

March 2000

**TAX  
ADMINISTRATION**

**IRS' Use of Nonaudit  
Contacts**



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**G A O**

Accountability \* Integrity \* Reliability

**United States General Accounting Office  
Washington, D.C. 20548**

**General Government Division**

B-283064

March 16, 2000

The Honorable Bill Archer  
Chairman, Committee on Ways and Means  
House of Representatives

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

In 1998, over 123 million individual taxpayers filed income tax returns. For most, this ended their interaction with the Internal Revenue Service (IRS) for the year. However, IRS audits about 1 percent of taxpayers with respect to the tax liability reported on their returns.<sup>1</sup> IRS also uses several types of nonaudit contacts to notify millions of additional taxpayers about potential errors in their reported tax liability.<sup>2</sup> IRS has publicly provided little information about such nonaudit contacts.

In 1998, Congress passed the IRS Restructuring and Reform Act to better balance compliance and service to taxpayers, among other things. As required by the act, IRS developed a new mission statement, providing for equal treatment of taxpayers with respect to compliance and taxpayer service as well as for operating efficiency. Although both audit and nonaudit contacts primarily focus on ensuring that taxpayers report the correct tax liability, they also must reflect mission objectives, such as balancing compliance and taxpayer service.

You asked us to describe IRS' use of nonaudit contacts with taxpayers. In response to your request, this report discusses the math error program, underreporter program,<sup>3</sup> and notices sent to taxpayers regarding duplicate Social Security Numbers (SSN) and potential errors on self-employment taxes. These programs are the major types of nonaudit contacts about

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<sup>1</sup>Audits are examinations of taxpayers' books and records by IRS auditors, either face-to-face or by correspondence.

<sup>2</sup>IRS makes many types of nonaudit contacts to improve compliance and to help it better serve taxpayers. We focused only on three of the programs where IRS contacts taxpayers about their reported tax liability. App. I provides a fuller description of these nonaudit contacts.

<sup>3</sup>In 1997, IRS changed the name of the Underreporter Program to the Individual Master File/Business Master File Reconciliation Program. Because we are dealing only with contacts of individual taxpayers, we use the previous name of the program in this report to help avoid confusion.

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reported tax liability. Specifically, the report describes the frequency of use, variation in timing, and types of taxpayer responses for the three major types of nonaudit contacts; to provide a frame of reference, we also describe these features for audit contacts. Also in response to your request, this report analyzes IRS' use of data from the three types of nonaudit contacts to improve compliance and service to taxpayers.

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## Results in Brief

During 1998, IRS contacted almost 11 million taxpayers through at least one of the nonaudit or audit contact programs we reviewed.

- About 6 million contacts were made through the math error program, which is designed to correct arithmetic and other errors, such as incorrect SSNs.
- About 2 million contacts were made through the underreporter program, which is designed to match income data reported on information returns by payers, such as employers and banks, to income reported by taxpayers on tax returns.
- About 2 million contacts were made through two types of soft notices<sup>4</sup>—one when more than one taxpayer claimed the same SSN for tax exemptions or other tax benefits and the other when a taxpayer had a potential self-employment tax liability but had not paid it.
- About 1 million contacts were made through audits, which involve examinations of taxpayer books and records for one or more income, deduction, credit, or other tax issue on the tax return.

The timing of the types of contacts varies. For example, math error notices are issued shortly after a return is filed. Initial underreporter notices are sent between 8 and 10 months after the April due date for the return. Soft notices are sent from 4 to 8 months after a return is filed. The start of audit contacts can range from months to years after a return is filed, but the audits are usually required to be finished within 3 years of filing. A number of reasons explain the different starting times for each type of contact.

These contacts also vary in how taxpayers are to respond. Math error and soft notice contacts do not ask taxpayers to respond by providing additional information. Nevertheless, some taxpayers may respond, for example, by filing amended returns or asking questions. Both underreporter and audit contacts usually ask taxpayers to provide

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<sup>4</sup>IRS refers to these contacts as "soft notices" because the notices do not make demands. Instead, the notices provide information about the potential error to the taxpayers involved and ask them to review their records and make corrections, if necessary. IRS does not assess tax in this program because it is not sure which taxpayer is entitled to the exemption or whether the taxpayer actually owes the self-employment tax.

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information about the reported tax liability and to eventually either agree or disagree with any changes to it. In addition, depending on the type of contact, taxpayers have different ways to dispute any changes to their tax liability.

IRS collects some data on nonaudit contacts, such as caseload and the amount of tax change, to help administer the programs. However, IRS does not regularly collect data that could be used to identify ways to improve taxpayer compliance and service. For example, IRS does not always collect data on why taxpayers did not comply or whether they repeated their noncompliance in the future. Without such data, IRS cannot know the areas in which taxpayers need clarification or how well the programs are meeting the goals of improving compliance and serving taxpayers. IRS officials said that such data has not been collected because of problems in their information systems and questions about the cost-effectiveness of collecting the data for all types of contacts.

We are recommending that IRS start to collect and analyze data on targeted types of contacts for each program in order to help meet its compliance and service goals. For the longer term, we are recommending that IRS, as it modernizes its information systems, determine a cost-effective way to collect such data for the types of contacts that can affect these goals.

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## Background

IRS' efforts to check whether taxpayers reported the correct tax liability begin as tax returns for a specific year are being processed and can continue for up to 3 years. Throughout this time, IRS must maintain staff to respond to taxpayer questions, process payments and amended returns, and prepare refund checks associated with these notices.

Historically, IRS' primary mission has been to collect the proper amount of tax at the least cost to the government. With the passage of the Restructuring and Reform Act, Congress sought to provide a more balanced environment in which IRS would focus on both compliance and taxpayer service. In addition to mandating that IRS revise its mission statement to achieve this balance, the act directed IRS to reorganize its structure, moving away from a geographical organization to one that focuses more on groups of similar taxpayers (e.g., individuals and small business). IRS has revised its mission statement and plans to have a new organization operational by the 2002 filing season.

## Scope and Methodology

To determine the frequency of use, variation in timing, and types of taxpayer responses for the three major types of nonaudit contacts as well as for audit contacts, we talked to responsible IRS officials. We obtained regulations governing the programs and requested information on the mission, objectives, and features for each program. We concentrated on math error, underreporter, and soft notices because they were the major IRS nonaudit contacts involving the reported tax liability on filed returns. We also included the soft notices because they were a new approach that IRS might use increasingly in the future.

To analyze information on IRS' use of data on these nonaudit contacts to improve compliance and service to the taxpayer, we talked to officials in IRS' Customer Service Division, Submission Processing Division, Research Division, and the Office of Program Evaluation and Risk Analysis. We also obtained the data available for each of the programs and discussed how the data could be used with these IRS officials.

We performed our work at IRS' headquarters offices in Washington, D.C., and New Carrollton, Maryland; the Western Region; and IRS' Fresno Service Center. We chose the Western Region and Fresno Service Center because we had staff available in these areas. Our work was done between June and December 1999 in accordance with generally accepted government auditing standards.

We requested comments on a draft of this report from the Commissioner of Internal Revenue. We received written comments from the Commissioner and on February 15, 2000, we received oral comments from representatives of the Commissioner in the Customer Service Division, Forms and Submission Processing Division, and the Office of Legislative Affairs. These comments are discussed near the end of this letter, and the written comments are reprinted in appendix II.

## Frequency, Timing, and Taxpayer Responses for Major Types of Nonaudit and Audit Contacts

IRS uses various types of contacts to check whether taxpayers reported the correct tax liability on their filed returns. IRS' most commonly used taxpayer contact programs include math error, underreporter, soft notice, and audits. The following defines each program.

- In the math error program, IRS uses computer comparisons and calculations to correct clerical and mathematical errors on tax returns. These corrections involve addition and subtraction errors; incorrect SSNs, filing status and exemptions; and missing schedules or forms. IRS analysts review the validity of the proposed correction identified by the computer before IRS notifies taxpayers.

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- In the underreporter program, IRS matches income reported on tax returns with income reported by third-party payers, such as banks and employers. If a return amount does not match the amount reported by a payer, the taxpayer may be sent a notice requesting additional information or indicating that IRS is proposing a change in the tax liability. IRS' analysts review the discrepancies noted by the computer to see whether they can resolve the discrepancies and avoid contacting taxpayers.
  - IRS currently sends two types of soft notices, one to taxpayers whose return cites a dependent or spouse SSN that has been used on at least one other return and another to taxpayers who report business-type income but fail to pay self-employment tax. Soft notices ask taxpayers to review their returns for errors but do not assess additional tax. IRS cannot assess the tax because it does not know for sure that an error has been made or which taxpayer made an error. For example, it is likely that at least one of the two or more taxpayers claiming the same SSN is entitled to claim it. Rather than assessing tax, soft notices are intended to educate taxpayers about their responsibilities for filing a correct return and to encourage them to correct any errors.
  - Audits are reviews of a taxpayer's books and records through either correspondence from 1 of IRS' 10 service centers or through face-to-face meetings at 1 of IRS' 33 field offices or at the taxpayer's place of business. Audits often cover tax issues that are more complex than those covered by other types of contacts and generally require a more complete review of the taxpayer's support for claims made on the tax return.

IRS uses nonaudit and audit contacts to help check whether taxpayers are reporting the correct tax liability. The features of each type of contact differ. The following sections discuss these differences as well as any similarities in the frequency of the contacts, the timing of the contacts, and the ways in which taxpayers can respond to the contacts.

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## Frequency of Contacts

As part of its responsibility to ensure that taxpayers neither overstate nor understate their reported tax liability, IRS contacted almost 11 million taxpayers in 1998 through the math error, underreporter, soft notice (duplicate SSN and self-employment tax), and audit programs. Table 1 summarizes the frequency of each of these types of contacts.<sup>5</sup>

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<sup>5</sup>App. I also provides more detailed information on the frequencies for the various types of math error and underreporter contacts.

**Table 1: Frequency of Contacts in IRS' Three Nonaudit and Audit Programs**

Type of contact	Contacts	
	Number	Percent
Math error	5,659,674 <sup>a</sup>	52.7
Underreporter	1,978,752 <sup>b</sup>	18.4
Soft notice		
Duplicate SSN	1,586,015 <sup>c</sup>	14.7
Self-employment tax	329,000 <sup>c</sup>	3.1
Audits	1,192,780	11.1
<b>Total contacts</b>	<b>10,746,221</b>	<b>100.0</b>

<sup>a</sup>The number of taxpayers contacted during calendar year 1998 about their tax year 1997 income tax return. IRS sent notices to another 300,000 taxpayers for pre-1997 tax returns filed during 1998.

<sup>b</sup>The number of taxpayers contacted during calendar year 1998 about their tax year 1995 and 1996 income tax returns.

<sup>c</sup>The number of taxpayers contacted during calendar year 1998 on tax year 1996 and 1997 income tax returns.

Source: GAO analysis of IRS data.

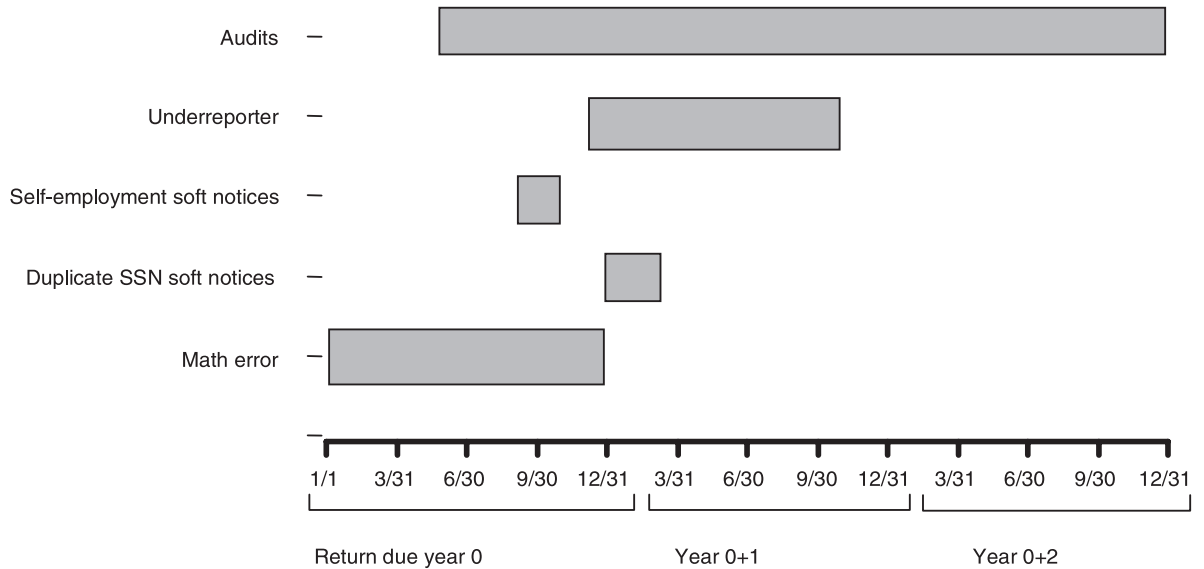
The number of actual or potential errors that IRS identifies when processing returns drives the frequencies for math error and soft notice contacts. Notices are to be sent for almost all such errors identified. For underreporter and audit contacts, the frequencies depend, among other things, on the resources available to make the contacts. For example, in 1998, IRS' underreporter program identified almost 12 million taxpayers whose reported income on tax returns did not match income reported by payers, but IRS contacted fewer than 2 million of these taxpayers about the discrepancies. Ten million cases were excluded for such reasons as the discrepancy being less than IRS' minimum tolerance amount and IRS not having the resources available to review returns and respond to taxpayer questions.

## Variation in the Timing of the Contacts

The timing of audit and nonaudit contacts varies in terms of when they start and end. Math error contacts start shortly after a return is filed and often end when the contact is made. Audit contacts can start as late as several years after returns are filed and last more than a year. Other types of contacts fall between these timeframes. Figure 1 shows the range of time periods during which IRS can start the audit and nonaudit contacts.



Figure 1: Range of Time Periods for Starting IRS Contacts



Source: GAO analysis of IRS data from each of the programs.

Math error notices are the earliest nonaudit contact that IRS initiates. IRS prepares and mails math error notices as tax returns are being processed. As a result, the starting point for making these contacts depends on when taxpayers file their returns. The contacts end when taxpayers receive the notice, unless they have questions for IRS, file an amended tax return to make corrections, or otherwise disagree with the changes that IRS made to their return.

IRS sends the two types of soft notices at different times. Notices for self-employment tax are to be sent in August of the year the return is filed. Duplicate SSN notices are to be sent in December of the year the return is filed and January of the following year. Although duplicate SSN notices could be sent sooner, IRS wants to send the notices as close to the next filing season as possible to maximize the impact on taxpayer behavior.<sup>6</sup> These contacts are also considered as completed when taxpayers receive the notice, unless they have questions, file an amended return, or otherwise disagree with IRS.

<sup>6</sup>IRS officials said they would like to send the self-employment notices in December also, but send them in August to spread out the workload for IRS staff that will have to deal with any taxpayer responses to the notices.

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IRS begins sending initial underreporter notices in December of the year the return is filed. IRS finishes sending initial notices by October of the next year. The first notices are not sent until December because IRS must wait until all tax returns and information returns have been filed and correctly entered into the computer before making the match. Depending on the type of notice and how quickly and completely taxpayers respond, these contacts can end in a few months or more than a year later.

Overall, audits have the longest period during which taxpayer contacts are started. Audit notices can be sent shortly after returns are filed<sup>7</sup> or more than 2 years after filing.<sup>8</sup> IRS is usually limited by statute from auditing returns more than 3 years after the return was filed.<sup>9</sup> This statute of limitations as well as audit scope and complexity affect when audits end.

The start of a contact can also vary by type of audit. Contacts for correspondence audits can start shortly after returns have been filed and continue throughout the calendar year. Contacts for field audits can start within months after return filing and continue for more than 2 years after filing. Most audit notices for a tax year are sent between September of the filing year and April of the following year. According to IRS officials, notices are not sent earlier because auditors are still working on prior year returns, and notices are not sent later because they would overlap with audits of subsequent year returns.

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## Types of Taxpayer Responses to Contacts

The contacts vary in how taxpayers can respond. Math error and soft notice contacts do not ask taxpayers to respond. Both underreporter and audit contacts usually ask taxpayers to provide information about the reported tax liability and to eventually inform IRS of their agreement or disagreement with any changes to it. Depending on the type of contact, taxpayers are afforded different ways to challenge changes to their tax liability.

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<sup>7</sup>These returns usually involve the Earned Income Credit (EIC) claims and begin soon after the return is filed in an attempt to finish the audit before releasing any refunds.

<sup>8</sup>Such delays are to allow IRS enough time to enter the return data into its computers, associate the tax returns with information returns, process returns filed after April 15, and identify returns with the greatest potential for noncompliance.

<sup>9</sup>The law generally requires that IRS complete audits within 3 years after the return is filed or obtain an extension from the taxpayer. IRS also is required to notify the taxpayer of the right to refuse to extend the statute of limitations or to limit the extension to particular issues or to a particular period of time. If the taxpayer denies an extension, IRS can assess additional tax on the amount in question, requiring taxpayers to file an appeal if they disagree. Congress' 1998 legislation to restructure IRS contains provisions that suspend the accrual of interest and some penalties if IRS fails to notify the taxpayer of additional tax liabilities within 18 months after a return is filed. In 2004, suspension will begin 12 months after a tax return is filed.

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For most math error notices, taxpayers do not need to respond. One exception would be when taxpayers ask for clarification about the error. Another exception would be when IRS' changes to tax returns are not correct because the taxpayers provided incorrect information or IRS erred in its analysis of the return. In such cases, taxpayers may contact IRS or submit amended returns to correct the errors.<sup>10</sup>

If taxpayers provide corrected information or evidence of an IRS error, IRS can reverse its math error decision by abating the tax change or allowing the tax credit or exemption that it initially disallowed. If IRS does not reverse a decision, tax law does not grant taxpayers the right to appeal or petition the tax court for an independent review of math error determinations.<sup>11</sup> However, within 60 days after the math error notice is sent, taxpayers may request an abatement of any assessment specified in the notice, even if IRS was correct. Upon receipt of the request, IRS must abate the assessment. IRS can make a reassessment using its general procedures for assessing deficiencies,<sup>12</sup> which would give taxpayers the right to petition the Tax Court.

Responses under the soft notice program are encouraged but not required. IRS provides information about claiming dependents and self-employment tax and an amended return form. If taxpayers determine, after reviewing their returns and the information enclosed in the soft notice, that they have provided incorrect information on the original return, they may file an amended return.

IRS requires taxpayers to become more involved in the underreporter and audit programs. Underreporter notices either request that taxpayers provide additional information about the potentially underreported income or inform taxpayers that IRS proposes to assess additional tax. When IRS' notice proposes an additional tax assessment, taxpayers can agree with it,

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<sup>10</sup>IRS does not maintain data on how often responses are received in the math error program.

<sup>11</sup>While IRS does not maintain data on abatements for the overall math error program, such data are available for certain types of math errors, such as those related to EIC. In 1998, IRS reversed about 46 percent of its decisions to disallow EIC and abated about 54 percent of the associated tax increase after the taxpayer provided corrected information in response to the notice.

<sup>12</sup>After determining that a deficiency exists, IRS must send the taxpayer a notice of deficiency before it may assess the tax or seek to collect. This notice gives the taxpayer 90 days to file a petition with the Tax Court contesting the deficiency. Upon expiration of the 90 days without the taxpayer filing or a determination by the Tax Court that the deficiency exists, IRS is authorized to officially assess the tax and send the taxpayer a notice and demand for payment. If these requirements are met and the tax is still unpaid, IRS may initiate enforced collection action.

provide information to support their filed return, or appeal the proposed assessment to IRS' Office of Appeals and the Tax Court.

The initial audit notice asks for specified information from the taxpayer's books and records about one or more issues on the return (such as income, deductions, or credits) rather than proposing a change to the reported tax assessment. If the audit later results in a notice that proposes such a tax change, as with the underreporter program, taxpayers can agree with the tax change, provide information to support the filed return, or appeal the proposed change to IRS' Office of Appeals and the Tax Court.

## IRS' Use of Data From the Major Types of Nonaudit Contacts to Improve Compliance and Taxpayer Service

IRS collects data on the major types of nonaudit contacts, such as number of cases closed and amount of additional taxes assessed. IRS primarily uses the data to plan and administer the contact caseload. In general, IRS has not collected data to use in identifying ways to improve taxpayer compliance and service to taxpayers (e.g., reducing taxpayer burden and increasing taxpayer satisfaction). Such data could include changes in taxpayers' compliance behavior after the contacts, reasons for the errors, and levels of taxpayer burden and satisfaction. Table 2 summarizes the data routinely collected for each program.

While some data are collected for nonaudit contacts, the data are not routinely used to identify ways to improve taxpayer compliance or service. Examples in the underreporter program are the data on abatements and on taxpayers who repeatedly do not comply. Similarly, some data from the math error and underreporter contact programs are not used, even though they raise questions about compliance or service. For example

- In the 1998 math error program, IRS reversed about 46 percent of its decisions to reduce or disallow the Earned Income Credit (EIC) claims after taxpayers provided corrected information, such as SSNs and names for themselves and dependents, to support these claims. IRS does not determine why taxpayers make such errors (such as incorrect SSNs and names) that result in their EIC being initially reduced or disallowed. Consequently, IRS does not know whether some change in the Schedule EIC or the program instructions would make it easier for taxpayers to comply in claiming eligibility for EIC.<sup>13</sup> Further, over half the taxpayers that had all or part of their EIC disallowed did not challenge the disallowance. IRS does not determine whether these taxpayers were afraid to respond, assumed IRS was correct, did not understand the forms and EIC requirements, or were trying to illegally claim EIC.

<sup>13</sup>The Schedule EIC is the form that taxpayers must complete to be eligible to claim EIC.

- In the underreporter program for tax year 1996, IRS refunded almost \$97 million. Almost \$37 million of these refunds resulted from taxpayers reporting less withheld tax on their tax returns than payers reported on information returns. IRS does not know why these taxpayers reported lower withheld amounts than reported by payers. IRS officials believe one reason may be that taxpayers do not understand their W-2s and confuse their withheld amounts with their payments to the Social Security Trust Fund. If this was one of the reasons, IRS' analysis of the data might lead to redesigning the W-2 to more clearly show the withheld amount. This could help taxpayers more accurately complete their returns.

**Table 2: Data Routinely Collected for Nonaudit Contact Programs**

Type of data routinely collected	Math error		Soft notices	
	Underreporter	Duplicate SSN	Duplicate SSN	Self-employment tax
Number of cases closed	Yes	Yes	Yes	Yes
Amount of assessments or refunds	Partial <sup>a</sup>	Yes	Yes	Yes
Amount of abate <sup>b</sup> ments <sup>b</sup>	Partial <sup>a</sup>	Yes	Not applicable	Not applicable
Changes in taxpayer compliance behavior <sup>c</sup>	No <sup>d</sup>	Yes <sup>e</sup>	Yes <sup>f</sup>	Yes
Reason(s) for the error	No <sup>d</sup>	No	Yes	Yes
Level of taxpayer burden	No	No	Yes	Yes
Level of taxpayer satisfaction	No	No <sup>g</sup>	No	No

<sup>a</sup>IRS collects information on assessments and abate<sup>b</sup>ments only for those math error codes related to some EIC, SSN, and child care credit errors. This represents about 27 percent of the math errors.

<sup>b</sup>Abate<sup>b</sup>ments are a reduction of any tax, interest, or penalty assessment on a taxpayer's account. There are no abate<sup>b</sup>ments attributable to the soft notice program.

<sup>c</sup>The primary compliance behavior that IRS could track is whether the taxpayer made the same error in a later tax year.

<sup>d</sup>IRS' Office of Research has prepared a profile report for selected types of math errors associated with EIC and is currently working on a report on math errors associated with invalid SSNs. However, these do not include data that are routinely collected as part of the math error program.

<sup>e</sup>IRS officials indicated that this information is available by comparing the results for different tax years, but such comparisons are not used.

<sup>f</sup>The behavior tracked in the duplicate SSN program was whether the taxpayer continued to claim an exemption that was also claimed on other tax returns.

<sup>g</sup>IRS did conduct a one-time, customer satisfaction survey that focused on how well taxpayers understood the notification letter. Also, IRS officials told us that they plan to begin routinely conducting customer satisfaction surveys by 2001.

Source: GAO discussions with IRS staff and analysis of data provided for each program.

At our exit conference in January 2000, IRS officials identified two recent efforts that (1) researched how the math error program has improved EIC compliance and (2) changed the Schedule EIC to help taxpayers complete it. However, IRS officials did not have evidence to show that these efforts

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were initiated by using math error program data.<sup>14</sup> Rather, these efforts seemed to be initiated in response to concerns or complaints about the EIC program. While these efforts might have been necessary as well as useful, they do not illustrate the use of nonaudit program data to provide a comprehensive perspective on the types of issues that most affect taxpayer compliance or service.

In the soft notice program, IRS does appear to have given more consideration to compliance and taxpayer service issues in data collection and analysis. For the self-employment tax soft notice, IRS researchers gathered data to identify the reasons that taxpayers had not shown self-employment tax on their returns. Their analysis led to recommendations on changing how IRS screens returns to identify taxpayers as potentially owing self-employment tax. This change might help avoid contacting compliant taxpayers that did not actually owe self-employment tax, which could reduce their burden.<sup>15</sup>

Also, for taxpayers sent soft notices on duplicate SSNs, IRS tracked how often more than one taxpayer continued to claim an exemption for the same SSN during the following tax year. This tracking helped IRS to determine changes in taxpayer compliance behavior involving duplicate SSN claims.

We did not determine the cost of collecting and analyzing data from nonaudit contacts to improve compliance and taxpayer service because it was outside the scope of our work. We recognize that collecting and analyzing such data would involve some additional costs.

Whether the costs should be incurred would depend on the likelihood that the resulting improvements in compliance and taxpayer service would be worth those costs. The costs and improvements from collecting and analyzing such data could differ for each type of nonaudit contact, particularly for certain types of math error or underreporter contacts. For example, IRS might decide that collecting and analyzing data from certain types of contacts would not be cost-effective in helping identify significant

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<sup>14</sup>IRS officials told us they have used a District Office of Research and Analysis to support the decision to redesign EIC material. However, this analysis apparently did not use math error data to identify specifically what was wrong with the Schedule EIC and related instructions. Also, IRS officials indicated that other efforts were under way to improve service to taxpayers and increase compliance.

<sup>15</sup>Researchers looked at why IRS identified several groups of taxpayers as potentially owing self-employment tax when the taxpayers were not liable. These groups included farmers who rent their farms and erroneously show farm rental income on the schedule F instead of on a form 4835 and Schedule E and taxpayers under age 18 who are employed by their parents or as a newspaper carrier.

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improvements in compliance and taxpayer service while doing so for other types of contacts would only be cost-effective in a targeted fashion.

Also, IRS officials indicated that they are limited in the amount and type of data they can collect on these programs until IRS modernizes its information systems under its ongoing effort to modernize the entire agency. They noted that it might not be cost-effective to collect new data about all types of nonaudit contacts until these systems are in place.

IRS recognizes the need to use data from programs to evaluate ways to improve compliance and taxpayer service. Its modernization plan indicates that each of the four new operating divisions is to have a Taxpayer Education and Communication unit. IRS plans to have this unit use data from enforcement programs to improve compliance and taxpayer assistance. The unit is to continually analyze program data to ensure that the products and services being developed will meet taxpayer needs. This plan does not yet describe whether and how the Taxpayer Education and Communication unit would use data from nonaudit contacts in its efforts. IRS officials involved in the planning for these divisions told us that those types of decisions would be made, at the earliest, for the 2002 filing season.

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## Conclusions

IRS' nonaudit contacts account for the majority of contacts with taxpayers about their reported tax liability on filed returns. In 1998, the three types of nonaudit contacts we reviewed affected almost 10 million taxpayers by increasing or decreasing the tax amounts owed or questioning claims made on the tax return. In comparison, audits affected just over 1 million taxpayers.

Data from the millions of nonaudit contacts could be helpful for learning more about how compliance and taxpayer service can be improved. However, only in the soft notice programs has IRS been routinely collecting and analyzing some data that could be used to identify such improvements.

Collecting and analyzing more data would impose some costs, which IRS could minimize by targeting the types of contacts within each program that are most likely to provide data that could lead to the greatest improvements in compliance and taxpayer service. Also, IRS may not be able to collect all such desirable data on nonaudit contacts until its information systems have been modernized. As it modernizes these systems, IRS also could consider how to cost-effectively collect these nonaudit data.

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## Recommendations

We recommend, while IRS completes its modernization effort, that the Commissioner of Internal Revenue start to collect and analyze available data from each of the three major nonaudit programs to help identify ways to improve compliance and taxpayer service. To minimize the costs, IRS could target the types of contacts under each of the three programs that have the greatest potential for generating such improvements. We also recommend that the Commissioner determine how the modernized information systems can cost-effectively collect such data on the various types of contacts in each of these nonaudit programs, and how the data can be used to improve compliance and increase customer service.

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## Agency Comments and Our Evaluation

IRS agreed with both of our recommendations and identified efforts to implement each one. These efforts generally were separate, one-time studies by IRS' Office of Research. However, IRS officials told us that these studies are to be linked efforts in which one study builds upon the results of earlier studies. If these efforts are indeed linked in the future and provide routine data collection on how these programs are contributing to IRS' mission to improve compliance and customer service, then the intent of our recommendations would be met. In this regard, IRS officials also said that they are currently trying to better coordinate efforts undertaken by the Office of Research with the data needs of the Customer Service Division.

In addition, IRS identified other efforts to improve compliance and service. We have no comment on these other efforts because they fall outside the scope of our review and recommendations. Finally, IRS provided technical comments on the data collected for the math error and the soft notice programs. We made changes to the report on the basis of these comments where appropriate.

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We are sending copies of this report to Representative Charles B. Rangel, Ranking Minority Member, House Committee on Ways and Means, and William J. Coyne, Ranking Minority Member of the Subcommittee on Oversight, House Committee on Ways and Means. We are also sending copies to the Honorable Lawrence H. Summers, Secretary of the Treasury; the Honorable Charles O. Rossotti, Commissioner of Internal Revenue; the Honorable Jacob J. Lew, Director, Office of Management and Budget; and other interested parties. We will also send copies to those who request them.



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

Sincerely yours,

A handwritten signature in black ink that reads "Cornelia M. Ashby". The signature is written in a cursive style with a large initial 'C' and a long, sweeping tail on the 'y'.

Cornelia M. Ashby  
Associate Director, Tax Policy and  
Administration Issues

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## Abbreviations

EIC	Earned Income Credit
IRS	Internal Revenue Service
SSN	Social Security Number

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# Summary of Program Operations for Selected Nonaudit Contacts

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This appendix contains additional information on how math error, underreporter, and soft notice contacts work and provides additional data on the frequency of these contacts.

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## Math Error Contacts

The purpose of the math error program is to correct certain errors on tax returns in returns processing before issuing refunds. Section 6213(b)(1) of the Internal Revenue Code allows IRS to make changes to tax returns for clerical and mathematical errors without following the normal assessment procedures.<sup>1</sup> In 1996, Congress amended the term “mathematical or clerical error” to include incorrect Social Security Numbers (SSN) required when claiming dependency exemptions<sup>2</sup> or the Earned Income Credit (EIC).<sup>3</sup> In 1997, Congress also amended the term to include incorrect SSNs used when claiming the Child Tax Credit.<sup>4</sup>

IRS uses computer processing to identify errors involving addition and subtraction, SSNs, filing status, exemptions, and incomplete schedules and forms. Once the computer has identified an error, the tax return package is to be sent to the Error Resolution office, where an IRS employee is to review the return, correct the error, and notify the taxpayer.

Some examples of math errors and how IRS treats them are discussed below:<sup>5</sup>

- If the taxpayer makes an addition or subtraction error or transfers an amount from one schedule to another incorrectly, the IRS employee is to make the correction, recalculate the tax liability, resubmit the return for processing, and notify the taxpayer of the correction.
- If a dependent SSN is incorrect, the IRS employee is to attempt to find the correct number on the return or other documents attached to it. If the correct number cannot be found, the dependent exemption is to be disallowed. Disallowing this exemption may change several items on the return, including filing status and eligibility for the child care tax credit and

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<sup>1</sup>Under normal assessment procedures, a tax deficiency may not be assessed until the taxpayer has been sent a notice of the deficiency and has been given a 90-day period to file a petition for redetermination in the Tax Court.

<sup>2</sup>P.L. 104-188.

<sup>3</sup>P.L. 104-193.

<sup>4</sup>P.L. 105-34.

<sup>5</sup>Changes made through the math error program to the reported tax liability may result in a reduction or increase in the taxes owed. If reduced, the notice will explain why and by how much. If the taxpayer owes money in excess of the amount already paid, the notice will explain how much is owed and why. The notice will also explain the options for paying any additional amount due.

**Appendix I**  
**Summary of Program Operations for Selected Nonaudit Contacts**

EIC. After the changes are made, the return is to be resubmitted and the taxpayer is to be notified about the nature of the error and the changes made to the return.

- If the IRS employee determines that IRS made a transcription error or that other information on the return explains the error identified by the computer, the IRS employee is to resubmit the return for processing with either a correction or an indication that the return is correct. No notification is to be sent to the taxpayer.

While some taxpayers make more than one error on their tax return, the taxpayer receives only one notice. For example, of the 7.5 million math error notices in 1998, about 1 million notices reported two errors, 260,000 reported three errors, and 75,000 reported four or more errors. Table I.1 summarizes the math errors identified in 1997 and 1998 by category.

**Table I.1: Major Types of Math Errors for 1997 and 1998**

Math errors	Number	
	1997	1998
Earned Income Credit	2,729,148	2,042,938
Exemptions and SSNs	2,028,441	1,460,669
Taxable income and tax calculations <sup>a</sup>	1,708,553	1,846,527
Standard or itemized deductions	590,712	564,635
Child care credit	389,734	235,969
Filing status	334,879	232,210
Social Security benefits	302,202	310,042
Self-employment tax calculation	263,045	240,558
Income section of the tax return	261,855	243,064
Schedules C, D, E, or F <sup>b</sup>	116,895	151,065
Tax credit calculation (other than child care and EIC)	56,318	59,822
Retirement related income	17,278	15,348
Form on household employees	11,365	10,036
All other errors	55,896	51,185
<b>Total</b>	<b>8,866,321</b>	<b>7,464,068</b>

<sup>a</sup>These numbers include 138,066 instances in 1997 and 124,773 in 1998 in which taxpayers asked IRS to calculate their tax liability rather than do their own calculation.

<sup>b</sup>Schedule C is used to report income from business. Schedule D is used to report capital gains and other income from sale of assets. Schedule E is used to report income from rental property and income from partnerships and S corporations. Schedule F is used to report income from farming activities. These errors do not include missing schedules.

Source: IRS math error code report.

## Underreporter Program Contacts

Each year, IRS receives over a billion information returns from third-party payers, such as banks and employers. These information returns show payments made to individuals, including wages that employers report to the Social Security Administration on Form W-2. In October of the year the return is due and February of the following year, IRS uses computer

software to match these payments to income reported on the taxpayer's return.

The computer match annually identifies 11 million to 13 million tax returns with reported income amounts that either overstate or understate the reported tax liability. According to IRS officials, returns that understate the tax liability (for which the taxpayer owes additional tax) are treated with the same priority as those involving an overstated liability (for which IRS owes the taxpayer a refund).

Once identified, returns with discrepancies that meet certain criteria are to be sent to an IRS service center for screening.<sup>6</sup> These criteria include the historic amount of underreported tax in this area and likelihood that the discrepancy is real and not explained on the tax return. During screening, IRS employees are to review the tax returns to see whether they can resolve the discrepancy.<sup>7</sup> If it can be explained by information on the return, the case is to be closed; if not, the taxpayer is to be sent a notice requesting more information or indicating IRS' proposed change. The taxpayer can agree with IRS, provide IRS with clarifying information, or appeal the decision to IRS' Office of Appeals.

In recent years, IRS has reduced the number of discrepant returns screened. In large part, this reduction has been due to staffing cutbacks and temporary reassignment of staff to other functions, such as answering phones during filing season.<sup>8</sup> Table I.2 summarizes the number of discrepant returns identified and screened, and the number of contacts made for tax year 1996, the most recent year for which data is most complete and available.

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<sup>6</sup>IRS operates the underreporter program in 6 of its 10 service centers—Atlanta, Austin, Brookhaven, Fresno, Ogden, and Philadelphia.

<sup>7</sup>IRS reviewers also check the Automated Underreporter System, which is a computer system that shows amounts reported by taxpayers and third-party payers. It automatically recalculates the correct tax liability and drafts correspondence to be sent to the taxpayer.

<sup>8</sup>The filing season typically runs from January 1 to April 15, except for taxpayers who get extensions to file until as late as October 15.

**Appendix I**  
**Summary of Program Operations for Selected Nonaudit Contacts**

**Table I.2: Discrepant Returns Identified and Screened and Taxpayer Contacts Made by Type of Issue, Tax Year 1996**

Discrepancy	Discrepant returns <sup>a</sup>			Screened returns	
	Number identified	Number screened <sup>b</sup>	Percent	Number contacted	Percent
Earned income <sup>c</sup>	2,946,268	1,532,167	52	1,029,757	67
Pension and retirement income <sup>d</sup>	1,211,925	639,271	53	443,108	69
Payments from states <sup>e</sup>	540,956	229,312	42	203,931	89
Investment income <sup>f</sup>	3,622,029	261,727	7	191,746	73
Discrepancies in withholding <sup>g</sup>	380,183	143,514	38	84,803	59
Income from rents and royalties	117,507	23,201	20	12,864	55
Mortgage interest payments	1,675,097	494	<sup>h</sup>	237	48
All other types of income <sup>i</sup>	1,380,014	282,324	20	227,277	81
<b>Total</b>	<b>11,873,979</b>	<b>3,112,010</b>	<b>26</b>	<b>2,193,723</b>	<b>70</b>

<sup>a</sup>IRS summarizes data by the tax year of the discrepancy, in this case, tax year 1996.

<sup>b</sup>IRS employees screen returns to see if discrepancies can be resolved without contacting taxpayers.

<sup>c</sup>Includes wages, nonemployee compensation, business gross receipts, and other earned income.

<sup>d</sup>Includes errors on Individual Retirement Accounts, Social Security, and other retirement income.

<sup>e</sup>Includes state unemployment compensation and state tax refunds.

<sup>f</sup>Includes interest, dividends, capital gains, and other types of investment income.

<sup>g</sup>This is the largest category of refunds.

<sup>h</sup>Less than 1 percent of cases identified were sent for screening.

<sup>i</sup>Includes such income as gambling winnings, agricultural subsidies, prizes, and awards.

Source: IRS data collected on the underreporter program.

## Contacts Through Soft Notices

In recent years, IRS has increasingly focused its efforts on alternative enforcement strategies, such as the soft notice. In 1998, IRS sent one of two soft notices to 2 million taxpayers. IRS sent one type of soft notice to taxpayers whose return cited a dependent or spouse SSN that had been used on at least one other return. IRS sent the other type of soft notice to taxpayers that reported business income but failed to pay self-employment taxes.<sup>9</sup>

Both types of soft notice started as research projects in IRS' Research Division, which continues to be involved by identifying taxpayers that may have made errors and evaluating the results of the notices. Both types of soft notice are operational programs managed by IRS' Taxpayer Services Division.

Soft notices get their name because they do not demand that the taxpayer pay more tax, provide documentation, or file an amended return. Instead, they are designed to educate the taxpayer and, ultimately, improve

<sup>9</sup>Self-employment taxes are paid by sole proprietors filing a schedule C, farmers, individuals receiving nonwage compensation regardless of whether they file a business return, and certain business income claimed on a schedule E.

voluntary compliance. While the notice may contain wording asking that the taxpayer file an amended return if appropriate, it is not required. In contrast, “hard” notices such as those from the math error and underreporter programs indicate that IRS has made or is proposing a change and that the taxpayer owes additional tax or has an additional refund due. These notices focus primarily on compliance rather than taxpayer education.

Shortly after individual tax returns are received, IRS begins to screen them for duplicate SSNs and unpaid self-employment tax. Once taxpayers that appear to meet the criteria have been identified, IRS sends them notice packages. These packages are sent in August (self-employment tax) and December (duplicate SSN). Each notice package is to contain a letter indicating IRS’ concern and provide information from IRS publications related to the issue, and, if needed, a form for use in preparing an amended tax return. The notice is also to list a toll-free number for taxpayers to call if they have questions.

IRS sent almost 1.6 million notices in 1998 when the same SSN was used to claim exemptions on more than one tax return.<sup>10</sup> Duplicate use of SSNs can occur when (1) two or more taxpayers claim the same dependent, (2) dependents claim themselves at the same time they are claimed by another taxpayer, or (3) taxpayers make a transcription error on their return.

IRS mailed 329,000 notices in 1998 to taxpayers who had self-employment income on their returns but had not completed a schedule SE or paid self-employment tax. The self-employment income might be reported on the other income line of the income tax return or on IRS schedules (e.g., schedules C and F) used for reporting this type of income.

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<sup>10</sup>IRS does not send soft notices when the same SSN appears on more than four returns. These returns generally are referred for audit.



# Comments From the Internal Revenue Service



COMMISSIONER

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

February 23, 2000

Ms. Cornelia M. Ashby  
Associate Director, Tax Policy  
and Administration Issues  
U.S. General Accounting Office  
441 G Street, N.W.  
Washington, D.C. 20548

Dear Ms. Ashby:

Thank you for the opportunity to review and comment on the draft report entitled "Tax Administration: IRS' Use of Nonaudit Contacts (Job Code 268877)," which focuses on nonaudit contacts to notify taxpayers about potential errors in their reported tax liability. The draft report provides a fair and balanced assessment of our efforts to improve compliance and service to taxpayers.

The report focuses on three specific nonaudit contacts. In addition to these nonaudit contacts, the IRS initiates numerous other contacts with taxpayers to help them reduce the burden of filing taxes, including:

- Tax package mailouts.
- Information mailings (such as those to taxpayers who may not need to file).
- Correspondence issued during processing to request needed forms or information.
- Maintaining an award-winning Web site where taxpayers can find answers to their questions, download forms and publications, and find helpful hints. In 1999, there were almost 1.2 billion hits on the IRS Web site and just under 90 million files were downloaded.
- Soliciting comments from taxpayers and sharing information internally. Some examples include the following:
  - We provide an opportunity for taxpayers and tax professionals to provide feedback on both current and early release draft forms on our Web site. This feedback is shared with the office that can best evaluate it.
  - We solicit taxpayer comments and suggestions about our tax products. Like the information received through our Web site, any comments we receive are evaluated and, if appropriate, changes are made.
  - We conduct focus groups to review new and revised forms and instructions. Data is collected and changes are made when appropriate.
  - We share information about common taxpayer/practitioner errors internally and consider those errors when revising forms.

In the comments below, I will describe our plans for addressing your recommendations.

**SHORT-TERM RECOMMENDATION**

We recommend, until the IRS completes its modernization effort, that the Commissioner of Internal Revenue start to collect and analyze available data from each of the three major nonaudit programs to help identify ways to improve compliance and taxpayer service. To minimize the costs, the IRS could target the types of contacts under each of the three programs that have the greatest potential for generating such improvements.

**COMMENTS**

We concur with GAO's underlying recommendation that the IRS expand its collection and analyses of nonaudit data in order to improve compliance and taxpayer service. The Office of Research, in conjunction with the District Office Research and Analysis (DORA) sites, has collaborated with the functions to implement several studies in this vein.

**Math Error**

The Office of Research has completed one product, the "Math Errors Profile Report," and is in process of completing the "Invalid SSN Math Error Correction Report." This report should be completed by July 2000. The first referenced report provides analyses of math error repeater rates and also presents trend data confirming improved compliance as it relates to decreasing volumes of math errors over a 3-year period.

The second referenced report, "Invalid SSN Math Error Correction," will provide an analysis of why math errors relevant to invalid SSNs are abated by comparing taxpayer data from Tax Years 1996 and 1997.

In addition to the reports referenced above, the Office of Research is measuring changes in taxpayer behavior, following an IRS contact, through the Subsequent Year Tracking Program (SYTP). The SYTP will use math error, soft notice, and audit data, as well as data from other taxpayer outreach efforts, to determine if taxpayers are repeating errors, making different errors, or are fully compliant. The behavior of taxpayers will be tracked on a continuing basis to determine Compliance Improvement Revenue, Alternate Treatment Revenue, and to measure the overall effectiveness of the program. The SYTP is scheduled to produce its first set of data in June 2000.

The enclosure provides some clarification regarding the math error program.

**Underreporter**

The Automated Underreporter (AUR) Program has several data collection methods. The repeater portion of the AUR inventory program most closely tracks changes in taxpayer behavior. This program identifies taxpayers that had discrepancies in a prior, but not consecutive, year. The program will identify and track these taxpayers even if

the discrepancies differ from year to year. Further analysis of this data will be performed in conjunction with the Measures and Analysis Branch and DORA, in order to determine whether the information contained in the report can be used for program improvement.

Our taxpayer education efforts include a discrepancy explanation in each CP 2000 notice and a suggestion that taxpayers review subsequent returns for the same issue. An AUR Customer Satisfaction Survey is under development and should be submitted to the vendor by July 2000. This survey will address the level of telephone service provided and clarity of notices mailed to taxpayers. Improvement efforts will be based on customer feedback.

**Soft Notices**

Self-Employment Tax (SET) soft notices - We plan to collect and analyze data for taxpayers that did not amend their returns for SET after receiving the educational soft notice. This will be done with the assistance of the Kansas-Missouri DORA. Follow-up contact will be made with taxpayers that still appear to be liable for the SET. In addition, programming changes are being requested to identify, during initial processing, returns not reporting the SET when it appears the tax is due. This programming change is also designed to identify taxpayers that did not satisfactorily reply to an initial contact, which is especially true for taxpayers who report miscellaneous income on returns. With this programming in place, we will be able to perform a follow-up analysis to compare repeat taxpayers in a subsequent year, and ascertain why the SET was not properly reported.

Duplicate SSN soft notices - Duplicate SSN soft notices were issued for Tax Years 1996, 1997, and 1998 tax returns. The North Florida DORA issued a report entitled "Duplicate SSN Project - Overview and Treatment Results" in November 1999. This report provides an analysis of the program and includes information on the types of duplicate SSN condition, percentage of taxpayers filing amended returns, and the percentage of taxpayers modifying their behavior. This report not only identifies the effectiveness of the program but also indicates the taxpayer population that would most benefit from this type of notice.

With assistance provided by the DORA Offices to analyze the data from the above three program areas, we can adjust program filters to best identify the most potentially liable taxpayers. Further analysis will determine if instructional notices provided to taxpayers are adequate, based on the content of their responses, or if further refinement is required. Subsequent year compliance behavior by taxpayers will be tracked to determine whether additional assistance, to enhance taxpayer's ability to comply with their tax requirements, is needed.

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**Appendix II**  
**Comments From the Internal Revenue Service**

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**LONG-TERM RECOMMENDATION**

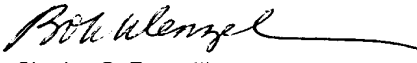
We recommend that the Commissioner determine how the modernized information systems can cost effectively collect data on the various types of contacts in each of these nonaudit programs, and how that data can be used to improve compliance and increase customer service.

**COMMENTS**

We will ensure that the organizations responsible for the above three program areas work in close coordination with the design teams, the Information Systems organization, and the PRIME. By working together, we can determine how the modernized information systems can cost effectively collect data on the various types of programs, and how that data can be used to improve compliance and increase customer service.

I assure you we will make every effort to resolve the issues noted in your report and am confident that plans put forth will successfully address these issues. If you have any questions or require additional information, please let me know or your staff may contact Robert C. Wilkerson, Assistant Commissioner (Customer Service), at (202) 622-5044.

Sincerely,

  
Acting for Charles O. Rossotti

Enclosure

ENCLOSURE

**MATH ERROR PROGRAM**

Math errors can be divided into two groups. The first group is math errors that are mathematical errors or missing schedule(s). The second group is math errors covered through the extension of math error authority (MEA). Math errors covered by MEA are in fact a program separate and apart from other math errors. Math errors covered by MEA primarily address name/SSN issues. Data in the report, concerning the subsequent abatement of tax and restoration of dollars are primarily attributed to this group. A more clear distinction between these two groups could be used in the report in order to present a more accurate picture of how and what specific nonaudit data is being used.

Page 19, Table 2, "Data Routinely Collected for Nonaudit Contact Programs," rows 4 and 5, "Changes in taxpayer compliance behavior" and "Reasons for the error" indicates "no" data is routinely collected for "Math errors." The Office of Research has already completed one product, the "Math Errors Profile Report," and is in process of completing the "Invalid SSN Math Error Correction Report." This report should be completed by July 2000. The first referenced report provides analyses of math error repeater rates and also presents trend data confirming improved compliance as it relates to decreasing volumes of math errors over a 3-year period. The second referenced report, "Invalid SSN Math Error Correction," will provide an analysis of why math errors relevant to invalid SSNs are abated by comparing taxpayer data from Tax Years 1996 and 1997. Table 2 should be updated to include "Partial," rather than "No Data," for rows 4 and 5 in the column entitled "Math error."

The report also indicates no data is routinely collected for "Amount of Abatements" for Duplicate SSN Soft Notices. Abatements are not attributed to soft notices; therefore, perhaps it would be more appropriate to say "Not Applicable" (N/A).

# GAO Contacts and Staff Acknowledgments

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## GAO Contacts

Cornelia M. Ashby (202) 512-9110  
Tom Short (202) 512-9110

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## Acknowledgments

In addition to those named above, Lou Roberts, Kathleen Seymour, and Rodney Hobbs made key contributions to this report.

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