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Before the Subcommittee on Oversight, Committee on Ways and Means, House of Representatives

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## TAX COMPLIANCE

## IRS Audit Trends for Individual Taxpayers Vary by Income

Statement of James R. McTigue, Jr., Director, Strategic Issues

Chairman Pascrell, Republican Leader Rice, and Members of the Subcommittee:

Thank you for the opportunity to discuss recent trends for Internal Revenue Service (IRS) audits of individual taxpayers.<sup>1</sup>

IRS audits individual taxpayers' tax returns to verify whether taxpayers accurately reported their tax liability and, if they did not, to determine whether additional taxes may be owed or refunded.<sup>2</sup> In recent years, IRS has audited a decreasing proportion of individual tax returns. Because audit rates for higher-income taxpayers have seen a larger decline than audit rates for lower-income taxpayers, the tax community has raised concerns about whether IRS is equitably selecting taxpayers for audit.<sup>3</sup> This trend has also raised concerns about the potential for a decline in taxpayers accurately reporting their tax liability. According to various studies, taxpayers are more likely to voluntarily comply with the tax laws if they believe their return may be audited. IRS estimates individual taxpayers underreported their income tax on average by \$245 billion each year for tax years 2011 to 2013.<sup>4</sup>

My testimony today summarizes the findings from our recently issued report on audit trends of individual taxpayers.<sup>5</sup> This testimony will focus

<sup>2</sup>IRS generally uses the terms "audit" and "examination" interchangeably.

<sup>3</sup>The tax community includes congressional committees, research and policy organizations, and the National Taxpayer Advocate, among others.

<sup>4</sup>Underreporting of income tax is the largest component of the tax gap. IRS defines the tax gap as the difference between the amounts of taxes owed and taxes paid voluntarily and timely. IRS issued its most recent tax gap estimate in September 2019. The average annual overall tax gap for tax years 2011 to 2013 is \$441 billion. Misreporting of the Earned Income Tax Credit (EITC), a refundable tax credit for low- to moderate-income working taxpayers, accounts for \$27 billion, or 6 percent of the overall tax gap and 11 percent of the tax gap from individuals underreporting their income tax. See IRS Pub. 1415.

<sup>5</sup>GAO, *Tax Compliance: Trends of IRS Audit Rates and Results for Individual Taxpayers by Income*, GAO-22-104960 (Washington, D.C.: May 17, 2022).

<sup>&</sup>lt;sup>1</sup>Individual taxpayers include married couples, heads of households, as well as individuals. They can be wage earners, self-employed, business owners, or some combination thereof. Individual taxpayers use IRS Form 1040 and related forms and schedules to file their income tax returns. IRS estimated that business income tax underreporting accounted for about 45 percent of total individual income tax underreporting, on average, for tax years 2011 to 2013.

on our findings as they relate to how audit trends vary for taxpayers at different income levels.

To conduct the work on which this statement is based, we analyzed data from audits of individual tax returns reporting various levels of income.<sup>6</sup> We interviewed IRS officials to identify contextual factors and likely reasons for any audit trends. We also reviewed documentation to understand IRS's audit data, budget, and staffing. Additional information on our scope and methodology is available in our report. Our work was performed in accordance with generally accepted government auditing standards.

## Background

IRS audits individual tax returns using three methods: (1) by mail (correspondence audits); (2) in person at IRS offices (office audits); or (3) in person at the taxpayer's home or business, or at a tax practitioner's office (field audit).

IRS concludes audits in three ways:

- If the taxpayer substantiates all items under review, IRS informs the taxpayer that no additional taxes are due or issues a refund.
- If the taxpayer agrees with the additional taxes IRS recommended or does not respond to IRS's notifications, IRS closes the audit and starts assessing and collecting the recommended tax amounts or withholds the refund.
- If the taxpayer disagrees with IRS's recommended tax changes, the taxpayer can attempt to resolve the dispute by meeting with an IRS manager, mediation, filing an appeal, or going to federal tax court. These processes can confirm IRS's initial audit recommendations or result in the taxpayer owing a different amount than IRS recommended.

<sup>&</sup>lt;sup>6</sup>For our analysis, we aggregated IRS Data Book income groupings of taxpayer total positive income. In general, total positive income is the sum of all positive amounts shown for the various sources of income reported on the individual tax return, and losses are treated as \$0. Our analysis reflects an average of audit data for each income group. Actual data within an income group can be above or below the stated result for that group.

	Recently enacted legislation has increased IRS's responsibilities. <sup>7</sup> For example, for tax year 2021, IRS delivered the periodic advance payment of a new expanded child tax credit under the American Rescue Plan Act. At the same time, IRS funding has decreased. According to IRS officials, after adjusting for inflation and anticipated mandatory pay raises, IRS's fiscal year 2021 budget is \$2.7 billion less than in fiscal year 2010—a 22 percent reduction in real terms. <sup>8</sup> Also, IRS has had difficulty replacing audit staff lost from attrition and retirements. <sup>9</sup>
Audit Trends Vary by Taxpayer Income	In our report, we analyzed audit rates by selected income categories, audit outcomes and resources used for auditing individual tax returns across the income categories, and likely reasons for any trends.
	<b>Audit rates.</b> From tax years 2010 to 2019, audit rates of individual tax returns decreased for all income levels. On average, individual tax returns were audited over three times more often for tax year 2010 (about 0.9 percent) than for tax year 2019 (0.25 percent). <sup>10</sup> Audit rates for taxpayers with incomes of \$200,000 and above decreased the most, largely because higher-income audits tend to be more complicated and require auditors to manually review multiple issues, according to IRS officials. Because audit staffing has decreased, IRS cannot conduct as many of these audits, compared to lower-income audits, which are generally less complex and involve more automated processes. In addition, IRS officials
	<sup>7</sup> These responsibilities include implementing provisions of the Patient Protection and Affordable Care Act, the Foreign Account Tax Compliance Act, and the law commonly known as the Tax Cuts and Jobs Act. IRS has also delivered multiple rounds of federal payments totaling more than \$837 billion in over 496 million payments to individuals under the CARES Act and other legislation.
	<sup>8</sup> In addition, in 2021, IRS also received approximately \$1.86 billion in appropriations through the American Rescue Plan Act, Pub. L. No. 117-2, 135 Stat. 4 (2021). For inflation-adjusted IRS funding comparisons from fiscal years 2001 to 2021, see GAO, <i>Tax Filing: 2021 Performance Underscores Need for IRS to Address Persistent Challenges</i> , GAO-22-104938 (Washington, D.C.: Apr. 11, 2022).
	<sup>9</sup> We have recommended that IRS improve its human capital management to address workforce planning and hiring challenges. See GAO, <i>Internal Revenue Service: Strategic</i> <i>Human Capital Management Is Needed to Address Serious Risks to IRS's Mission</i> , GAO-19-176 (Washington, D.C.: Mar. 26, 2019).
	<sup>10</sup> Generally, IRS can include returns filed within the last 3 years in an audit. Because tax year 2019 is still within this 3-year period, the audit rate will increase as additional returns are selected for audit.

stated that the number of returns filed by higher-income populations is growing, meaning more audits are needed to achieve the same audit rate.

Although audit rates decreased the most for higher-income taxpayers during this time period, IRS continued to audit higher-income taxpayers at higher rates than lower-income taxpayers, in general. However, IRS audited taxpayers claiming the Earned Income Tax Credit (EITC) at a higher rate than average (see fig. 1, using tax year 2019 as an example). IRS officials explained that EITC audits are limited in scope and historically have high rates of improper payments and therefore require a greater enforcement presence.<sup>11</sup>

Figure 1: Audit Rates by Total Positive Income and Earned Income Tax Credit (EITC), Tax Year 2019



Source: GAO analysis of Internal Revenue Service data. | GAO-22-106032

Note: In general, total positive income is the sum of all positive amounts shown for the various sources of income reported on the individual tax return, and losses are treated as \$0. Audits of the EITC are included in appropriate income categories and are also shown as a separate category to facilitate comparisons. EITC audits are not double-counted in the average audit rate.

<sup>11</sup>An improper payment is generally defined as any payment that should not have been made or that was made in an incorrect amount (including an overpayment or an underpayment) under a statutory, contractual, administrative, or other legally applicable requirement. See 31 U.S.C. § 3351(4). According to IRS estimates, EITC has consistently had a high improper payment rate. For fiscal year 2020, IRS estimated that \$16 billion—or 23.5 percent—of EITC payments were improper, of which \$15 billion, or 91 percent, are from the inability to authenticate eligibility.

Additional tax recommended. The majority of the total amount of additional tax IRS recommended came from audits of taxpayers with incomes below \$200,000. However, on average, IRS recommended higher amounts of additional tax per audit as income increased (see table 1, using fiscal year 2021 as an example).

## Table 1: Average Recommended Additional Tax per Individual Tax Return Audit, Fiscal Year 2021

Income groups by total positive income	Dollars
\$1 to <\$25K	5,169
\$25K to <\$200K	6,565
\$200K to <\$500K	18,263
\$500K to <\$5M	46,881
\$5M or more	284,810
Earned Income Tax Credit (EITC) only	4,955
Average	9,272

Source: GAO analysis of Internal Revenue Service data. | GAO-22-106032

Note: In general, total positive income is the sum of all positive amounts shown for the various sources of income reported on the individual tax return, and losses are treated as \$0. Audits of the EITC are included in appropriate income categories and are also shown as a separate category to facilitate comparisons. EITC audits are not double-counted in the average audit rate.

**Audit hours.** From fiscal years 2010 to 2021, the average number of hours spent per audit increased about 30 percent, from 5.0 hours to 6.5 hours. Average audit hours were generally stable for lower-income returns but more than doubled for incomes of \$200,000 and above. IRS officials cited auditor attrition, major work disruptions, and tax law changes as the primary reasons for the increase in average audit hours.

Additional tax recommended per audit hour. Audits of the lowestincome taxpayers, particularly those claiming the EITC, resulted in higher amounts of recommended additional tax per audit hour compared to all but the highest income group, as shown in figure 2.





Source: GAO analysis of Internal Revenue Service data. | GAO-22-106032

Note: In general, total positive income is the sum of all positive amounts shown for the various sources of income reported on the individual tax return, and losses are treated as \$0. Audits of the EITC are included in the appropriate income categories and are also shown as a separate category to facilitate comparisons.

IRS officials said they have to invest fewer hours in audits of lowerincome taxpayers, including those claiming the EITC, because many of these taxpayers do not respond to IRS's correspondence or provide adequate responses.<sup>12</sup> In these cases, IRS closes the audits with additional taxes recommended. Audits of the highest-income taxpayer returns require many more audit hours because they are generally more complex and often conducted in-person; however, these audits can generate high amounts of recommended taxes so the recommended additional tax per audit hour is higher than other income groups.

**Additional tax collected.** We found that IRS collected about 47 percent of all recommended additional taxes from individual taxpayer audits closed in fiscal years 2011 to 2020.<sup>13</sup> IRS officials explained that EITC and lower-income audits had higher collection rates because IRS conducts most of these audits before issuing refunds. As a result, IRS already possesses the tax amounts in question. In addition, IRS automatically assesses the recommended tax amounts when taxpayers do not respond to IRS's correspondences.

According to IRS officials, higher-income audits generally had lower collection rates because they are more likely to involve higher recommended tax amounts that may be abated or more difficult to fully collect.<sup>14</sup> They added that the collection rate for audits of taxpayers with income of \$1 million or above depends on a relatively small number of taxpayers. Therefore, a few large payments, such as for 2017, can increase the collection rate.

In conclusion, because over half of the tax gap across tax years 2011 to 2013, on average, can be attributed to the underreporting of individual income tax, auditing individuals' tax returns is a key strategy to ensure tax

<sup>13</sup>Due to data limitations, we used broader income categories than our earlier analysis to determine the amount of recommended taxes IRS collected from audits.

<sup>14</sup>Abatements reduce the amounts that taxpayers owe.

<sup>&</sup>lt;sup>12</sup>The National Taxpayer Advocate has reported that lower-income taxpayers are less likely to respond to IRS notices when audited. For example, IRS closed 35 percent of fiscal year 2019 audits of individual taxpayers with total positive income below \$50,000 without a response from the taxpayer. About 14 percent of these nonresponsive taxpayers may have been unaware of the audit because IRS's initial audit contact notices were returned as undeliverable. Higher-income taxpayers did not respond to audit contact notices 20 percent of the time, with less than 6 percent of these audit notices being returned as undeliverable. See Taxpayer Advocate Service, *National Taxpayer Advocate Annual Report to Congress 2021* (Washington, D.C.: December 31, 2021). For EITC claims, the National Bureau of Economic Research reported that IRS disallowed claims in up to 80 percent of audits analyzed because of undeliverable audit notices or inadequate taxpayer responses to the notices. See National Bureau of Economic Research, *The Effects of EITC Correspondence Audits on Low-Income Earners* (Cambridge, MA: December 2019).

	compliance and address the tax gap. IRS faces difficult decisions about how to optimally allocate audit resources. To ensure fairness and deter noncompliance, IRS must maintain an audit presence across different types of taxpayers and income levels. At the same time, it seeks to maximize the collection of taxes owed and minimize taxpayer burden. Moreover, it must balance these competing goals within the constraints of declining budgets, staff attrition, and hiring challenges. Our analyses highlight the need for continued attention toward addressing these agencywide management challenges, as well as better understanding the return on investment for various audits to inform where improvements can be made.
	Chairman Pascrell, Republican Leader Rice, and Members of the Subcommittee, this completes my prepared statement. I would be pleased to respond to any questions that you may have at this time.
GAO Contact and Staff Acknowledgments	If you or your staff have any questions about this testimony, please contact James R. McTigue, Jr., Director, Strategic Issues at (202) 512- 6806 or mctiguej@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this statement. GAO staff who made key contributions to this testimony are Tom Short (Assistant Director), Elizabeth Fan (Analyst-in-Charge), Jesse Mitchell, and Meredith Moles.

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