

GAO

Report to the Committee on Finance,
U.S. Senate

June 2003

TAX ADMINISTRATION

IRS Is Implementing the National Research Program as Planned



G A O

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Highlights of [GAO-03-614](#), a report to the Committee on Finance, U.S. Senate

Why GAO Did This Study

The Internal Revenue Service (IRS) needs up-to-date information on voluntary compliance in order to assess and improve its programs. IRS's last detailed study of voluntary compliance was done in the late 1980s, so the compliance information IRS is using today is not current. IRS is now carrying out the National Research Program (NRP), through which IRS auditors are reviewing about 47,000 randomly selected tax year 2001 individual tax returns. In June 2002, GAO reported that NRP was necessary, that its design was sound, and that it appeared to meet IRS's goals of acquiring useful compliance data while minimizing burden on taxpayers with returns in the sample.

GAO was asked to review IRS's implementation of NRP. GAO reviewed IRS's method of gathering internal and third-party data (casebuilding) and IRS's process of reviewing casebuilding materials to determine if audits are necessary (classification) and assessed IRS's plans to ensure consistent data collection while minimizing burden on taxpayers.

What GAO Recommends

GAO is not making recommendations in this report because IRS is following through with its sound research plans in the ongoing implementation of NRP. Furthermore, when GAO identified quality assurance steps that IRS could add to NRP during the course of this review, IRS agreed with the suggestions and included the steps.

www.gao.gov/cgi-bin/getrpt?GAO-03-614.

To view the full product, including the scope and methodology, click on the link above. For more information, contact James White at (202) 512-5594 or White.J@GAO.gov.

TAX ADMINISTRATION

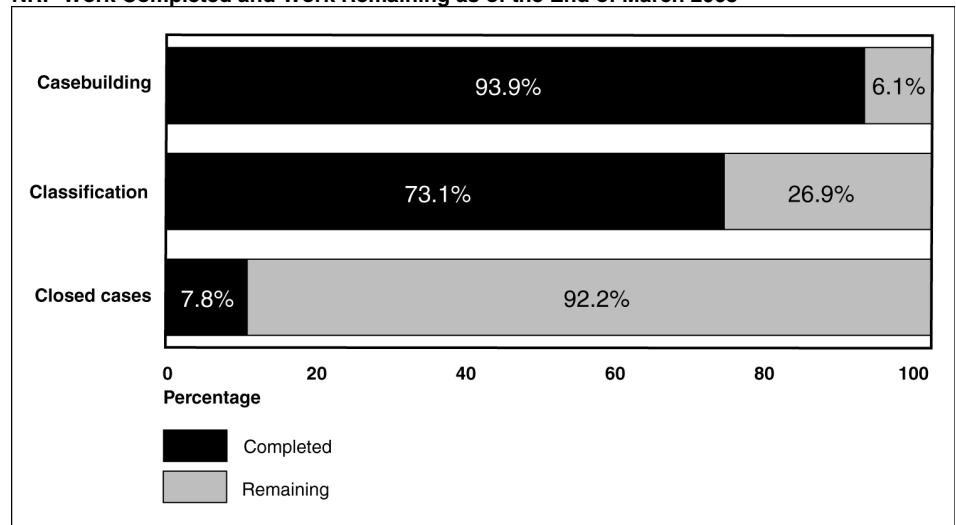
IRS Is Implementing the National Research Program as Planned

What GAO Found

IRS's NRP is being implemented as planned and consequently is on track to meet the agency's objectives of obtaining quality research results while minimizing the burden on the approximately 47,000 taxpayers with returns in the NRP sample. IRS officials have completed the development and testing of NRP processes and have selected and trained staff members to carry out the program. Additionally, as the graphic illustrates, IRS is currently nearing the completion of casebuilding and has made progress in classifying NRP returns. Audits, when required, began in November 2002. As of the end of March 2003, IRS had closed 3,651 NRP cases. In accordance with IRS's plans to minimize burden on taxpayers with returns in the NRP sample, some cases have been closed without any taxpayer contact or with only limited audits. The NRP plan recognized that the initial estimates for the overall NRP sample size and the number of returns to be audited were uncertain because they were based on aging data. The overall NRP sample size will be smaller and IRS officials expect to conduct more face-to-face audits than initially estimated.

As IRS completes NRP casebuilding, classification, and audits, it is implementing quality assurance steps, including efforts to ensure that key audit steps are completed on all NRP audits before they are formally closed with taxpayers. This is important since the data collected from each NRP audit represent information from thousands of similar taxpayers.

NRP Work Completed and Work Remaining as of the End of March 2003



Source: GAO representation of IRS data.

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Abbreviations

EQMS	Examination Quality Measurement System
IRS	Internal Revenue Service
NRP	National Research Program

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United States General Accounting Office
Washington, DC 20548

June 16, 2003

The Honorable Charles E. Grassley
Chairman
The Honorable Max Baucus
Ranking Minority Member
Committee on Finance
United States Senate

Understanding taxpayers' compliance with the nation's tax laws is critical to the ability of the Internal Revenue Service (IRS) to improve the effectiveness of its programs to enforce and promote voluntary compliance. While IRS strives to target enforcement audits to taxpayers who are not complying with tax laws, this has become increasingly difficult for IRS to do because the information it uses to identify likely noncompliant tax returns is out of date. This means that a large and growing number of IRS enforcement audits are directed at compliant taxpayers. IRS needs more current data on compliance to be able to appropriately target audits to problem returns. IRS last studied voluntary compliance with random audits of tax year 1988 tax returns. These studies included intensive, line-by-line audits and imposed a significant burden on taxpayers with returns in the sample.

IRS is now carrying out a detailed study of taxpayer compliance—the National Research Program (NRP). IRS has identified a random sample of 47,000 tax year 2001 returns and has begun NRP data gathering, including limited audits where necessary to verify information reported by taxpayers.

NRP is intended to produce useful compliance data while minimizing the burden on the taxpayers selected for the study. IRS designed NRP to minimize taxpayer burden by gathering IRS and third-party information—a process called casebuilding—in order to limit taxpayer information requests to items that cannot be verified without such a request. Specially trained IRS agents then review the approximately 47,000 returns in the NRP sample and their supporting casebuilding files and identify lines on the returns that cannot be verified without auditing the taxpayers—a process called classification. With this approach, some taxpayers will not be contacted at all and most others will be asked to verify only some of the line items on their returns.

In June 2002, we reported to you our assessment of IRS's NRP plans.¹ At that time we determined that NRP was necessary and that its design addressed both the need for up-to-date information on taxpayer compliance and IRS's goal of minimizing the burden NRP imposed on taxpayers. We also reported that IRS had important casebuilding and classification procedures testing to complete, as well as selection and training of IRS personnel to carry out the program. You then asked us to assess whether IRS is implementing NRP as planned. Accordingly, this report describes and assesses (1) IRS's completion of NRP development and testing, (2) staff selection and training, (3) implementation progress of the program, (4) quality assurance steps IRS is taking to ensure consistent and accurate data collection, and (5) steps the agency is taking to minimize burden on taxpayers with returns in the NRP sample.

To monitor IRS's final development and implementation of NRP, we reviewed agency documents concerning NRP design, testing, and implementation. We also directly observed sessions of most aspects of NRP training and two key tests of NRP procedures. We held frequent discussions with the IRS personnel implementing the program and conducted field office visits to several of the locations where NRP classification is taking place. During our field visits, we met with managers and classifiers and discussed their understanding of the program and any implementation issues that came up. Our assessment of NRP implementation is based on IRS's NRP plans as described in our June 2002 report.

Results in Brief

IRS is implementing key aspects of NRP according to the plans the agency laid out in 2002 and the program is now fully under way. IRS has completed NRP process testing and development and has identified and trained over 3,000 enforcement auditors to be NRP classifiers and auditors. IRS has started carrying out NRP reviews. As of the end of March 2003, IRS had selected a sample of about 47,000 tax year 2001 returns, completed casebuilding files for over 90 percent of them, and classified over 70 percent of these returns. IRS had completed all NRP work on 3,651 NRP cases.

¹ U.S. General Accounting Office, *Tax Administration: New Compliance Research Effort Is on Track, but Important Work Remains*, [GAO-02-769](#) (Washington, D.C.: June 27, 2002).

As described in its plans, IRS has incorporated important quality assurance measures into NRP. IRS has made data consistency checks, regular communication with staff members carrying out NRP, and classification and audit reviews part of NRP. IRS has also adopted suggestions we made in the course of this study that it add additional quality checks to NRP in the form of classification site visits and centralized evaluation of classification review results.

Also, as IRS planned, NRP casebuilding and classification processes are helping minimize burden on taxpayers with returns in the NRP sample by limiting most audits to line items that cannot be verified without directly contacting taxpayers. Additionally, while the NRP sample size is now smaller than originally projected, the number of face-to-face NRP audits that IRS officials expect to take place is now larger than originally estimated. The original NRP sample size estimates were based on now obsolete 1988 compliance study data, the only data available. The number of expected face-to-face audits, now projected to be about 39,000, is larger than originally estimated because the estimates were also based on the obsolete 1988 data and because IRS modified its classification guidelines to better match the training and skill level of the auditors selected to conduct NRP correspondence and face-to-face audits with the issues to be covered by those audits.

In commenting on a draft of this report, the Commissioner of Internal Revenue concurred with our findings and conclusions about IRS's implementation of NRP. He noted that as NRP continues, IRS will continue to emphasize delivering quality results and minimizing taxpayer burden. The commissioner's letter is reprinted in appendix I.

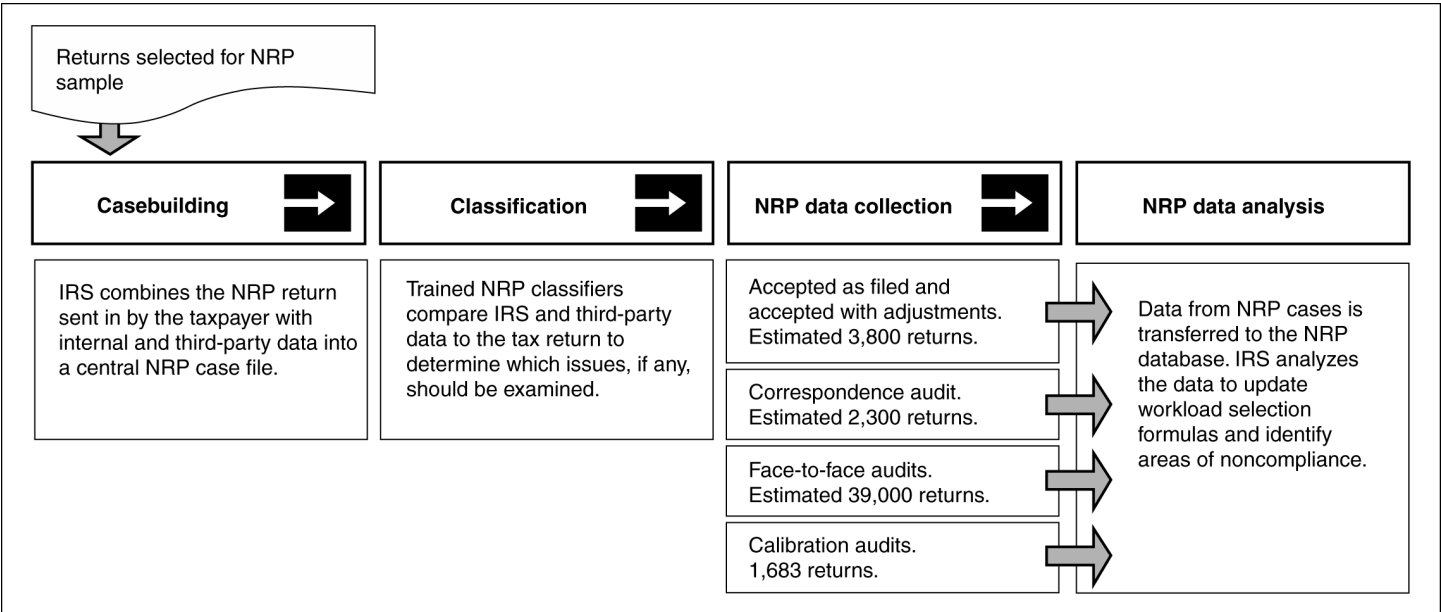
Background

IRS designed NRP to obtain new information about taxpayers' compliance with the tax laws. While IRS is using NRP to measure voluntary filing, reporting, and payment compliance, the majority of NRP efforts are devoted to obtaining accurate voluntary reporting compliance data. In measuring reporting compliance, IRS's two primary goals are to obtain accurate information but minimize the burden on the approximately 47,000 taxpayers with returns in the NRP sample. IRS plans to use NRP data to update return selection formulas, allow IRS to design prefilling programs that will help taxpayers comply with the tax law, and permit IRS

to focus its limited resources on the most significant areas of noncompliance.²

NRP's reporting compliance study consists of three major processes: (1) casebuilding—creating information files on returns selected for the NRP sample, (2) classification—using that information to classify the returns according to what, if any, items on the returns cannot be verified without additional information from the taxpayers, and (3) taxpayer audits limited to those items that cannot be independently verified. We reported in June 2002 that NRP's design, if implemented as planned, is likely to yield the sort of detailed information that IRS needs to measure overall compliance, develop formulas to select likely noncompliant returns for audit, and identify compliance problems for the agency to address. Figure 1 shows NRP's main elements.

Figure 1: NRP Process for Measuring Voluntary Reporting Compliance



Source: GAO representation of IRS data.

² IRS uses compliance research to determine the characteristics of tax returns that are likely to be noncompliant. Screening tax returns for those characteristics is an early step in selecting returns for enforcement audits.

IRS designed the casebuilding process to bring together available data to allow the agency to establish the accuracy of information reported by taxpayers on their returns. For each taxpayer with a return in the NRP sample, IRS is compiling internal information, such as past years' returns and information reported to IRS by third parties, such as employers and banks, and information from outside databases, such as property listings, address listings, and stock sale price data.

Classification is where IRS uses the casebuilding information to determine whether an NRP audit is necessary and which items need to be verified through an audit. Classifiers place NRP returns into one of four categories: (1) accepted as filed, (2) accepted with adjustments, (3) correspondence audit, and (4) face-to-face audit. If the casebuilding material allows IRS to verify all of the information that a taxpayer reported on his or her tax return, then the taxpayer will not be contacted and the return will be classified as accepted as filed. On returns where minor adjustments are necessary, the adjustments will be recorded for research purposes, but the taxpayers will not be contacted. These returns will be classified as accepted with adjustments. NRP returns that have one or two items from a specified list requiring examination will be classified for correspondence audits. All other NRP returns for which the casebuilding material does not enable IRS to independently verify the information reported on the returns will be classified for face-to-face audits.

NRP audits will take place either through correspondence with the taxpayers or through face-to-face audits. When classifiers determine that an NRP return will be sent for a correspondence audit, IRS will request that the taxpayer send documentation verifying the line items in question. To ensure accurate and consistent data collection, NRP audits will address all issues identified by classifiers and will not be focused only on substantial issues or cases for which there is a reasonable likelihood of collecting unpaid taxes, according to IRS officials. NRP auditors also may expand the scope of the audits to cover items that were not classified initially.

IRS plans to conduct detailed, line-by-line audits on 1,683 of the approximately 47,000 returns in the NRP sample in order to assess the accuracy of NRP classification and, if necessary, to adjust NRP results—a process called calibration. One-third of the returns in the calibration sample will be returns that were classified accepted as filed (either with or without adjustments), one-third from those classified for correspondence audits, and one-third from those classified for face-to-face audits. None of

the taxpayers with returns in the calibration sample will have been audited or otherwise contacted by IRS prior to the start of these line-by-line audits.

Scope and Methodology

To describe IRS's implementation of NRP, we have conducted frequent meetings with officials in IRS's NRP Office and other IRS officials as they have implemented the program. We reviewed NRP training materials and observed NRP classifier, correspondence examination, and field examination training sessions. We also observed NRP process tests and conducted site visits to IRS area offices in Baltimore, Maryland; Brooklyn, New York; Oakland, California; Philadelphia, Pennsylvania; and St. Paul, Minnesota, in order to observe and review NRP classification in field offices.

We considered whether NRP is being implemented in accordance with its design. In our report issued on June 27, 2002, we found that NRP's design, if implemented as planned, is likely to provide IRS with the type of information it needs to ensure overall compliance, update workload selection formulas, and discover other compliance problems that the agency needs to address. For this review, we also considered whether IRS was maintaining a focus on meeting NRP's objectives of obtaining quality research results while, at the same time, minimizing taxpayer burden. This assessment was also based on IRS's NRP implementation plans.

As of the completion of our work, IRS had a significant amount of NRP implementation to carry out. Our evaluation of IRS's efforts to implement NRP, therefore, only provides an assessment of efforts that have taken place through the time of our work. Additionally, we did not attempt to assess IRS's efforts to measure filing compliance and payment compliance through NRP. Our evaluation focuses only on IRS's efforts to obtain voluntary reporting compliance information.³ A more detailed description of NRP can also be found in our 2002 report.

³ There are three types of voluntary compliance measures: filing compliance, which measures the percentage of taxpayers who file returns in a timely manner; payment compliance, which measures the percentage of tax payments that are paid in a timely manner; and reporting compliance, which measures the percentage of actual tax liability that is reported accurately on returns. Although IRS's NRP plans include reviews of all three types of compliance, the majority of its efforts have been devoted to development of reporting compliance measurement procedures. Reporting compliance is also the only aspect of NRP that will include audits of taxpayers.

We conducted our work from September 2002 through April 2003 in accordance with generally accepted government auditing standards.

IRS Completed NRP Process Testing

In addition to the two tests described in our prior report on NRP, IRS conducted two more tests of NRP processes prior to implementing the program. IRS tested the casebuilding and classification processes in an NRP simulation in July 2002, and conducted another classification process test during the initial classification training session in September 2002. IRS used the preliminary results of both of these tests to estimate NRP classification outcomes and to evaluate the effectiveness of NRP training. As we recommended in our June 2002 report, IRS substantially completed this testing prior to full NRP implementation, though final reports from the tests were not completed until later.

In July 2002, IRS used draft NRP training materials to train 16 auditors from IRS field offices in the use of NRP casebuilding materials to carry out the NRP classification process. The newly trained classifiers then classified 506 tax year 2000 returns. NRP staff members reviewed the classifiers' results and found that, overall, the results of this NRP simulation were positive. They found that the classifiers understood the NRP approach to classification but that there were instances where the classifiers overlooked some of the issues indicated by the casebuilding materials or made other errors.

In September 2002, IRS conducted another test of the NRP classification process immediately following the initial training session using final classification training materials. As we recommended in our June 2002 report, IRS had NRP classifiers classify previously audited tax returns in order to compare classifiers' results with the results of actual audits. Twenty-two newly trained classifiers classified 44 previously audited returns, with each return classified by 5 different classifiers. All of the earlier audits resulted in some changes. NRP staff members then compared the classifiers' results with those of the other classifiers and with the results of the earlier audits. NRP officials reported that the test showed that about three-fourths of the time the trained NRP classifiers were able to identify issues where noncompliance was found through an audit.

IRS used preliminary results of these tests to identify and implement improvements to NRP. For example, NRP staff members noticed early in the course of the second test that NRP classifiers were failing to classify some line items in accordance with NRP guidelines. Trainers reiterated the

importance of following the classification guidelines for these items. NRP staff members also saw that the format of the form that classifiers were to use to record their classification decisions made it easy to make mistakes. They revised the form to make decision recording less error-prone. IRS also used these tests to identify the need for more stringent classification review guidelines than initially planned in order to ensure that classifiers understand and follow the classification guidelines.

IRS did not finish analysis and documentation of the NRP simulation and assessment and the classification process test until after the beginning of classification in IRS area offices. NRP classification began at IRS area offices during November 2002, but IRS did not finalize its report on the July 2002 NRP simulation until December 2002, and the report on the September 2002 NRP process test was finalized in December 2002. According to NRP officials, this did not create problems because they made changes to NRP processes and training materials before the reports of these tests were final. Though the final reports were not completed until later, these tests and the NRP modifications they generated were complete before full implementation of NRP.

NRP Staff Selection and Training Is Complete

IRS identified and trained staff to complete NRP classification and audits. IRS selected NRP classifiers and auditors from field offices across the country to handle NRP cases along with the non-NRP enforcement cases and carried out plans for special training of the staff members tasked with NRP responsibilities. IRS delayed the delivery of computer software training to managers and clerks involved in NRP audits due to technical problems with NRP software. This initially delayed the start of NRP audits, but the training is now complete. The timing of NRP staff selection and training fit the conclusion and recommendation in our June 2002 report that IRS should make sure that these key steps are carried out in the appropriate sequence and not rushed to meet an earlier, self-imposed deadline.

IRS Selected Auditors to Carry Out NRP

IRS selected over 3,000 auditors to handle NRP cases. Most of these auditors are assigned to the Small Business/Self Employed operating division.⁴ IRS selected 138 Small Business/Self Employed auditors to be

⁴ IRS has four business operating divisions: Wage and Investment, Small Business/Self Employed, Large and Mid-Sized Business, and Tax Exempt and Government Entities.

NRP classifiers and about 3,500 to handle NRP face-to-face audits. According to NRP staff members, IRS offices across the country now have one or more auditors trained to handle the NRP cases that come to those offices. IRS area office managers determined how many auditors should receive NRP training based on the projected distribution of NRP returns to their areas.

Unlike face-to-face audits, NRP correspondence audits are being handled out of a single office. IRS selected two groups of correspondence auditors—26 correspondence auditors—from the Wage and Investment operating division’s Kansas City office to handle NRP correspondence audits.

IRS originally planned to select a cadre of auditors to work only on NRP face-to-face audits. According to NRP officials, the geographic distribution of NRP returns would have made it difficult to have a cadre of auditors dedicated entirely to NRP examinations because they would have had to travel extensively to carry out NRP audits. IRS officials said that even though they did not implement the plan for a dedicated cadre of NRP auditors, the number of full-time equivalent employees needed for NRP—about 1,000 in fiscal year 2003—has not changed.

NRP Classifier Training Is Complete

In September 2002, IRS trained 138 auditors to perform NRP classification. The classifiers learned how to apply the guidelines for NRP classification and were shown how to use NRP casebuilding materials. Instructors stressed the concept of “when in doubt, classify the item” meaning that, unless the casebuilding materials explicitly verify the line item in question, the classifier should classify the item as needing to be verified through an audit. Instructors explained that with a random sample such as in NRP, every return represents many others so even small oversights on the part of classifiers or auditors can have a substantial impact on data quality.

After the classification training, the classifiers remained at the training location and began classifying NRP returns. Specially trained classification reviewers reviewed most of the classified cases and provided rapid feedback to the newly trained NRP classifiers. The intent of this was to ensure that NRP classifiers understood and consistently applied the NRP classification guidelines and received any needed retraining before returning to their respective field offices and participating in future NRP classification sessions.

NRP Auditor Training Is Complete

IRS delivered NRP correspondence and face-to-face auditor training during late 2002 and early 2003. Instructors provided an overview of NRP goals and objectives, reviewed the casebuilding materials that auditors would have at their disposal, and explained the guidelines for NRP audits.

IRS trained about 3,500 auditors to conduct NRP face-to-face audits. This training took place in IRS field offices across the country from October 2002 through February 2003. Each face-to-face NRP audit training session lasted 3 days. The training consisted of an overview of NRP goals and objectives, an explanation of how NRP audits differ from traditional enforcement audits, and a description of how to apply NRP guidelines during NRP audits. Trainers stressed that, for the purposes of consistent and accurate data collection, NRP auditors should not focus solely on significant issues or take into consideration the likelihood of collecting unpaid taxes when conducting NRP audits, but should make sure that every item identified by the classifier is carefully verified in the course of the audit. Correspondence auditor training was similarly focused, and the 1-day training took place in September 2002. Staff members were trained before they began to carry out NRP tasks.

Computer Software Training for Managers and Clerks Was Delayed

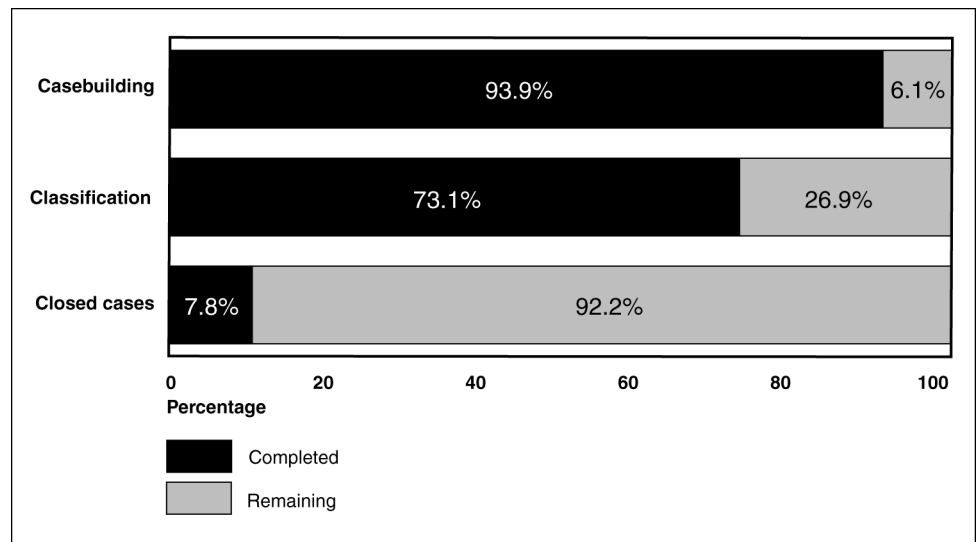
IRS needed to provide training to NRP auditors and to IRS managers and clerks with NRP responsibilities in order for staff members to understand how to use the computer program IRS developed to capture NRP information. Because of some problems IRS encountered in installing the NRP software in offices across the agency, IRS had to delay training some clerks and managers. This led to delays in starting some NRP audits because managers were unable to assign NRP cases to auditors and clerks were unable to assist in loading NRP cases on NRP auditors' laptop computers. IRS resolved these problems and finished delivering the majority of this training by the end of January 2003.

NRP Reviews Are Under Way

IRS is nearly finished creating NRP casebuilding files, has classified nearly three-fourths of the NRP returns, and has begun conducting NRP audits. As of the end of March 2003, IRS completed NRP casebuilding for about 94 percent of the approximately 47,000 returns in the NRP sample and about 73 percent of NRP returns have been classified. Also, for 3,651 NRP cases, IRS completed all necessary audit work. Some of these are cases where correspondence or face-to-face audits are finished, but most of the NRP cases closed so far—2,709—are those that did not require audits. Cases involving audits take longer to complete, so few have been closed thus far. IRS made substantial progress in casebuilding and classification starting in

2002, and the number of cases assigned to NRP auditors has been increasing quickly since January 2003. Figure 2 shows the progress IRS has made in casebuilding, classifying, and closing cases.

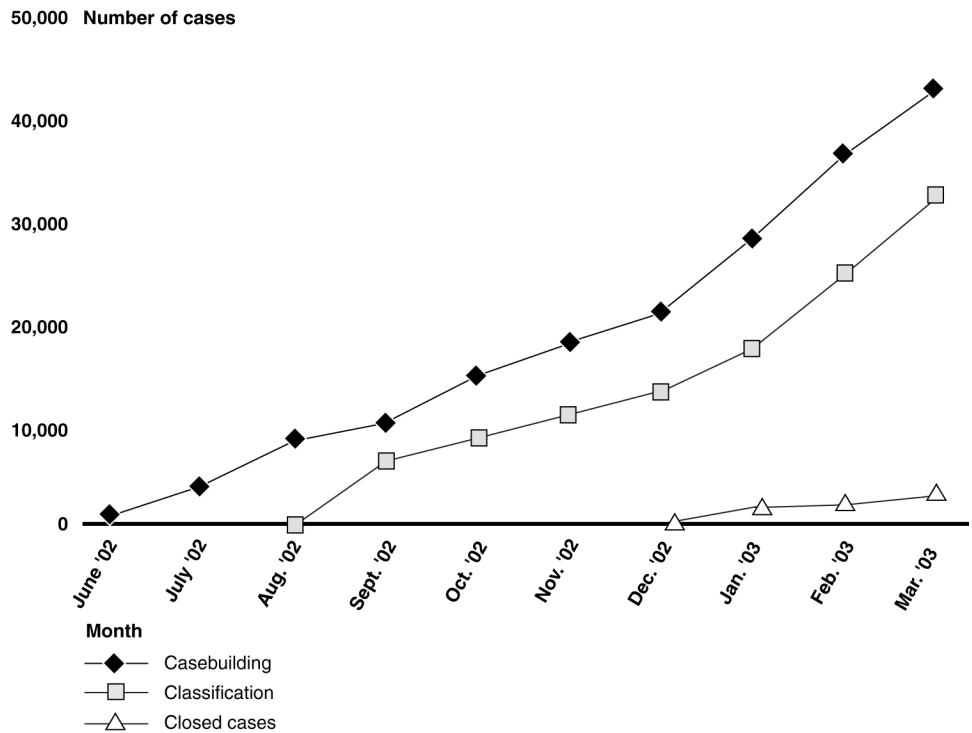
Figure 2: NRP Work Completed and Work Remaining as of the End of March 2003



Source: GAO representation of IRS data.

The number of completed NRP casebuilding files began to grow during the second half of 2002, as shown in figure 3. As figure 3 also illustrates, NRP classification began in September 2002. These were the cases classified during sessions held immediately after classifier training. Over 9,000 NRP returns were classified by the end of October 2002. After these sessions, classification became an area office function, with some offices scheduling weeklong classification sessions on a somewhat regular basis and others classifying returns as they come into the office.

Figure 3: NRP Implementation Progress



Source: GAO representation of IRS data.

Note: Casebuilding and classification data from July through September 2002 are estimates because IRS did not keep monthly records on these processes during this period.

IRS began conducting some NRP audits during November 2002, though these audits began in earnest during the first quarter of 2003. By the end of January 2003, IRS had assigned over 4,600 NRP cases to auditors to begin conducting face-to-face and correspondence audits. By the end of March 2003, about 18,000 taxpayers had been contacted regarding NRP audits.

IRS Has Implemented NRP Quality Assurance Measures

IRS recognizes the need for accurate NRP data and, as planned, has built into the program several measures to ensure the quality of NRP results. IRS designed the NRP classification process to include quality assurance reviews and has added additional quality assurance measures in response to suggestions we made in the course of this engagement. The NRP audit process also includes quality assurance measures that include both in-process and completed case reviews, with all NRP audits reviewed before they are formally closed with the taxpayer. IRS also built accuracy checks into the data capture steps that take place throughout the NRP process.

IRS Is Conducting Classification Reviews on a Sample of Returns

IRS designed NRP classification to include regular reviews of classifiers' decisions. We found that these reviews are generally taking place according to NRP guidelines. We also found that additional measures could further improve NRP classification accuracy, and IRS implemented our suggestions.

NRP guidelines specify that NRP classification reviewers review all cases for which returns are classified as needing either no audit at all or only correspondence audits to confirm their accuracy. Additionally, reviewers must initially review 25 percent of the cases classified by each auditor that are selected for face-to-face audits until they are satisfied with the quality and consistency with NRP guidelines of the classifier's work. After that standard has been met, the guidelines specify that reviewers need only review approximately 10 percent of the cases that each classifier selects for face-to-face audit.

We conducted site visits to five IRS area offices where NRP classification was taking place and found that IRS's plans to implement the classification steps of the program were generally well understood by the classifiers carrying them out. Classifiers were knowledgeable about the differences between the NRP classification process and the classification process used in the enforcement audit environment and supported NRP goals in general. However, we also found instances where NRP classifiers were not consistently following NRP classification guidelines.

Another issue we identified involved the use of the classification review sheets that reviewers fill out when they find problems with classifiers' decisions. We learned that there was no provision for further review of these forms. In some cases, we found that reviewers were not always documenting classification errors on the forms. We discussed with NRP officials the potential benefits of using NRP classification review sheets for more than identifying issues at the area office level. Specifically, we suggested that classification review sheets be forwarded from the area offices to a central location in order to identify problems that may be occurring in different locations around the country or other trends that the NRP Office may need to address during the course of NRP classification. The NRP Office agreed with our suggestion and added centralized review of classification review sheets to its other classification quality assurance measures.

The NRP Office adopted our suggestion that it conduct site visits to area offices to identify NRP classification implementation issues. Similar to the visits we conducted, NRP staff members visited area offices and met with

classifiers, reviewers, and managers to identify issues encountered in carrying out NRP classification and possible areas where NRP guidelines may have been misinterpreted. Among the issues they are asking about is the usefulness of the various materials included in the casebuilding files, information which may prove useful in the design of the casebuilding portion of future iterations of NRP. NRP staff members are also conducting separate reviews of completed classification cases.

NRP Audit Quality Assurance Measures Include a Mix of In-Process and Completed Audit Reviews

IRS has designed NRP to include several steps to identify NRP audit quality problems at both the individual auditor level and across the program. Reviews include quality checks while cases are in progress and after work is complete, and reviews by managers at different levels. Importantly, IRS's plans call for every NRP audit to be reviewed at least once at a point where it is still possible to return to the taxpayer and complete additional audit steps, if necessary. These quality assurance measures will serve to mitigate the risk of IRS including erroneous or incomplete data in the NRP database.

NRP guidelines task group managers with reviewing one open NRP audit for each auditor in the first 90 days of that auditor's NRP activity and another in the first 180 days.⁵ NRP officials intend for these in-process reviews to be extensive and timed early enough in the program to identify individual auditors' misunderstandings of the program, correct them on the audits under review, and prevent them on future NRP audits.

IRS has also created Quality Review Teams both to oversee individual audit cases and identify problems at the area office level and systemically across NRP. These teams are made up of IRS managers and are tasked with checking for compliance with NRP-specific and overall IRS standards on 40 open cases and 20 closed cases for each of IRS's 15 area offices. These reviews will be repeated in each area about once every 3 months throughout the planned 18-month NRP audit period. The IRS standards applied by the teams to the audits they review are the same standards employed by IRS's Examination Quality Measurement System (EQMS).⁶

⁵ Most auditors work in groups headed by group managers. Groups are part of territories, which are part of areas. There are 15 area offices participating in NRP.

⁶ EQMS measures compliance with IRS standards in several areas, including audit planning, timeliness, and depth and how well the auditor considered large, unusual, or questionable items and income on the taxpayer's return.

Similar to the visits NRP officials made to area offices to review classification activities, NRP officials are also visiting area offices to review NRP audit activities. NRP officials said that any systemic issues identified through Quality Review Team reviews will then be addressed across NRP.

Another NRP audit quality assurance element calls for all face-to-face audits to be checked by group managers after work is completed but before the cases are formally closed with the taxpayers. This review will include assessing technical correctness, mathematical accuracy, completeness, and adherence to procedural requirements. IRS officials said that these requirements include adherence to the NRP-specific requirement that audits include verification of all items identified through the NRP classification process. These reviews also include assessing adherence to IRS standards in areas such as audit depth and reviewing large, unusual, or questionable items on the audited return. We were initially concerned that IRS planned for these reviews to take place after NRP audits were completely closed, precluding IRS from reopening the cases or otherwise obtaining additional information from the taxpayers even if the reviewers found that the original NRP audits were incomplete.⁷ However, senior IRS officials informed us in March 2003 that these reviews will take place after NRP auditors consider their audit work to be complete but before the taxpayers are notified that the audits are over. The officials explained that these reviews of all NRP cases will be timed to provide an important means of ensuring that complete and accurate audit results are entered into the NRP database. They also explained that the importance of NRP audit reviews has been stressed throughout NRP implementation and will be the subject of ongoing communication with managers in the field.

It is very important that IRS conduct reviews of NRP audits before they are closed because IRS data show that auditors do not always meet enforcement audit quality standards. In fiscal year 2002, IRS's EQMS found that auditors in the field did not meet the audit depth standard about 15 percent of the time on field audits; the standard for auditing taxpayer income was not met about 25 percent of the time on field audits; and the standard concerning audits of large, unusual, or questionable items was

⁷ After IRS notifies a taxpayer that an audit is closed, IRS may only reopen the audit with the taxpayer in order to correct errors if special circumstances, such as fraud, exist or if reopening the case will benefit the taxpayer.

not met 40 percent of the time on field audits. IRS officials said that accurate audit results in these areas are critical to NRP's overall accuracy.

IRS officials pointed out that the error rate for NRP audits should be lower than in the enforcement audit environment because NRP auditors received special training and because the NRP classification process will enhance NRP audit quality. For example, NRP guidelines call for classifiers to identify large, unusual, or questionable items on returns (the largest EQMS error category) and NRP auditors must address all classified items. However, IRS did not implement its earlier plan of having a selected cadre of auditors work only on NRP cases. While NRP-specific training will serve to prevent many audit errors, NRP audits are now being conducted by a cross section of auditors from IRS field offices across the country and more typical of the auditors who generated the 2002 EQMS error rates. Because every return in the NRP sample represents many returns in the whole population of 1040 filers, even a small number of cases closed with incomplete information could affect the accuracy of NRP data.

IRS officials also noted that their plan to conduct early reviews of NRP cases will identify problems with auditors' understanding of NRP and help to keep them from recurring on subsequent NRP audits. At least two of each NRP auditor's early cases will have extensive manager involvement while the cases are still in progress, and other managers will be looking at a sample of both completed and open cases to identify problems. IRS officials believe that these measures are sufficient to ensure NRP audit quality.

NRP Includes Data Consistency Checks

IRS is including a series of data consistency checks in the NRP database to verify that the information NRP auditors record in IRS's NRP reporting system agrees with the information that IRS recorded from the tax returns earlier in processing. NRP auditors must first record the results of NRP audits in the report-generating software that was modified for NRP purposes. Once auditors have recorded audit results, NRP coordinators must use a data conversion program to transfer the data into a format that the NRP database will accept. Following data conversion, IRS coordinators transfer the audit data to the NRP database.

Once the data are transferred to the NRP database, a series of data consistency checks take place to confirm that the data IRS originally transcribed from the tax return are consistent, within specified tolerances, with the data that NRP auditors recorded in the NRP reporting software. If any of the consistency checks fail for a return in the NRP sample, the NRP

area coordinator will be notified and the mistake will need to be corrected. According to IRS officials, they will impress upon NRP auditors the importance of entering data into the NRP software correctly the first time because it will be time-consuming to correct errors. NRP officials have developed a case tracking system in order to monitor which cases still need to pass all of the consistency tests and which tests they need to pass. IRS officials reported that, as of early April 2003, the NRP database and related programs were running and that completed NRP cases were being entered into the database. They said that they were still making some enhancements, but that the programs were fully functional.

IRS Is Taking Steps to Minimize and Assess Taxpayer Burden

As IRS planned, NRP casebuilding and classification processes are helping minimize the burden on taxpayers with returns in the NRP sample. In addition, the size of the NRP sample is now smaller than IRS expected it to be. However, the number of taxpayers who will be subject to NRP audits has increased. IRS plans to survey taxpayers who receive NRP audits to assess their perceptions of the burden posed by those audits. IRS also used input from tax practitioners to identify ways to improve interactions with taxpayers subject to NRP audits.

NRP Processes Are Helping to Reduce Taxpayer Burden

IRS is following its plans to reduce burden on taxpayers selected as part of the NRP sample by (1) compiling NRP casebuilding materials that allow IRS to verify certain items on tax returns without requesting the information from the taxpayer, (2) classifying returns according to items that need to be verified through an audit, and (3) limiting most NRP audits to items that cannot be verified without an audit. IRS officials also intend to compare classification decisions with the results of NRP audits to identify ways of improving the classification process for future rounds of NRP. Moreover, IRS's intent in carrying out NRP is to reduce the burden on taxpayers in general by developing better audit selection formulas and reducing the number of audits of fully compliant taxpayers.

The NRP casebuilding and classification processes described on page 4 are having their intended effect of reducing the burden NRP creates for taxpayers with returns in the NRP sample. IRS has assembled IRS and third-party data on most of the returns in the NRP sample and classifiers have used these data to verify information on the returns, where possible, without contacting taxpayers. The remaining casebuilding and classification work was under way as of the end of March 2003. The material in the casebuilding files has allowed IRS to fully verify about 10 percent of NRP returns without any audit. Classifiers were able to use the

casebuilding material to verify all but one or two items on another 5 percent of NRP returns, and these were sent for correspondence audits.

Classifiers identified line items needing verification through a face-to-face audit on about 85 percent of NRP returns classified as of the end of March 2003. Because of the casebuilding and classification processes IRS developed for NRP, these audits will generally be limited to line items that cannot be verified using the information in the casebuilding files. This is a substantial change from earlier compliance research efforts, in which all returns were subject to audits of every line on the return. Only the 1,683 taxpayers with returns selected for NRP calibration audits will be subject to complete audits of their returns.

IRS plans to use NRP results to improve future iterations of NRP. For example, NRP officials plan to compare classification outcomes with NRP audit results to help them to identify possible changes needed in casebuilding materials and the NRP classification process. They have told us that it may be possible to further reduce the number of accurately reported line items that are subject to compliance research audits. On the other hand, IRS may also find through NRP calibration audits that classification missed many items that should have been audited, so more line items should receive some form of audit in future rounds of NRP in order for the research results to be useful. IRS also intends to apply lessons learned in NRP classification to classification in the enforcement audit environment.

As we noted in our prior report, NRP should also lead to reductions in taxpayer burden in general. IRS plans to use NRP results to help identify and reduce causes of noncompliance and to better target enforcement audits to noncompliant taxpayers, reducing the number of audits of fully compliant taxpayers. IRS projects that, without improved audit selection formulas based on NRP results, the percentage of enforcement audits that result in no tax change will be about 35 percent higher in 2005 than it was in 1993, the first year that selection formulas from the 1988 compliance study were available. Taxpayer burden will decrease if successful execution of NRP enables IRS to reduce the number of these audits of compliant taxpayers.

NRP Sample Is Smaller Than IRS Initially Estimated

The NRP sample consists of 46,860 tax returns. We reported in June 2002 that the NRP sample would consist of 49,251 returns. The current number is smaller than the initial estimate because IRS originally estimated the NRP sample size based on the characteristics of the filing population that

existed during the 1988 reporting compliance study. According to IRS officials, when they applied the NRP sampling plan to the 2001 filing population, the number of returns necessary to satisfy the requirements for some of the NRP strata declined because filing rates for those strata were smaller than IRS officials had projected.⁸ The final NRP sample consists of about 2,400 fewer returns than initially planned.

IRS Estimates That NRP Classification Will Result in More Audits Than Expected

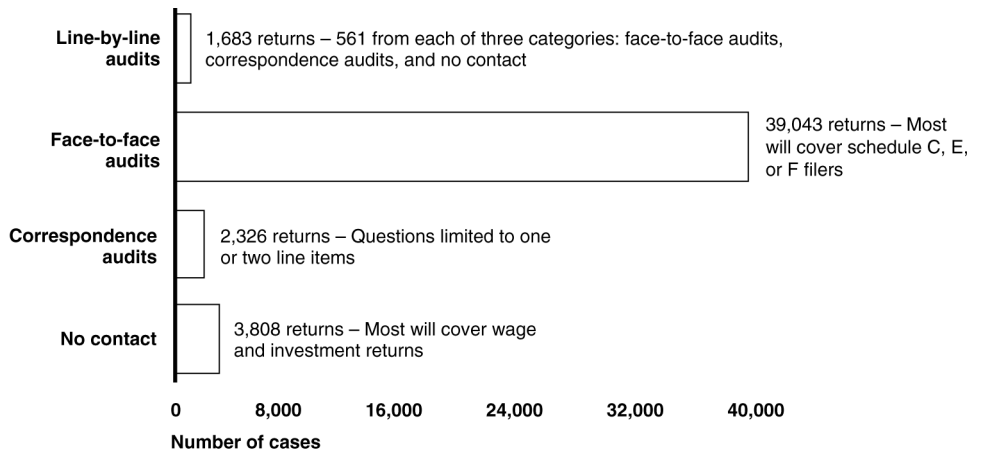
IRS officials are currently finding that the NRP classification results are different than initially planned. IRS now estimates that more face-to-face audits will take place than initially projected because (1) as the NRP plan recognized, IRS's initial estimates were uncertain and based on aging data and (2) the final form of NRP classification guidelines meant more face-to-face and fewer correspondence audits.

IRS initially estimated that out of an NRP sample of over 49,000 tax returns, classification would result in about 30,000 face-to-face audits of selected line items, about 9,000 correspondence audits covering no more than two line items, and about 8,000 taxpayers who would not undergo any audit because classifiers were able to either verify all of the items on their returns or could correct some line items without contacting the taxpayers.

The final NRP sample is 46,860 returns, and IRS now estimates that NRP classification will result in face-to-face audits of about 39,000 taxpayers, with approximately an additional 2,300 receiving correspondence audits and 3,800 subject to no audit at all. IRS also plans to conduct 1,683 line-by-line calibration audits, drawing 561 returns from each of the three classification categories—these numbers have not changed. Figure 4 shows IRS's current estimate of how the three NRP classification categories will be distributed.

⁸ The NRP sample is divided into 30 categories, each of which is referred to as a stratum. Each stratum contains a different type of taxpayer based on the taxpayer's total positive income and the various schedules that the taxpayer filed.

Figure 4: Estimated NRP Sample by Level of Taxpayer Contact



Source: GAO representation of IRS data.

NRP officials explained that the number of face-to-face NRP audits is higher than expected because they were relying on aging data and preliminary classification guidelines. Our 2002 report on NRP also noted the preliminary nature of these estimates. Initial classification breakdown estimates were made using 14-year-old data from the 1988 Taxpayer Compliance Measurement Program study. NRP staff members said that changes in the tax code and in the economic makeup of the filing population since the 1988 study make the returns from that study an unreliable tool for predicting NRP classification results, though that was all they had to work with.

They also said that some of the change can be attributed to changes they made in the final form of NRP classification guidelines. NRP staff members said that they modified the NRP classification guidelines as a result of discussions that took place between NRP staff members and representatives from IRS's business operating divisions. They instituted the changes to the classification guidelines in order to better match the training and skills of the examiners selected to conduct NRP correspondence and face-to-face audits with the types of issues to be covered by those audits. One change is that discrepancies between the casebuilding files and the tax returns for issues such as Individual Retirement Account contributions and Social Security income were removed from the list of issues that could be verified through a correspondence audit. Another change is that the final guidelines call for virtually all business returns to receive face-to-face audits—initial

assumptions about the classification process allowed for some business returns to be accepted as filed or receive only correspondence audits.

IRS Will Survey NRP Taxpayers

IRS will survey taxpayers who are subject to NRP audits to assess overall customer satisfaction and their perceptions of the burden audits created for them. IRS will ask taxpayers to fill out the same survey it uses to assess customer satisfaction in the enforcement audit environment and compare the results for the two populations.

The surveys include issues related to taxpayer burden in the form of questions about the amount of time taxpayers spent preparing for the audits and the amount of time that they spent on the audits themselves. The surveys also ask whether taxpayers receiving NRP audits believe the information that they were asked to provide seemed reasonable and whether they feel they received fair treatment from IRS.

After collecting the survey results, IRS will then develop a “score” for each question on the survey that relates to burden. IRS will compare the results from the NRP customer satisfaction survey to the results from surveys completed after enforcement audits.

IRS Consulted with Practitioners

IRS consulted with outside stakeholders to enhance its efforts to minimize the burden NRP created for taxpayers with returns in the sample. IRS consulted with members of organizations that provide feedback to IRS on matters concerning taxpayers, including the National Public Liaison, the Information Reporting Program Advisory Committee, and the Internal Revenue Service Advisory Council.⁹ According to IRS, practitioner input led to wording changes on taxpayer notification letters and improvements to training materials, which strengthened the emphasis on maintaining good relations with NRP-selected taxpayers. Representatives of the National Public Liaison also participated in the training for the staff members who were selected to conduct NRP auditor training.

⁹ The National Public Liaison coordinates with tax practitioner organizations, other government agencies, and IRS's formal advisory groups to provide a forum for external feedback. The Information Reporting Program Advisory Committee provides input to IRS on reporting issues, and the Internal Revenue Service Advisory Council provides input to IRS on tax administration issues.

Conclusions

IRS continues to be on track for meeting its NRP goal of obtaining meaningful compliance data while minimizing the burden on taxpayers with returns in the NRP sample. IRS has followed the key elements of the plans it laid out last year and has responded to identified needs to modify the program that have come from its own testing as well as from outside stakeholders. Because of this, we are not making any recommendations in this report.

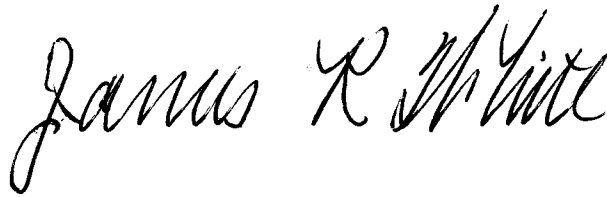
We recognize that IRS efforts to gather information about NRP implementation while the program is under way are very important to IRS's continued success in carrying out NRP. Classification review results, audit review results, and customer satisfaction surveys all provide the means for IRS to make immediate adjustments to NRP now and to enhance the design of future iterations of the program. Provisions for 100 percent review of NRP audits before they are closed are particularly important because even a small number of erroneous or incomplete cases will negatively affect the quality of NRP data.

Agency Comments

On May 22, 2003, we received written comments on a draft of this report from the Commissioner of Internal Revenue (see app. I). The commissioner noted the importance of NRP and IRS's continued emphasis on minimizing taxpayer burden and delivering quality results. We also received technical comments from NRP staff members, which we have incorporated into this report where appropriate.

As agreed with your offices, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days after its date. At that time, we will send copies of this report to the Secretary of the Treasury, the Commissioner of Internal Revenue, and other interested parties. This report is also available at no charge on GAO's Web site at <http://www.gao.gov>.

If you or your staffs have any questions, please contact Ralph Block at (415) 904-2150, David Lewis at (202) 512-7176, or me at (202) 512-9110. Thomas Gilbert was also a key contributor to this assignment.

A handwritten signature in black ink that reads "James R. White". The signature is written in a cursive style with a large, stylized 'J' and 'W'.

James R. White
Director, Tax Issues
Strategic Issues Team

Appendix I: Comments from the Internal Revenue Service



COMMISSIONER

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

May 22, 2003

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

Dear Mr. White:

I reviewed your draft report "Tax Administration: IRS is Implementing the National Research Program as Planned".

The National Research Program's (NRP) approach to measuring compliance continues to emphasize the reduction in taxpayer burden by minimizing the number of taxpayers contacted and shifting much of the burden of data collection from taxpayers to the IRS. The comments you shared with us during the review process have helped us make decisions that will improve the quality of the final NRP data.

Establishing and maintaining a compliance measurement program that employs reliable processes and systems, minimizes taxpayer burden, and delivers quality results is our top priority. As we move into the audit phase of this project, we continue to emphasize these goals, with special attention to assuring consistent, high-quality audit results, that will better identify noncompliant taxpayers, and reduce the burden on compliant taxpayers.

We are planning the next phase of the study, which will measure some components of business compliance, a population we have not formally studied for many years. The project will provide information that will allow us to more efficiently allocate our resources for business taxpayers and provide new information on compliance.

I appreciate the feedback GAO has provided on the National Research Program and welcome your continued support of our efforts to measure voluntary compliance.

Sincerely,

A handwritten signature in black ink, appearing to read "Mark W. Everson".

Mark W. Everson

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