March 15, 2007

The Honorable Max Baucus  
Chairman  
Committee on Finance  
United States Senate

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

Subject: Using Data from the Internal Revenue Service’s National Research Program to Identify Potential Opportunities to Reduce the Tax Gap

The Internal Revenue Service (IRS) most recently estimated that the gross tax gap—the difference between what taxpayers pay in taxes voluntarily and on time and what they should pay under the law—reached $345 billion for tax year 2001. The tax gap arises when taxpayers fail to comply with their individual income, corporate income, employment, estate, or excise tax obligations through (1) underreporting of tax liabilities on tax returns; (2) underpayment of taxes due from filed returns; or (3) nonfiling, which refers to the failure to file a required tax return altogether or on time.

IRS’s tax gap estimates are based on a variety of data sources. Recently, IRS studied individual taxpayer compliance through the National Research Program (NRP), and used the resulting compliance data to estimate the tax gap for individual income tax underreporting and the portion of employment tax underreporting attributed to self-employment taxes for tax year 2001. NRP, which involved reviewing around 46,000 individual tax returns, has yielded very important new information on taxpayer compliance for the first time since IRS’s previous compliance measurement study.

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1IRS estimated that it would eventually collect about $55 billion of the gross tax gap through late payments and IRS enforcement actions, leaving a net tax gap of around $290 billion. Unless otherwise noted, references to the tax gap refer to the gross tax gap.

2Self-employed individuals are generally required to calculate and remit Social Security and Medicare taxes to the U.S. Treasury each quarter. As employment taxes and income taxes for self-employed taxpayers are largely assessed on the same income, self-employed individuals who underreport their income consequently underreport the employment tax due on that income.
was undertaken for tax year 1988. Compliance measurement studies such as NRP have the potential to identify ways to improve taxpayer compliance, which could in turn reduce the tax gap and improve the nation’s fiscal stability. For example, each 1 percent reduction in the net tax gap would likely yield around $3 billion annually.

Given its potential to improve individual taxpayer compliance, you asked us to review the results of the 2001 NRP study. In response, we agreed to identify (1) specific areas of individual taxpayer noncompliance that are promising targets for additional research to improve reporting compliance, and (2) opportunities, if any, found through the course of our work to improve future NRP studies.

To identify specific areas of individual taxpayer noncompliance that are promising targets for additional research to improve reporting compliance, we examined IRS’s tax gap estimates for tax year 2001 and the underlying data from NRP upon which IRS based its estimates. We determined that IRS’s tax gap and compliance estimates were sufficiently reliable for the purposes of this engagement based on our previous reviews of the tax gap and NRP data. For a fuller description of how we selected promising targets, see enclosure 1. To identify opportunities, if any, found through the course of our work to improve future NRP studies, we identified weaknesses in NRP that we found during this and other GAO reviews that used NRP data and, based on discussions with IRS research and compliance officials, identified opportunities to address any such weaknesses. We conducted our work from September 2006 through February 2007 in accordance with generally accepted government auditing standards.

On February 28, 2007, we briefed your staff on the results of our work. This report formally conveys the information provided during that briefing (which appears in enclosure 1).

Results

Areas of individual taxpayer noncompliance that are promising targets for additional research to improve reporting compliance include:

- income/losses from partnerships and S corporations,
- income/losses from rental real estate,
- sole proprietor income/losses,
- income/losses from farming,
- other income—net operating losses,
- gambling income/losses,

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• capital gains for assets other than securities,
• other gains/losses,
• Earned Income Tax Credit,
• Additional Child Tax Credit,
• deduction for charitable contributions,
• deduction for medical and dental expenses,
• deduction for job expenses and most other deductions, and
• exemptions.

Our process for selecting these areas and further information on these areas appears in enclosure 1.

IRS could benefit from electronically capturing complete NRP examination case files. Although IRS creates an electronic record for each tax return reviewed for NRP, these records do not contain all of the information contained in the corresponding hard copy examination case files. For example, information taxpayers provide to IRS during examinations is only included in the paper case file and not in the electronic records. Furthermore, some paper case files are not obtainable. For a prior review on the capital gains tax gap for securities, IRS was not able to provide 11 percent of NRP examination case files we requested because complete files could not be located or were being used by IRS units. Having complete electronic NRP examination case files would make it easier for IRS to get the full value from NRP studies because the files could be assessed more easily than hard copy files. Additionally, complete electronic case files would lower the risk of lost files and would allow files to be accessed simultaneously by multiple users. According to IRS research and examination officials, the cost and timing of electronically capturing complete examination case files would vary by how they are made electronic.

Conclusion

NRP is an important research program that could help IRS identify ways to reduce taxpayer noncompliance and the tax gap. An evaluation of NRP data revealed a variety of areas of noncompliance where further research could provide information on how to address noncompliance. However, IRS cannot maximize the value of information it collects through NRP if it cannot locate or efficiently access examination case files.

Recommendation for Executive Action

To ensure that IRS maximizes its return on investment from future NRP studies, IRS should develop a plan for capturing complete NRP examination case files that

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(1) determines the most cost effective means for capturing information electronically and (2) lays out a schedule for when it will begin to capture information electronically.

Agency Comments and Our Evaluation

In commenting on a draft of this report, the Commissioner of Internal Revenue concurred with our recommendation (see enclosure II for the full text of IRS's comments). IRS also provided separate comments on several technical issues, which we 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 from its issue date. At that time, we will send copies to the Chairman and Ranking Minority Member, House Committee on Ways and Means; the Secretary of the Treasury; the Commissioner of Internal Revenue; and other interested parties. We will also make copies available to others upon request. In addition, this letter will be available at no charge on the GAO Web site at http://www.gao.gov.

If you or your staff have any questions, please contact me on (202) 512-9110 or whitej@gao.gov. Contact points for our offices of Congressional Relations and Public Affairs may be found on the last page of this letter. Individuals making key contributions to this report are listed in enclosure III.

James R. White  
Director, Tax Issues  
Strategic Issues Team

Enclosures
Enclosure I

Congressional Briefing on NRP Data

Using Data from The Internal Revenue Service’s National Research Program to Identify Potential Opportunities to Reduce the Tax Gap

Briefing for the Senate Committee on Finance
February 28, 2007

Engagement Objectives

- Analyze data from the Internal Revenue Service’s (IRS) National Research Program (NRP) Tax Year 2001 study of individual taxpayer compliance to identify specific areas of individual taxpayer noncompliance that are promising targets for additional research to improve reporting compliance
- opportunities, if any, found through the course of our work to improve future NRP studies
Background: Taxpayer Noncompliance and the Tax Gap

- The tax gap is the difference between tax amounts that should have been paid voluntarily and on time and what was actually paid for a particular year, and is the result of three types of taxpayer noncompliance:
  - Underreporting—when taxpayers misreport tax liabilities on tax returns filed on time
  - Underpayment—when taxpayers fail to pay on time the taxes due from tax returns filed on time
  - Nonfiling—when taxpayers fail to file a return altogether or on time

Background: IRS’s Most Recent Tax Gap Estimate Is Based on NRP

- IRS reviewed tax returns from tax year 2001 for about 46,000 individual taxpayers, most of whom were subject to a face-to-face examination

- NRP has yielded very important and new information on taxpayer compliance for the first time since IRS’s previous compliance measurement study was undertaken for tax year 1988

- NRP data allowed IRS to update its tax gap estimates for underreporting of individual income taxes and the portion of employment taxes from self employment

- IRS will use NRP data to improve examination selection beginning with tax returns filed in 2006
Background: IRS’s Tax Gap Estimate for Tax Year 2001

Gross tax gap: $345 billion

- Nonfiling $27 billion
- Underpayment $33 billion
- Underreporting $285 billion
  - Individual income tax $197 billion
  - Employment tax $54 billion
  - Corporation income tax $30 billion
  - Estate & excise taxes $4 billion

Source: IRS.

• IRS estimates its enforcement activities, coupled with other late payments, will recover about $55 billion of the tax gap, leaving a net tax gap of $290 billion for tax year 2001

Background: Tax Gap Details

• IRS estimates the tax gap for some specific line items from the individual tax return and in aggregate for other broad categories, such as tax credits and deductions

• For each line item or broad category, IRS estimates include
  • the amount of the tax gap in dollars
  • net misreporting percentage (NMP), which is the net amount misreported on a given line item or category expressed as a percentage of the sum of the absolute values of the amounts that should have been reported for that item or category
### Background: Components of the 2001 Tax Gap for Individual Income Tax Underreporting

<table>
<thead>
<tr>
<th>Type of income or offset</th>
<th>Tax gap amount (dollars in billions)</th>
<th>Net misreporting percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business income</td>
<td>109</td>
<td>43</td>
</tr>
<tr>
<td>Nonbusiness income</td>
<td>56</td>
<td>4</td>
</tr>
<tr>
<td>Credits</td>
<td>17</td>
<td>26</td>
</tr>
<tr>
<td>Deductions</td>
<td>14</td>
<td>5</td>
</tr>
<tr>
<td>Exemptions</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>Adjustments</td>
<td>-3</td>
<td>-21</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>197</strong></td>
<td><strong>18</strong></td>
</tr>
</tbody>
</table>

Source: IRS.

### Background: 2001 Individual Income Tax Gap – Business Income

<table>
<thead>
<tr>
<th>Type of income</th>
<th>Tax gap amount (dollars in billions)</th>
<th>Net misreporting percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Farm income</td>
<td>6</td>
<td>72</td>
</tr>
<tr>
<td>Sole proprietor (nonfarm)</td>
<td>68</td>
<td>57</td>
</tr>
<tr>
<td>Rental real estate, royalties</td>
<td>13</td>
<td>51</td>
</tr>
<tr>
<td>Partnerships, S corporations, estates, and trusts</td>
<td>22</td>
<td>18</td>
</tr>
<tr>
<td><strong>Total business income</strong></td>
<td><strong>109</strong></td>
<td><strong>43</strong></td>
</tr>
</tbody>
</table>

Source: IRS.
### Background: 2001 Individual Income Tax Gap – Nonbusiness Income

<table>
<thead>
<tr>
<th>Type of income</th>
<th>Tax gap amount (dollars in billions)</th>
<th>Net misreporting percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>State income tax refunds</td>
<td>1</td>
<td>12</td>
</tr>
<tr>
<td>Social Security benefits</td>
<td>1</td>
<td>6</td>
</tr>
<tr>
<td>Pensions &amp; annuities</td>
<td>4</td>
<td>4</td>
</tr>
<tr>
<td>Dividend income</td>
<td>1</td>
<td>4</td>
</tr>
<tr>
<td>Interest income</td>
<td>2</td>
<td>4</td>
</tr>
<tr>
<td>Alimony income</td>
<td>&lt;0.5</td>
<td>7</td>
</tr>
<tr>
<td>Wages, salaries, tips</td>
<td>10</td>
<td>1</td>
</tr>
<tr>
<td><strong>Total nonbusiness income</strong></td>
<td><strong>$56</strong></td>
<td><strong>4</strong></td>
</tr>
</tbody>
</table>

Source: IRS.

### Background: 2001 Individual Income Tax Gap – Credits, Deductions, and Exemptions

<table>
<thead>
<tr>
<th>Type of offset</th>
<th>Tax gap amount (dollars in billions)</th>
<th>Net misreporting percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credits</td>
<td>$17</td>
<td>26</td>
</tr>
<tr>
<td>Deductions</td>
<td>14</td>
<td>5</td>
</tr>
<tr>
<td>Exemptions</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>Adjustments</td>
<td>-3</td>
<td>-21</td>
</tr>
<tr>
<td>Self-employment tax deduction</td>
<td>-4</td>
<td>-51</td>
</tr>
<tr>
<td><strong>All others adjustments</strong></td>
<td>1</td>
<td>6</td>
</tr>
</tbody>
</table>

Source: IRS.
Methodology: Selecting Targets for Additional Research

To select promising targets for additional research to improve reporting compliance, we followed a three-stage methodology:

- **Stage 1**—from IRS’s tax gap estimates, we identified specific line items from the individual tax return or broad categories (e.g., credits, deductions) with
  - a net misreporting percentage of 5 percent or greater and
  - a tax gap amount of $1 billion or greater

- **Stage 2**—to determine what specific line items appear to drive noncompliance within broad categories that met the criteria from stage 1, we
  - reviewed IRS’s compliance estimates from the raw NRP data (which differ from the tax gap because of additional information IRS uses to estimate the tax gap) to identify line items with
    - a net misreporting percentage of 5 percent or greater
    - an estimated dollar amount of net misreporting of $3 billion or greater and
    - an average misreported amount of $450 or greater per taxpayer
Methodology: Selecting Targets for Additional Research

- Stage 3—to determine which identified areas of noncompliance would be promising targets for future research with the end result of improving compliance, we
  - obtained the views of IRS examiners and compliance officials
  - determined if the type of income or expense was subject to tax withholding or information reporting, which have been shown to lead to high levels of compliance

Methodology: Opportunity to Improve Future NRP Studies

- To identify opportunities, if any, found through the course of our work to improve future NRP studies, we
  - identified weaknesses in NRP that we found during this and other GAO reviews that used NRP data and,
  - based on discussions with IRS research and compliance officials, identified opportunities to address any such weaknesses
Based our methodology, we identified the following promising targets for additional research to improve reporting compliance:

- income/losses from partnerships and S corporations
- income/losses from rental real estate
- income/losses from farming
- sole proprietor income/losses
- “other” income–net operating losses
- gambling income/losses
- capital gains for assets other than securities
- other gains/losses
- Earned Income Tax Credit
- Additional Child Tax Credit
- deduction for charitable contributions
- deduction for medical/dental expenses
- deduction for job expenses and most other deductions
- exemptions

For each promising target for additional research to improve reporting compliance, potential questions to evaluate are:

- What is the extent of, and reasons for, noncompliance?
- How does IRS address the noncompliance and what challenges, if any, does it face?
- What are options to improve compliance (legislative or administrative)?
Targets for Additional Research: Income and Losses from Partnerships and S Corporations

<table>
<thead>
<tr>
<th>Net misreporting percentage</th>
<th>Tax gap amount (billions of dollars)</th>
<th>Percentage of individual income tax underreporting tax gap</th>
</tr>
</thead>
<tbody>
<tr>
<td>18</td>
<td>$22</td>
<td>11</td>
</tr>
</tbody>
</table>

- The above NMP and tax gap figures include income from estates and trusts, but the NRP data show that partnerships and S corporations are the primary drivers of noncompliance for this area.
- NMP and share of individual income tax underreporting tax gap have increased for this line item from about 8 percent and about 4 percent for tax year 1988, respectively.
- The 2001 NRP studied the income and losses passed through to taxpayers from these entities; IRS is currently studying compliance of S corporations.

Targets for Additional Research: Income and Losses from Partnerships and S Corporations

- Losses that taxpayers can deduct from partnerships and S corporations may be limited by “at risk” and passive activity loss rules.
- Taxpayers' losses and deductions from S corporations are limited to the adjusted basis of the taxpayers' stock and any debt the corporations owe to the taxpayers.
- IRS and the tax courts have determined that some S corporation owners improperly treat payments for services they perform as corporate distributions or dividends instead of salaries to avoid employment taxes.
### Targets for Additional Research: Income and Losses from Rental Real Estate

<table>
<thead>
<tr>
<th>Net misreporting percentage</th>
<th>Tax gap amount (billions of dollars)</th>
<th>Percentage of individual income tax underreporting tax gap</th>
</tr>
</thead>
<tbody>
<tr>
<td>51</td>
<td>$13</td>
<td>7</td>
</tr>
</tbody>
</table>

- These NMP and tax gap figures include income from royalties, but the NRP data show that rental real estate is the primary driver of noncompliance for these two income sources, as, collectively, taxpayers overreported their income from royalties.
- NMP and share of individual income tax underreporting tax gap have increased for this line item from about 17 percent and about 3 percent for tax year 1988, respectively.

### Targets for Additional Research: Income and Losses from Farming

<table>
<thead>
<tr>
<th>Net misreporting percentage</th>
<th>Tax gap amount (billions of dollars)</th>
<th>Percentage of individual income tax underreporting tax gap</th>
</tr>
</thead>
<tbody>
<tr>
<td>72</td>
<td>$5</td>
<td>3</td>
</tr>
</tbody>
</table>

- NMP has increased for this line item from about 32 percent for tax year 1988, while the share of the tax gap remains largely unchanged.
- Deductions for losses from farming activities not carried on with the intent of profits, such as for hobby or recreation activities, are limited.
- The Internal Revenue Code provides that activities, such as farming, are presumed to be carried on for profit if a profit is produced in at least 3 out of the last 5 years.
- Taxpayers cannot deduct expenses for anything raised for personal use.
### Targets for Additional Research: Sole Proprietor Income and Losses

<table>
<thead>
<tr>
<th>Net misreporting percentage</th>
<th>Tax gap amount (billions of dollars)</th>
<th>Percentage of individual income tax underreporting tax gap</th>
</tr>
</thead>
<tbody>
<tr>
<td>57</td>
<td>$68</td>
<td>35</td>
</tr>
</tbody>
</table>

- Accounts for largest share of the entire tax gap
- GAO is reviewing sole proprietor tax compliance under a separate engagement that will
  - identify specific options that could improve compliance
  - use data sources in addition to NRP

### Targets for Additional Research: Other Income

<table>
<thead>
<tr>
<th>Net misreporting percentage</th>
<th>Tax gap amount (billions of dollars)</th>
<th>Percentage of individual income tax underreporting tax gap</th>
</tr>
</thead>
<tbody>
<tr>
<td>64</td>
<td>$23</td>
<td>12</td>
</tr>
</tbody>
</table>

- NMP and share of individual income tax underreporting tax gap have increased for this line item from 25 percent and 9 percent for tax year 1988, respectively
- IRS does not have separate NMP or tax gap estimates for the various types of income or losses taxpayers report as other income, which IRS estimated taxpayers to have reported for 2001 as follows:
  - other income: $28.2 billion
  - gambling income: $17.1 billion
  - net operating losses: ($54.5 billion)
  - exclusion of foreign income: ($13.9 billion)
  - other net losses: ($8.7 billion)
Targets for Additional Research: Other Income—Net Operating Loss (NOL)

- Taxpayer can carry back or carry forward certain losses to previous or subsequent years
- The NRP data show that taxpayers misreported these net operating losses

Targets for Additional Research: Gambling

- Taxpayers are to report gambling winnings as other income and report gambling losses as a miscellaneous, itemized deduction
- Withholding and information reporting may apply to gambling winnings; reporting is not required for gambling losses
- The NRP data show that taxpayers misreported gambling losses
### Targets for Additional Research: Capital Gains for Assets Other Than Securities

<table>
<thead>
<tr>
<th>Net misreporting percentage</th>
<th>Tax gap amount (billions of dollars)</th>
<th>Percentage of individual income tax underreporting tax gap</th>
</tr>
</thead>
<tbody>
<tr>
<td>12</td>
<td>$11</td>
<td>6</td>
</tr>
</tbody>
</table>

- NMP increased for this line item from about 7 percent for tax year 1988, while the share of the tax gap remains largely unchanged.
- GAO recently reported on ways to improve compliance for capital gains from securities (GAO-06-603).
- In reviewing securities reporting compliance, we found that taxpayers misreported capital gains for these other assets:
  - residential rental property
  - residences
  - ownership in an S corporation, partnership, estate, or trust
  - land, including farmland
  - business personal property and real estate
  - other assets

### Targets for Additional Research: Other Gains and Losses

<table>
<thead>
<tr>
<th>Net misreporting percentage</th>
<th>Tax gap amount (billions of dollars)</th>
<th>Percentage of individual income tax underreporting tax gap</th>
</tr>
</thead>
<tbody>
<tr>
<td>64</td>
<td>$3</td>
<td>2</td>
</tr>
</tbody>
</table>

- NMP and share of individual income tax underreporting tax gap have increased for this line item from about 28 percent and about 1 percent for tax year 1988, respectively.
- Other gains and losses include those for the sale of business property.
- When selling business property, taxpayers must determine whether to report gains or losses as capital or ordinary.
Targets for Additional Research: Earned Income and Additional Child Tax Credits

- IRS estimates noncompliance for these credits jointly
- IRS does not separately estimate the tax gap for these credits, but estimated that taxpayers misreported $14.3 billion in claiming these two credits
- In a separate study for 1999, IRS estimated a tax loss of up to $10 billion for the Earned Income Tax Credit

Targets for Additional Research: Deductions for Charitable Contributions

- IRS does not separately estimate the tax gap for these deductions, but estimated that taxpayers misreported $13.6 billion in deductions for charitable cash contributions and $3.8 billion in deductions for charitable noncash contributions
- Taxpayers are required to keep records of their contributions
  - Taxpayers must have written acknowledgment from charities for contributions of $250 or more
  - A 2006 law requires that taxpayers must keep bank records or written acknowledgment from charities for all cash contributions (previously, taxpayers could use reliable, written records to substantiate cash contributions of less than $250)
- Generally, charities are not required to report taxpayers’ charitable contributions to IRS
Targets for Additional Research: Deduction for Medical and Dental Expenses

- IRS does not separately estimate the tax gap for these deductions, but estimated that taxpayers misreported $7.6 billion in deductions of medical and dental expenses.
- Taxpayers can deduct the portion of certain medical expenses that exceed 7.5 percent of their adjusted gross income.

Targets for Additional Research: Deduction for Job Expenses and Most Other Deductions

- IRS does not separately estimate the tax gap for these deductions, but estimated that taxpayers misreported $24.3 billion in deductions of job expenses and most other miscellaneous deductions (which IRS estimates jointly).
- Taxpayers can deduct job expenses and certain miscellaneous deductions that exceed 2 percent of their adjusted gross income, such as:
  - unreimbursed employee expenses
  - tax preparation fees
  - certain legal and accounting fees
### Targets for Additional Research: Exemptions

<table>
<thead>
<tr>
<th>Net misreporting percentage</th>
<th>Tax gap amount (billions of dollars)</th>
<th>Percentage of individual income tax underreporting tax gap</th>
</tr>
</thead>
<tbody>
<tr>
<td>5</td>
<td>$4</td>
<td>2</td>
</tr>
</tbody>
</table>

- NMP remains largely unchanged from tax year 1988, while the share of the tax gap has decreased from about 5 percent
- Taxpayers can usually claim exemptions for themselves, spouses, and qualified dependents (children and relatives)

### Targets for Additional Research: Areas Not Selected

- Other areas of noncompliance that met the first stage of selection criteria (or are within a broad category that met the initial criteria), but failed to meet subsequent criteria are
  - state income tax refunds
  - Social Security benefits
  - all other credits
  - deduction for state and local income taxes
  - deduction for real estate taxes
  - deduction for personal property and other taxes
  - deduction for home mortgage interest and points
  - deduction for investment interest
  - deduction for charitable contribution carryovers
  - deduction for casualty or theft losses
  - other miscellaneous deductions
Opportunity to Improve Future NRP Studies: NRP Examination Case Files

- For NRP, IRS maintains electronic records for each tax return reviewed in addition to hard copy case files for each examination.
- IRS’s research organization and GAO sometimes review examination case files to learn more about a particular compliance issue.
- However, IRS’s electronic records do not contain all of the information developed during examinations, and IRS cannot consistently locate its paper files.

Opportunity to Improve Future NRP Studies: NRP Examination Case Files

- NRP electronic records contain examination results such as the amount of income adjustments examiners made.
- Only NRP hard copy examination case files contain additional information such as documents provided by taxpayers during examinations.
Opportunity to Improve Future NRP Studies: NRP Examination Case Files

• GAO requested examination case files from IRS for two recent engagements.
• For our review of compliance for capital gains from securities, we requested 1,043 NRP examination case files, but IRS was not able to provide 115 (11 percent) of them.
• For our ongoing work focused on sole proprietors, we requested 250 case files but IRS has not provided 38 (15 percent) of them.
• Paper case files were sometimes not available because IRS could not locate them, and sometimes because they were being used by IRS units.

Opportunity to Improve Future NRP Studies: Benefits of Electronic Examination Case Files

• Having complete electronic NRP examination case files would make it easier to get the full value from NRP studies because the files could be accessed more easily than hard copy files.
• Additionally, complete electronic case files would lower the risk of lost files and allow files to be accessed simultaneously by multiple users.
Opportunity to Improve Future NRP Studies: Costs of Electronic Examination Case Files

- According to IRS research and examination officials, the cost and timing of electronically capturing complete examination case files would vary by how they are made electronic; options include
  - having examiners input all information on examination results into an electronic system
  - using an “imaging” process to import information from hard copy files into an electronic system
  - scanning hard copy files as stand-alone electronic documents

Conclusion

- Evaluation of NRP data reveals a variety of areas of noncompliance where further research could provide information on how to address noncompliance
- IRS cannot maximize the value of information it collects through NRP if it cannot locate or efficiently access examination case files
Recommendation

- To ensure that IRS maximizes its return on investment from future NRP studies, IRS should develop a plan for capturing complete NRP examination case files that
  - determines the most cost-effective means for capturing information electronically
  - lays out a schedule for when it will begin to capture information electronically
March 14, 2007

Mr. James R. White
Director, Tax Issues
Strategic Issues Team
United States Government Accountability Office
Washington, DC  20548

Dear Mr. White:

Thank you for the opportunity to respond to your draft report entitled "Using Data from the Internal Revenue Service’s National Research Program to Identify Potential Opportunities to Reduce the Tax Gap" (GAO-07-423R).

We appreciate that your report notes the importance of the Internal Revenue Service’s (IRS) National Research Program (NRP) for identifying ways to reduce taxpayer noncompliance and to estimate the tax gap. The Government Accountability Office’s support for these efforts has helped improve operations at the IRS.

We concur with the recommendation that electronically capturing complete NRP examination case files would be beneficial to the IRS. Accordingly, the IRS will explore options for cost-effective ways to electronically capture and store this data.

A response to the recommendation is enclosed. If you have any questions, please call me or a member of your staff may contact Mark Mazur, Director of the Office of Research, Analysis, and Statistics, at (202) 874-0100.

Sincerely,

Mark W. Everson

Enclosure
Enclosure II

To ensure that IRS maximizes its return on investment from future NRP studies, GAO recommends:

Recommendation:

IRS should develop a plan for capturing complete NRP examination case files that (1) determines the most cost effective means for capturing information electronically and (2) lays out a schedule for when it will begin to capture information electronically.

Response:

We concur that ready access to case file information is beneficial to the IRS and that we should determine the most cost effective means to capture this information. Case files from prior research studies under the Taxpayer Compliance Measurement Program (TCMP) were captured via microfiche, a procedure that was appropriate when those studies were conducted. NRP will consider all means, electronic or other, for accomplishing this objective. NRP has already implemented procedures for electronic capture of selective case file information. Examiner reports (i.e. Forms 4605, 4549, 886zc and 5344) for the current NRP reporting compliance study of S corporation returns are imaged and captured in the Reports Generation Software (RGS). Also, NRP is developing procedures to integrate the process of imaging tax returns into the case building process for the next NRP reporting compliance study. These imaged files will be readily accessible for case processing and research activities. However, we recognize that these procedures do not encompass capture of other case file information such as examiner workpapers and copies of source documents obtained from taxpayers. NRP and SB/SE staff will explore options for developing a plan and procedures to capture and store complete case file information contingent on there being cost effective ways of capturing that information.
Enclosure III

Contact and Staff Acknowledgments

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