audit rates for lower income business filers compared with those with higher incomes during fiscal years 1999 and 2000.

Effect of the Recent Declining Audit Rate on Tax Compliance Levels Is Not Known

The specific effect of the recent decline in the audit rate on the level of voluntary compliance is not known. One reason is that IRS does not have current reliable information on the levels of voluntary compliance. IRS last measured overall income tax compliance for tax year 1988. IRS and others are concerned that changes in the tax laws, economy, and demographics since 1988 have made the compliance information out of date.

Even if IRS had this information, IRS would still need to take a number of steps to try to determine the specific link between changes in audits and changes in voluntary compliance levels. Historically, measuring the specific impact of audit rate changes on voluntary compliance has been difficult. It is difficult to collect data on nonaudit factors that also can affect voluntary compliance levels, and then to control for these factors in order to isolate the impact of audit rate changes.

For example, it is difficult to determine the effect of declining audit rates on voluntary compliance when IRS' nonaudit checks could offset to some degree any negative effects of declining audit rates on compliance. Since the 1970s, for example, the underreporter program has grown, covering more types of income especially among nonbusiness taxpayers. IRS also uses the math error program to help ensure taxpayer compliance. Since the math error and underreporter checks can be similar to correspondence audits, growth in these programs may offset to some degree the decline in the audit rate.

Furthermore, it has also been difficult to measure how improvements in assisting and educating taxpayers about their tax obligations compensate for declining rates. These IRS efforts, although not designed to find noncompliance, could help taxpayers to voluntarily comply. To the extent that education efforts succeed in promoting compliance, overall compliance would not necessarily decline if the audit rate declines. IRS has been allocating more resources to taxpayer assistance and education. One example is the increased use of revenue agents and tax auditors to provide taxpayer assistance.

Because IRS does not have a measure of voluntary compliance, we do not know the net effects on tax compliance levels of the declining audit rates, changes in the volume of nonaudit checks, and any improvements in IRS' educational efforts.

Agency Comments

On April 19, 2001, we received written comments on a draft of this report from the Commissioner of Internal Revenue (see app. IV.). The Commissioner said that IRS agrees with our presentation and analysis of the audit rate data as well as with the need for current and reliable data on voluntary compliance. The Commissioner agreed that changes in the economy and tax laws have rendered IRS' compliance data obsolete. The Commissioner's comments also expanded on what IRS officials told us during our work about the reasons for the audit rate decline. Specifically, the comments said that two provisions (sections 1203 and 1204) of the Restructuring and Reform Act of 1998 created a cautionary environment that led to audits taking longer. [8]

The Commissioner also said that the report did not acknowledge historical data in two studies--one by IRS and one by external researchers--on the effects of the decline in audit rates on voluntary compliance.[9] We did not acknowledge these studies in the report because, while they estimate a relationship between audits and compliance, they are not based on current data. The most recent of the studies used data from 1982 through 1991. Because of the possibility that changes over time in the economy, tax laws, demographics, and IRS compliance programs have changed the relationship between audit rates and voluntary compliance, we did not cite the studies. These two studies did report a positive relationship between audit rates and voluntary compliance. This finding is consistent with the concern, which we describe in the report, that a decline in audit rates could lead to a decline in voluntary compliance.

As arranged with your office, unless you publicly announce its contents earlier, we plan no further distribution of this letter until 30 days from its

[8]Section 1203 requires the Commissioner of Internal Revenue to terminate any IRS employee that was proven to have committed certain violations in connection with the performance of official duties. Section 1204 prohibits the use of enforcement statistics in imposing or suggesting production quotas or in evaluating employee performance.

[9]Upon checking with IRS officials, we found out that these two studies are Dubin, Graetz, and Wilde, "The Effect of Audit Rates on the Federal Income Tax, 1977-1986," *National Tax Journal* (1990), and *The Determinants of Individual Income Tax Compliance: Estimating the Impacts of Tax Policy, Enforcement, and IRS Responsiveness* (IRS Pub. 1916, 1996).

date of issue. We will then send copies to Representative William M. Thomas, Chairman, and Representative Charles B. Rangel, Ranking Minority Member, House Committee on Ways and Means; Representative William J. Coyne, Ranking Minority Member, Subcommittee on Oversight, House Committee on Ways and Means, and Senator Charles E. Grassley, Chairman, and Senator Max Baucus, Ranking Minority Member, Senate Committee on Finance. We will also send copies to the Honorable Paul H. O'Neill, Secretary of the Treasury; the Honorable Charles O. Rossotti, Commissioner of Internal Revenue; the Honorable Mitchell E. Daniels, Jr., Director, Office of Management and Budget; and other interested parties. Copies of this report will be made available to others upon request.

If you have any questions, please contact me or Tom Short at (202) 512-9110. Key contributors to this report are acknowledged in appendix V.

James R. White

James R. White
Director, Tax Issues

Appendix I: Individual Income Tax Audit Rate Trends for Fiscal Years 1996 Through 2000

Table 8: Audit Rates for Individual Taxpayers Overall and by Income Level

	Fiscal year audit rate					
Income level	**1996**	**1997**	**1998**	**1999**	**2000**	**Percent change**
Overall audit rate for individuals	**1.67%**	**1.28%**	**0.99%**	**0.90%**	**0.49%**	**-70%**
Nonbusiness returns						
TPI under $25,000	1.82	1.39	1.06	1.18	0.55	-70
TPI $25,000 under $100,000	1.03	0.73	0.60	0.36	0.22	-78
TPI $100,000 and over	2.85	2.27	1.66	1.14	0.84	-70
Subtotal	**1.54**	**1.15**	**0.88**	**0.82**	**0.42**	**-73**
Business returns						
Schedule C						
TGR under $25,000	4.21	3.19	2.37	2.69	2.43	-42
TGR $25,000 under $100,000	2.85	2.57	1.82	1.30	0.93	-67
TGR $100,000 and over	4.09	4.13	3.25	2.40	1.48	-64
Subtotal	**3.60**	**3.15**	**2.35**	**2.03**	**1.55**	**-57**
Schedule F						
TGR under $100,000	1.59	1.28	0.93	0.68	0.35	-78
TGR $100,000 and over	3.61	2.75	1.63	1.23	0.80	-78
Subtotal	**2.29**	**1.82**	**1.21**	**0.90**	**0.54**	**-77**

Legend

TPI = total positive income (income from positive sources only)

Schedule C-TGR = total gross receipts (profit or loss from business)

Schedule F-TGR = total gross receipts (profit or loss from farming)

Note: We combined two of IRS' income levels ($25,000 to $50,000 and $50,000 to $100,000) into one income group ($25,000 to $100,000) because their audit rates were similar.

Source: GAO analysis of IRS data.

Table 9: Individual Income Tax Returns Filed and Percent Change by Income Level

	Returns filed by calendar year					
Income level	**1995**	**1996**	**1997**	**1998**	**1999**	**Percent change**
Total individual returns filed	**116,059,700**	**118,362,600**	**120,342,400**	**122,546,900**	**124,887,100**	**8**
Nonbusiness returns						
TPI under $25,000	59,211,700	58,790,700	58,266,600	57,432,900	56,247,800	-5
TPI $25,000 under $100,000	44,282,200	46,205,800	47,736,300	49,704,900	51,987,400	17
TPI $100,000 and over	4,540,800	5,260,500	6,044,700	7,025,000	8,151,600	80
Subtotal	**108,034,700**	**110,257,000**	**112,047,600**	**114,162,800**	**116,386,800**	**8**
Business returns						
Schedule C						
TGR under $25,000	2,436,300	2,464,700	2,530,100	2,546,800	2,541,000	4
TGR $25,000 under $100,000	3,082,000	3,140,300	3,228,300	3,267,300	3,351,100	9
TGR $100,000 and over	1,738,300	1,770,700	1,835,500	1,876,000	1,948,900	12
Subtotal	**7,256,600**	**7,375,700**	**7,593,900**	**7,690,100**	**7,841,000**	**8**
Schedule F						
TGR under $100,000	500,800	459,200	424,500	417,000	391,200	-22
TGR $100,000 and over	267,600	270,700	276,400	277,000	268,100	0
Subtotal	**768,400**	**729,900**	**700,900**	**694,000**	**659,300**	**-14**

Legend

TPI = total positive income (income from positive sources only)

Schedule C-TGR = total gross receipts (profit or loss from business)

Schedule F-TGR = total gross receipts (profit or loss from farming)

Note 1: We combined two of IRS' audit income levels ($25,000 to $50,000 and $50,000 to $100,000) into one income group ($25,000 to $100,000) because their audit rates were similar.

Note 2: Returns filed in calendar years1995 through 1999 are used to compute fiscal years 1996 through 2000 audit rates.

Source: GAO analysis of IRS data.

Table 10: Individual Income Tax Returns Audited and Percent Change by Income Level

	Returns audited by fiscal year					
Income level	**1996**	**1997**	**1998**	**1999**	**2000**	**Percent change**
Total individual audits	**1,941,546**	**1,519,243**	**1,192,780**	**1,100,273**	**617,765**	**-68**
Nonbusiness returns						
TPI under $25,000	1,076,945	817,072	619,065	677,164	308,217	-71
TPI $25,000 under $100,000	456,376	336,819	286,552	181,038	115,696	-75
TPI $100,000 and over	129,320	119,575	100,079	80,038	68,616	-47
Subtotal	**1,662,641**	**1,273,466**	**1,005,696**	**938,240**	**492,529**	**-70**
Business returns						
Schedule C						
TGR under $25,000	102,558	78,553	60,023	68,450	61,695	-40
TGR $25,000 under $100,000	87,691	80,861	58,877	42,391	31,226	-64
TGR $100,000 and over	71,050	73,049	59,728	44,945	28,781	-59
Subtotal	**261,299**	**232,463**	**178,628**	**155,786**	**121,702**	**-53**
Schedule F						
TGR under $100,000	7,944	5,868	3,949	2,832	1,384	-83
TGR $100,000 and over	9,662	7,446	4,507	3,415	2,150	-78
Subtotal	**17,606**	**13,314**	**8,456**	**6,247**	**3,534**	**-80**

Legend

TPI = total positive income (income from positive sources only)

Schedule C-TGR = total gross receipts (profit or loss from business)

Schedule F-TGR = total gross receipts (profit or loss from farming)

Note: We combined two of IRS' audit income levels ($25,000 to $50,000 and $50,000 to $100,000) into one income group ($25,000 to $100,000) because their audit rates were similar.

Source: GAO analysis of IRS data.

Table 11: Combined Audit Classes of Nonbusiness and Business Schedule C Returns and Percent Change

	Audit rate by fiscal year					
Nonbusiness and business schedule C income level	**1996**	**1997**	**1998**	**1999**	**2000**	**Percent change**
Under $25,000	1.91%	1.46%	1.12%	1.24%	0.63%	-67%
$25,000 under $100,000	1.15	0.85	0.68	0.42	0.27	-77
$100,000 and over	3.19	2.74	2.03	1.40	0.96	-70

Note: We combined two of IRS' audit income levels for nonbusiness and schedule C returns into 3 income levels of under $25,000, between $25,000 and less than $100,000, and $100,000 and over.

Source: GAO analysis of IRS data.

Table 12: Calculation of Fiscal Year 1999 Audit Rate for Combined Nonbusiness and Business Returns for Lower Income and Higher Income Individuals

Income level	Returns filed	Returns audited	Audit rate	Percent of combined audit rate
Nonbusiness				
Lower income	57,432,900	677,164	1.18%	96%
Higher income	7,025,000	80,038	1.14	79
Subtotal	**64,457,900**	**757,202**	[a]	[a]
Business				
Lower income	2,546,800	68,450	2.69	4
Higher income	1,876,000	44,945	2.40	21
Subtotal	**4,422,800**	**113,395**	[a]	[a]
Combined nonbusiness and business				
Lower income	59,979,700	745,614	1.24	100
Higher income	8,901,000	124,983	1.40	100
Subtotal	**68,880,700**	**870,597**	[a]	[a]

[a]Not applicable.

Source: GAO analysis of IRS data.

The audit rate for lower income individuals is greater than the rate for higher income individuals for both nonbusiness and business filers in fiscal year 1999. However, when nonbusiness and business filers are combined into one category the audit rate for higher income individuals is greater than the audit rate for lower income individuals.

This occurs due to the large number of lower income nonbusiness filers (57.4 million) compared to the number of lower income business filers (2.5 million). As a result, the combined audit rate for lower income individuals is more dominated by the audit rate for nonbusiness filers (1.18 percent) and less dominated by the audit rate for business filers (2.69 percent). Therefore, the combined audit rate only increases to 1.24 percent from the 1.18-percent audit rate for lower income nonbusiness filers.

On the other hand, the difference between the number of higher income nonbusiness filers (7 million) and the number of higher income business filers (1.9 million) is not nearly as large as for lower income individuals. As a result, the combined audit rate for higher income filers is less dominated by the audit rate for nonbusiness filers (1.14 percent) and more dominated by the audit rate for business filers (2.40 percent) compared to lower income filers. Therefore, the combined audit rate increases to 1.40 percent from the 1.14-percent audit rate for higher income nonbusiness filers.

Table 13: Audits of Lower Income and Higher Income Individuals by Type of Audit

	Fiscal year				
Income level	**1996**	**1997**	**1998**	**1999**	**2000**
Lower income					
Total correspondence audits	855,789	614,628	471,279	624,078	291,462
Total face-to-face audits	323,714	280,997	207,809	121,536	78,450
Total audits	**1,179,503**	**895,625**	**679,088**	**745,614**	**369,912**
Percent of audits that are correspondence audits	73%	69%	69%	84%	79%
Percent of audits that are face-to-face audits	27%	31%	31%	16%	21%
Total percent	**100%**	**100%**	**100%**	**100%**	**100%**
Higher income					
Total correspondence audits	68,851	52,614	39,343	33,489	37,034
Total face-to-face audits	131,519	140,010	120,464	91,494	60,363
Total audits	**200,370**	**192,624**	**159,807**	**124,983**	**97,397**
Percent of audits that are correspondence audits	34%	27%	25%	27%	38%
Percent of audits that are face-to-face audits	66%	73%	75%	73%	62%
Total percent	**100%**	**100%**	**100%**	**100%**	**100%**

Source: GAO analysis of IRS data.

Table 14: Correspondence and Face-to-Face Audit Rates by Income Level

Type of audit	**1996**	**1997**	**1998**	**1999**	**2000**
Correspondence					
Lower income audits	855,789	614,628	471,279	624,078	291,462
Higher income audits	68,851	52,614	39,343	33,489	37,043
Lower income audit rate	1.39%	1.00%	0.78%	1.04%	0.50%
Higher income audit rate	1.10%	0.75%	0.50%	0.38%	0.37%
Face-to-Face					
Lower income audits	323,714	280,997	207,809	121,536	78,450
Higher income audits	131,519	140,010	120,464	91,494	60,363
Lower income audit rate	0.53%	0.46%	0.34%	0.20%	0.13%
Higher income audit rate	2.09%	1.99%	1.53%	1.03%	0.60%

Source: GAO analysis of IRS data.

Appendix II: Assessment of Reasons Affecting Audit Rate Changes for Fiscal Years 1996 Through 2000

Table 15: Direct Audit Hours and Percent Change by Type of Auditor

Type of auditor	1996	1997	1998	1999	2000	Percent change
Revenue agents	5,100,559	4,582,079	3,710,634	3,093,550	2,531,153	-50
Tax auditors	2,320,524	2,083,472	1,722,219	1,332,571	1,034,599	-55
Tax examiners[a]	858,088	396,868	601,874[b]	826,266[c]	699,425[d]	-18
Total	**8,279,171**	**7,062,419**	**6,034,727**	**5,252,387**	**4,265,177**	**-48**

[a]Tax examiner totals for fiscal years 1998, 1999, and 2000 include service center and district office tax examiner totals.

[b]Includes 16,339 district office correspondence audits.

[c]Includes 24,341 district office correspondence audits.

[d]Includes 13,547 district office correspondence audits.

Source: GAO analysis of IRS data.

Table 16: Direct Audit Hours per Audit and Percent Change by Type of Auditor

Type of auditor	1996	1997	1998	1999	2000	Percent change
Revenue agents	20.21	21.84	22.08	24.84	27.64	37
Tax auditors	4.56	4.12	4.49	5.66	7.09	56
Tax examiners[a]	0.73	0.49	0.94	1.12	1.84	153
Total	**25.49**	**26.45**	**27.51**	**31.62**	**36.56**	**43**

[a]Tax examiner totals for fiscal years 1998, 1999, and 2000 include service center and district office tax examiner totals.

Source: GAO analysis of IRS data.

Table 17: Staff Years Spent on Nonaudit Activities and Percent Change by Type of Auditor

Type of auditor	1996	1997	1998	1999	2000	Percent change
Revenue agents						
Taxpayer assistance	148	148	293	451	549	270
Other details	132	134	141	174	210	59
Training	679	633	751	1,029	1,016	50
Total	**960**	**915**	**1,185**	**1,654**	**1,776**	**85**
Tax auditors						
Taxpayer assistance	34	121	158	151	209	510
Other details	20	20	19	26	23	14
Training	163	85	96	138	126	-23
Total	**217**	**225**	**273**	**314**	**358**	**65**

Source: GAO analysis of IRS data.

Appendix III: Audit Rates by Geographic Location for Fiscal Years 1996 Through 1999

Table18: IRS Individual Audit Rates by Region and District Office

Region and district	Audit rate by fiscal year 1996	1997	1998	1999	Average audit rate
Northeast	**0.44%**	**0.41%**	**0.34%**	**0.23%**	**0.35%**
Brooklyn	0.58	0.56	0.48	0.33	0.49
Connecticut-Rhode Island	0.60	0.45	0.36	0.28	0.42
Manhattan	0.75	0.77	0.63	0.44	0.65
Michigan	0.44	0.36	0.29	0.19	0.32
New England	0.46	0.37	0.31	0.21	0.33
New Jersey	0.42	0.39	0.34	0.20	0.34
Ohio	0.34	0.32	0.22	0.16	0.26
Pennsylvania	0.36	0.41	0.33	0.23	0.33
Upstate New York	0.36	0.37	0.31	0.18	0.30
Southeast	**0.58**	**0.52**	**0.40**	**0.28**	**0.44**
Delaware-Maryland	0.53	0.53	0.42	0.25	0.43
Georgia	0.79	0.64	0.54	0.31	0.57
Gulf Coast	0.83	0.74	0.53	0.41	0.62
Indiana	0.51	0.43	0.31	0.22	0.37
Kentucky-Tennessee	0.40	0.48	0.37	0.22	0.37
North Florida	0.52	0.45	0.32	0.24	0.38
North-South Carolina	0.48	0.34	0.29	0.21	0.33
South Florida	0.71	0.68	0.54	0.42	0.58
Virginia-West Virginia	0.42	0.39	0.30	0.22	0.33
Midstates	**0.62**	**0.59**	**0.49**	**0.32**	**0.50**
Arkansas-Oklahoma	0.72	0.63	0.58	0.35	0.57
Houston	0.76	0.64	0.55	0.44	0.59
Illinois	0.47	0.53	0.46	0.20	0.42
Kansas-Missouri	0.51	0.45	0.38	0.25	0.39
Midwest	0.53	0.52	0.41	0.31	0.45
North Central	0.68	0.76	0.65	0.50	0.65
North Texas	0.96	0.82	0.53	0.35	0.66
South Texas	0.55	0.50	0.50	0.31	0.46
Western	**1.09**	**1.00**	**0.73**	**0.47**	**0.81**
Central California	1.17	0.91	0.72	0.56	0.84
Los Angeles	1.59	1.55	0.98	0.67	1.20
Northern California	1.24	1.34	1.09	0.60	1.06
Pacific-Northwest	0.63	0.51	0.37	0.24	0.43
Rocky Mountain	0.73	0.67	0.49	0.28	0.54
Southern California	1.63	1.35	0.94	0.69	1.14
Southwest	0.81	0.81	0.62	0.36	0.64

Note: IRS regional data for fiscal year 2000 were not available at the time of publication.

Source: GAO analysis of IRS data.

Table 19: IRS Districts With the Highest and Lowest Audit Rates

District office	Audit rate by fiscal year				Average audit rate
Highest rates	**1996**	**1997**	**1998**	**1999**	
Los Angeles	1.59%	1.55%	0.98%	0.67%	1.20%
Southern California	1.63	1.35	0.94	0.69	1.14
Northern California	1.24	1.34	1.09	0.60	1.06
Central California	1.17	0.91	0.72	0.56	0.84
North Texas	0.96	0.82	0.53	0.35	0.66
North Central	0.68	0.76	0.65	0.50	0.65
Manhattan	0.75	0.77	0.63	0.44	0.65
Southwest	0.81	0.81	0.62	0.36	0.64
Gulf Coast	0.83	0.74	0.53	0.41	0.62
Houston	0.76	0.64	0.55	0.44	0.59
Lowest rates					
Ohio	0.34	0.32	0.22	0.16	0.26
Upstate New York	0.36	0.37	0.31	0.18	0.30
Michigan	0.44	0.36	0.29	0.19	0.32
North-South Carolina	0.48	0.34	0.29	0.21	0.33
Virginia-West Virginia	0.42	0.39	0.30	0.22	0.33
Pennsylvania	0.36	0.41	0.33	0.23	0.33
New England	0.46	0.37	0.31	0.21	0.33
New Jersey	0.42	0.39	0.34	0.20	0.34
Indiana	0.51	0.43	0.31	0.22	0.37
Kentucky-Tennessee	0.40	0.48	0.37	0.22	0.37

Note: IRS regional data for fiscal year 2000 were not available at the time of publication.

Source: GAO analysis of IRS data

Table 20: Comparison of IRS Individual Audit Rates, Including and Excluding Service Center Audits

Location	1996	1997	1998	1999	Percent change
United States (with service centers)	**1.67%**	**1.28%**	**0.99%**	**0.90%**	**-46**
United States (without service centers)	**0.66**	**0.60**	**0.47**	**0.31**	**-52**
Northeast Region	0.44	0.41	0.34	0.23	-49
Southeast Region	0.58	0.52	0.40	0.28	-52
Midstates Region	0.62	0.59	0.49	0.32	-49
Western Region	1.09	1.00	0.73	0.47	-57

Note: IRS regional data for fiscal year 2000 were not available at the time of publication.

Source: GAO analysis of IRS data.

Appendix IV: Comments From the Internal Revenue Service

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

COMMISSIONER

April 19, 2001

Mr. James R. White
Director
Tax Issues
United States General Accounting Office
Washington, DC 20548

Dear Mr. White:

Thank you for the opportunity to review and comment on the General Accounting Office's (GAO) draft report titled "IRS Audit Rates: Rate for Individual Taxpayers Has Declined But Effect on Compliance Is Unknown." We agree with your presentation and analysis of the audit rate data and your call for current, reliable data on voluntary compliance. As you note, the IRS last measured overall income tax compliance in 1988. Changes in our economy and laws since that time have rendered this data obsolete. Without an up to date measure of compliance, the IRS does not have the information it needs to determine where it can most effectively allocate its resources. Finally, we do not think your report acknowledged the historical data showing the effect of the decline in audit rates on voluntary compliance.

As the report noted, the drop in examination was, to a large degree, caused by the following:

- Long-term decline in staffing-- between FY 1992 and 2000, our workforce decreased by 17 percent while the number of tax returns filed (including supplemental documents, such as Forms 1040X, 4868, 2688, 1120X and 7004) increased 13 percent to 230 million;
- Assignment of compliance staff to customer service duties to support the filing season; and,
- Added responsibilities of the Restructuring and Reform Act of 1998 (RRA 98) -- RRA 98 has added more than 30 additional steps to the completion of an examination and the addition of third party notification.

RRA 98 also indirectly affected our operations. Two provisions, in particular, which you did not mention in your report, greatly affected the time required to conduct many activities. They are: Section 1203 and Section 1204 which prohibited use of enforcement statistics in setting goals or including statistics in personnel evaluations at any level in the agency and violations could result in the employee's termination.

Both provisions caused a great deal of concern among front-line employees and their managers when taking enforcement action. The cautionary environment created by Section 1204 was magnified by the extensive number of investigations and disciplinary actions of managers that was undertaken in 1998 and 1999 for misuse of statistics. In addition, uncertainty over the reorganization, which flattened the organization and eliminated management layers, caused a temporary loss of focus. All these factors increased the time it takes to complete cases, reducing the number of cases completed per FTE by 20 to 30 percent.

The report did not acknowledge the effect of the decline in audit rates on voluntary compliance. At least one external study and a 1996 internal study established a significant, positive link between audit rates and voluntary compliance. Even if the magnitude of that relationship has changed somewhat in the last ten years, it is probable that the audit rate decline has resulted in a drop in voluntarily compliance, even after controlling for other determinants of compliance.

If you have any questions, please contact me or Joseph Kehoe, Commissioner, Small Business and Self-Employed Division, at (202) 622-0600.

Sincerely,

Bob Wenzel

for Charles O. Rossotti

Appendix V: GAO Contacts and Staff Acknowledgments

GAO Contacts

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Thomas Short (202) 512-9110

Acknowledgments

In addition to those named above, Helen Branch, Jay Pelkofer, Susan Baker, Michele Fejfar, Anne Rhodes-Kline, MacDonald Phillips, and Robert DeRoy made key contributions to this report.

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