



*Trends in Compliance Activities  
Through Fiscal Year 2006*

**March 27, 2007**

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This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.

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TREASURY INSPECTOR GENERAL  
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C. 20220

March 27, 2007

**MEMORANDUM FOR DEPUTY COMMISSIONER FOR SERVICES AND  
ENFORCEMENT**

**FROM:** *Michael R. Phillips*  
Michael R. Phillips  
Deputy Inspector General for Audit

**SUBJECT:** Final Audit Report – Trends in Compliance Activities Through Fiscal  
Year 2006 (Audit # 200730016)

This report presents the results of our review of statistical information that reflects activities of the Collection and Examination functions. The overall objective of this review was to provide statistical information requested by the Internal Revenue Service (IRS) Oversight Board and trend analyses of that information.

*Impact on the Taxpayer*

During this annual review, we analyze information from the IRS' management information system reports to determine the trends and changes in the major areas of compliance. Overall, many compliance activities increased and results improved during Fiscal Year (FY) 2006. Continued effort to improve compliance is important to maintaining the integrity of the voluntary tax compliance system.

*Synopsis*

Since FY 2000, the IRS has been reversing many of the downward trends in compliance activities that had occurred in prior years. In FY 2006, many of these activities continued to increase as Collection and Examination function field staffing increased slightly. Both the Collection and Examination functions hired enforcement personnel during FY 2006, but there may be little hiring during FY 2007 due to budget constraints.



## *Trends in Compliance Activities Through Fiscal Year 2006*

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In FY 2006, the level of compliance activities and the results obtained in many Collection function areas showed a continued increase. The use of liens<sup>1</sup> and levies (collection enforcement tools) was greater, surpassing the FY 1997 levels. The use of seizures also increased, but it is unlikely that the use of seizures will return to the pre-1998 levels in the foreseeable future. Enforcement revenue collected continued to increase (to \$48.7 billion), but the total dollar amount of uncollected liabilities also increased to \$271 billion. However, the gap between new delinquent accounts and account closures narrowed slightly during FY 2006.

The Collection function collected 5.5 percent more than in FY 2005, but the number of taxpayers (779,272) and the amount owed (\$27.2 billion) on accounts in the Queue were each a 10-year high. One reason for the increase in the Queue this year is a rise in the number of compliance assessments.<sup>2</sup> While the Queue is a source of work for Collection Field function employees, a significant amount may never be worked. In addition, from FYs 2001 through 2006, the IRS removed almost 6.8 million accounts with balance-due amounts totaling more than \$28 billion from Collection function inventory; these accounts may never be worked. In September 2006, the IRS started assigning balance-due cases that otherwise would not have been worked to private collection agencies. As of January 18, 2007, the IRS had received \$12.6 million on cases assigned to the collection agencies. However, continued use of private collection agencies is uncertain because some members of Congress want the IRS to discontinue their use.

During FY 2006, the overall percentage of tax returns examined increased by just over 4 percent, and the number of field Examination function personnel increased by just over 9 percent. However, the overall percentage of tax returns examined is still 27 percent lower than it was in FY 1997.

Overall, the number of individual tax returns examined increased during FY 2006. Correspondence examinations accounted for 87 percent of the examinations of individuals with incomes under \$100,000 and 62 percent of those with incomes of \$100,000 and over.<sup>3</sup> Correspondence examinations are usually not as comprehensive as face-to-face examinations, and the impact on compliance may be limited. In a report issued last year,<sup>4</sup> we noted that high-income taxpayers did not always respond to correspondence examinations. About 86 percent of the amount assessed on these no-response cases was either reversed or not collected after almost 2 years from the date of the assessment. In addition, the dollar yield per hour decreased for individual income tax return examinations conducted by revenue agents but increased for those conducted by tax compliance officers.

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<sup>1</sup> See Appendix IV for a glossary of terms used in this report.

<sup>2</sup> Compliance assessments are those generated by the Examination function, the Automated Underreporter program, the Substitute for Return program, and the 6020(b) program.

<sup>3</sup> This information was computed using the Audit Technique Codes that identify how the employees are conducting the audits. This number differs from some publicized reports that use the organizational code.

<sup>4</sup> *While Examinations of High-Income Taxpayers Have Increased, the Impact on Compliance May Be Limited* (Reference Number 2006-30-105, dated July 25, 2006).



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In FY 2006, the number of corporate tax returns examined decreased 1 percent, after increasing 71 percent in FY 2005. However, the number of returns examined has still decreased 59 percent since FY 1997. The total number of corporate tax returns examined decreased from 1 out of 37 returns filed in FY 1997 to 1 out of 80 returns filed in FY 2006. The number of tax returns examined for larger corporations (those with assets of \$10 million and over) decreased just over 2 percent. Yield indicators for examinations of corporate tax returns improved again. There were increases in the amount of tax adjustments and in hours spent examining those returns for the year. The net effect was an increase in the dollar yield per hour.

Some of the positive changes noted in this report might be attributed to management emphasis on the Collection and Examination programs. Over the last few years, the Small Business/Self-Employed Division has implemented reengineering and organizational changes that could have had a positive impact on enforcement efforts. In addition, both functions continue to work toward improved workload selection methods.

Despite actions the IRS has taken to improve its enforcement efforts, the Government Accountability Office regarded enforcement of tax laws (collection of unpaid taxes and Earned Income Tax Credit noncompliance) as 1 of the 26 high-risk areas in the Federal Government in its January 2007 update.<sup>5</sup> However, as our report points out, the IRS has moved toward reversing many of the enforcement declines in both the Collection and Examination functions.

Continued effort to improve compliance is important to maintaining the integrity of the voluntary tax compliance system. According to a tax gap strategy document dated September 2006, the tax gap for Tax Year 2001 is \$345 billion.<sup>6</sup> The strategy document provides a broad base on which to build future efforts to address the tax gap but depends on future budgets to provide detailed strategy elements.

### *Recommendation*

We made no recommendations in this report. However, key IRS management officials reviewed the report prior to issuance and agreed with the facts and conclusions.

Copies of this report are also being sent to the IRS managers affected by the report information. Please contact me at (202) 622-6510 if you have questions or Daniel R. Devlin, Assistant Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-5894.

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<sup>5</sup> *HIGH-RISK SERIES – An Update* (GAO-07-310, dated January 2007).

<sup>6</sup> *A Comprehensive Strategy for Reducing the Tax Gap* (Department of the Treasury, Office of Tax Policy, dated September 26, 2006).



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*Abbreviations*

ACS	Automated Collection System
CFf	Collection Field function
FY	Fiscal Year
IRS	Internal Revenue Service
TDA	Taxpayer Delinquent Account
TDI	Taxpayer Delinquency Investigation
TIGTA	Treasury Inspector General for Tax Administration



## *Background*

We initiated this review of nationwide compliance statistics for examination and collection activities at the request of the Internal Revenue Service (IRS) Oversight Board. Our data analyses were performed in the Treasury Inspector General for Tax Administration (TIGTA) Chicago, Illinois, office during the period December 2006 through March 2007 using national reports from Collection and Examination function management information system reports. The audit was conducted in accordance with *Government Auditing Standards*. However, because we relied on information accumulated by the IRS in established reports, we did not verify the accuracy of the data.

Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II. A Glossary of Terms is included in Appendix IV. Detailed charts and tables referred to in the body of this report are included in Appendix V. Most of the calculations throughout the report and Appendix V are affected by rounding. All initial calculations were performed using the actual numbers rather than the rounded numbers that appear in the report.

Much of the data included in this report update prior TIGTA audit reports on compliance trends. See Appendix VI for a list of those reports.



## *Results of Review*

Overall, many compliance activities increased and results improved during Fiscal Year (FY) 2006. Since FY 2000, the IRS has been reversing numerous downward trends in compliance activities that had occurred in prior years in both the Collection and Examination functions. In FY 2006, many of these activities continued to increase, while others fell slightly from the prior year.

Although the IRS has started to reverse many of the downward trends in compliance activities, the Collection and Examination functions enforcement staffing level is not significantly higher than the 10-year low experienced in FY 2003. The combined Collection and Examination functions enforcement personnel<sup>1</sup> declined from approximately 20,600 at the beginning of FY 1997 to 15,500 at the end of FY 2006, a 25 percent decrease. After decreasing 1 percent during FY 2005, staffing increased 7 percent this year. The budget was a 7 percent increase over the FY 2005 budget for tax law enforcement, and the Collection and Examination functions hired enforcement personnel during the year. However, Congress never passed an actual budget for FY 2007, and spending will be limited to FY 2006 levels with some required increases. Therefore, most enforcement hiring will be curtailed for the fiscal year. The President's Budget Proposal for FY 2008 includes an increase of almost 6 percent for Collection and Examination function enforcement.

### ***Overall, Compliance Activities Increased and Results Improved***

For some time, the total number of tax returns filed and the total dollars the IRS received (gross collections) increased with the growing economy. In the past 10 years, the total number of tax returns filed grew 12 percent, from 158 million in Calendar Year 1996 to 177 million in Calendar Year 2005. From FYs 1997 to 2001, IRS gross collections grew from \$1.62 trillion to \$2.13 trillion but then fell a total of 8 percent during FYs 2002 and 2003, to \$1.95 trillion. These were the first decreases in total revenue since FY 1983. However, since FY 2003, gross collections have increased 29 percent and reached a new record high of \$2.52 trillion this year.<sup>2</sup>

After remaining relatively constant for FYs 1999 through 2002, the amount of enforcement revenue collected increased 43 percent in the last 4 years. During FY 2006, enforcement

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<sup>1</sup> Collection and Examination function staff located in field offices, excluding management and overhead staff.

<sup>2</sup> See Appendix V, Figure 1.



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revenue collected increased 3 percent to \$48.7 billion.<sup>3</sup> This amount (not adjusted for inflation) is 31 percent higher than the FY 1997 level.<sup>4</sup>

As our report points out, the IRS has moved toward reversing many of the enforcement declines in both the Collection and Examination functions. However, despite work the IRS is doing to improve its enforcement efforts, the Government Accountability Office regarded enforcement of tax laws (collection of unpaid taxes and Earned Income Tax Credit noncompliance) as 1 of the 26 high-risk areas in the Federal Government in its January 2007 update.<sup>5</sup> The Government Accountability Office states that improvements in compliance with tax laws will require efforts on the part of the IRS and Congress.

Continued effort to improve compliance is important to maintaining the integrity of the voluntary tax compliance system. According to a tax gap strategy document dated September 2006, the tax gap for Tax Year 2001 is \$345 billion, representing a compliance rate of about 84 percent.<sup>6</sup> The purpose of the strategy document was to provide a broad base on which to build future efforts to address the tax gap. Additional detailed strategy elements to address the tax gap are, in part, contingent upon the budget process for FYs 2008 and beyond. One of the seven components included in the strategy is to be better able to prevent, detect, and remedy noncompliance.

In a prior audit report on tax gap projections, we concluded that the IRS does not have sufficient information to completely and accurately measure the overall tax gap.<sup>7</sup> While the IRS is conducting research to obtain a better and updated measure of the tax gap, it still faces large challenges to completely and accurately measure the tax gap. We believe improvements can be made, but sufficient resources need to be provided.

### ***Collection Function Compliance Activities Increased and Results Improved***

The Collection Field function (CFf) revenue officer personnel assigned delinquent cases increased 5 percent in FY 2006; there were 3,876 field revenue officers as of the end of the fiscal year.<sup>8</sup> However, since the start of FY 1997, revenue officer staffing is down 30 percent.

In addition to the increase in staffing during FY 2006, the Small Business/Self-Employed Division implemented an organizational change during FY 2005 and continues with efforts to improve business processes. Also, workload selection methods continue to be studied with the

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<sup>3</sup> See Appendix V, Figure 3.

<sup>4</sup> See Appendix V, Figure 2.

<sup>5</sup> *HIGH-RISK SERIES – An Update* (GAO-07-310, dated January 2007).

<sup>6</sup> *A Comprehensive Strategy for Reducing the Tax Gap* (Department of the Treasury, Office of Tax Policy, dated September 26, 2006).

<sup>7</sup> *Some Concerns Remain About the Overall Confidence That Can Be Placed in Internal Revenue Service Tax Gap Projections* (Reference Number 2006-50-077, dated April 2006).

<sup>8</sup> See Appendix V, Figure 5.



## Trends in Compliance Activities Through Fiscal Year 2006

goal of identifying the best cases to be worked. These efforts could have had some positive impacts in the Collection function activities that continued to show improvement during FY 2006. However, the results of some activities were not positive.

### **Many Collection function operations showed improvement**

The following activities showed positive results for the Collection function during FY 2006.

- Dollars collected on Taxpayer Delinquent Accounts (TDA) by the Automated Collection System (ACS) and the CFf employees totaled almost \$6.2 billion, an increase of 5.5 percent from FY 2005.<sup>9</sup> This year's amount is up 71 percent from the 10-year low that occurred in FY 2000.
- The number of TDAs closed (excluding shelved accounts) and the number closed by full payment increased 6.7 percent and 8.7 percent, respectively, from FY 2005.<sup>10</sup> This year's volumes are the highest since FY 1997.
- The number of Taxpayer Delinquency Investigations (TDI) closed by the ACS and the CFf because delinquent tax returns were received by the IRS increased 5 percent from FY 2005. There has been a 71 percent increase since a 10-year low that occurred in FY 2002.
- As shown in Figure 1, the use of liens (a collection enforcement tool) has increased 275 percent since the low experienced in FY 1999. The number of liens issued by the CFf and the ACS increased in FY 2006 by 24 percent and 16 percent, respectively.<sup>11</sup> The ACS volume represented a 10-year high, and the CFf volume approached the 10-year high of FY 1997.

**Figure 1: Use of Collection Enforcement Tools**

	Liens	Levies	Seizures
FY 1997	543,613	3,659,417	10,090
FY 1998	382,755	2,503,409	2,259
FY 1999	167,867	504,403	161
FY 2000	287,517	219,778	74
FY 2001	426,165	674,080	234
FY 2002	482,509	1,283,742	296
FY 2003	544,316	1,680,844	399
FY 2004	534,392	2,029,613	440
FY 2005	522,887	2,743,577	512
FY 2006	629,813	3,742,276	590

Source: Small Business/Self-Employed Division Collection Planning and Analysis, Collection National Reports, and IRS Data Book.

<sup>9</sup> See Appendix V, Figure 9.

<sup>10</sup> See Appendix V, Figures 14 and 15.

<sup>11</sup> See Appendix V, Figure 16.



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## *Trends in Compliance Activities Through Fiscal Year 2006*

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In last year's trends report,<sup>12</sup> we noted there should be an increase in the number of liens filed on accounts with large balance-due amounts based on procedural changes being made by the Collection function.<sup>13</sup>

As also shown in Figure 1, the uses of levies and seizures (additional collection enforcement tools) increased substantially from lows experienced in FY 2000. Levies increased 1,603 percent, and seizures increased 697 percent.<sup>14</sup> The number of levies surpassed the FY 1997 volume in FY 2006. However, the number of seizures made was still substantially lower than the number made before FY 1998. It is unlikely the IRS' use of seizures will return to the pre-1998 volumes in the foreseeable future.

### **Some Collection function operations showed mixed results**

Some indicators were not positive for Collection function compliance activity during FY 2006.

- The amount of gross accounts receivable increased almost 5 percent (to \$271 billion) after decreasing just over 9 percent during FY 2005.<sup>15</sup> This occurred even though there were increases in gross collections and enforcement revenue collected.
- The average amount collected per CFf staff year on TDAs decreased almost 4 percent from FY 2005. However, the average amount increased almost 105 percent to \$554,909, from a low of \$271,110 in FY 1999.<sup>16</sup>
- There were more TDA receipts than closures; however, the gap between TDA receipts and TDA closures narrowed slightly during the fiscal year after widening during FY 2005.<sup>17</sup> The gap had decreased by almost 4 percent to 1,174,824 accounts as of the end of the year. Except for FY 2004, this gap is still smaller than at the end of any fiscal year since FY 1998.

An inventory of unassigned collection cases is maintained in the Queue. After decreasing slightly during FY 2005, the number of taxpayers with unpaid accounts in the Queue and the amount owed on these accounts increased to 10-year highs during FY 2006.<sup>18</sup> The number of taxpayer accounts increased just over 28 percent to 779,272. At the same time, the amount owed increased just over 34 percent to \$27.2 billion. One reason for the increase in the Queue this

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<sup>12</sup> *Trends in Compliance Activities Through Fiscal Year 2005* (Reference Number 2006-30-055, dated March 2006).

<sup>13</sup> *High-Risk Work Is Selected From the Unassigned Delinquent Account Inventory, but Some Unassigned Accounts Need Management's Attention* (Reference Number 2006-30-030, dated February 2006).

<sup>14</sup> See Appendix V, Figures 17 and 18.

<sup>15</sup> See Appendix V, Figure 3.

<sup>16</sup> See Appendix V, Figure 8.

<sup>17</sup> See Appendix V, Figure 12.

<sup>18</sup> See Appendix V, Figure 13.



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year is a rise in the number of compliance assessments.<sup>19</sup> In addition, the number of taxpayers with unfiled tax returns increased just over 15 percent to 824,936, but there was a small (just over 8 percent) decrease in the number of these accounts that were shelved or surveyed (removed from inventory) during the year.<sup>20</sup> Although many of the cases in the Queue may be assigned to be worked, a significant amount may never be worked.

As noted above, the Queue inventory increased during FY 2006. However, those inventory figures do not include the millions of tax periods for unpaid accounts and unfiled return investigations shelved or surveyed (removed) from Collection function inventory during the last few years. From FYs 2001 through 2006, the IRS removed almost 6.8 million TDAs<sup>21</sup> (with balance-due amounts totaling more than \$28 billion) and almost 15.2 million TDI tax periods from Collection function inventory. However, the pace for removal of both TDAs and TDIs has slowed each year since FY 2004. These cases were removed from Collection function inventory because they were potentially less productive than other available inventory and may never be worked.

The Collection function is unable to work all of the existing accounts in the Queue with current staffing, and, as stated above, the number of TDA receipts is outpacing closures. If changes do not occur, a significant number of cases will continue to not be worked. This reinforces the need for additional resources to work the cases. As previously noted, the Collection function hired additional staff during FY 2006, but it is unlikely that hiring will take place during FY 2007. In addition, in September 2006, the IRS started assigning balance-due cases that otherwise would not have been worked to private collection agencies. As of January 18, 2007, the IRS had received \$12.6 million on cases assigned to the collection agencies. Continued use of private collection agencies is uncertain because some members of Congress want the IRS to discontinue their use.

### ***Examination Function Compliance Activities Increased and Results Improved***

Overall, the number of field Examination function personnel that conduct examinations of tax returns increased just over 9 percent between FYs 2005 and 2006. The number of revenue agents increased to 10,513, while the number of tax compliance officers (formerly referred to as tax auditors) increased to 1,145 as of the end of the fiscal year.<sup>22</sup> However, there has been an

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<sup>19</sup> Compliance assessments are those generated by the Examination function, the Automated Underreporter program, the Substitute for Return program, and the 6020(b) program. See Appendix V, Figures 47 and 48.

<sup>20</sup> See Appendix V, Figures 10 and 11.

<sup>21</sup> See Appendix V, Figure 11.

<sup>22</sup> See Appendix V, Figure 4.



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## *Trends in Compliance Activities Through Fiscal Year 2006*

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almost 22 percent decrease in the number of examiners in field offices<sup>23</sup> since the start of FY 1997.

In addition to the increased staff during FY 2006, over the last few years the Small Business/Self-Employed Division has implemented some reengineering and organizational changes that could have had a positive impact within the Examination function in some of the areas noted below. In addition, the Examination function continues to study methods that will result in the identification of tax returns for examination that contain greater potential for noncompliance.

Compared to FY 2005, the percentage of tax returns examined increased for most types of tax returns during FY 2006. At the same time, examination yield per hour (the amount of tax adjustments on tax returns divided by the number of hours spent examining those returns) also increased for corporate and other types of tax returns, but revenue agent results for individual tax returns decreased.<sup>24</sup>

### **The number of tax returns examined increased, but many examinations were conducted via correspondence**

When analyzing examination coverage rates, it is important to recognize differences in the types of contacts that are counted in Examination function statistics. Examinations range from an IRS notice asking for clarification of a single tax return item that appears to be incorrect (correspondence examination) to a full face-to-face interview and review of the taxpayer's records. Face-to-face examinations are generally more comprehensive and time consuming for the IRS and the taxpayers, and they typically result in higher dollar adjustments to the tax amounts. Thus, caution should be used when combining statistics from the various Examination function programs into overall examination rates. During FY 2006, almost 70 percent of all examinations were conducted via correspondence.<sup>25</sup>

In addition, the IRS uses several computer-matching and automated error-checking routines in the Computing Centers to check the accuracy of tax returns. The running of these routines often results in adjustments to tax liabilities; however, these adjustments are not included in the traditional "audit rates" and are not generally reported separately as enforcement efforts.

The overall percentage of tax returns examined (including face-to-face and correspondence examinations) increased by just over 4 percent<sup>26</sup> from FY 2005 and has increased 84 percent

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<sup>23</sup> Examiners in field offices include revenue agents, tax compliance officers, tax examiners, and revenue officer examiners.

<sup>24</sup> See Appendix V, Figures 20 through 23.

<sup>25</sup> This information was computed using the Audit Technique Codes that identify how the employees are conducting the audits. This number differs from some publicized reports that use the organizational code.

<sup>26</sup> The IRS has traditionally calculated the percentage of examination coverage by dividing the number of returns examined in the current fiscal year by the number of returns filed in the preceding calendar year.

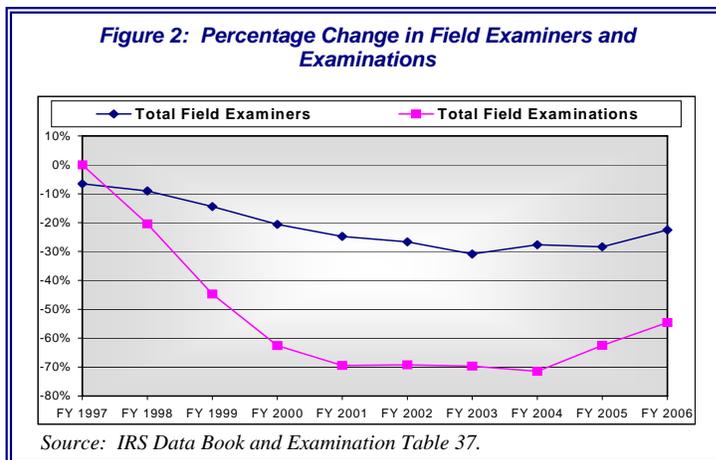


## Trends in Compliance Activities Through Fiscal Year 2006

since FY 2000. However, the rate is still 27 percent lower than it was in FY 1997. The largest increase in the examination rate from FY 2000 was for individual tax returns. Examinations of other types of tax returns did not increase as significantly or decreased.

Examination function staffing increased during FY 2006. However, hiring during FY 2007 was curtailed due to budget considerations. This may reverse again in FY 2008, as the President's Proposed Budget provides for an increase in Examination function enforcement.

Figure 2 compares the change in field Examination function staffing to the change in examinations for all types of tax returns by field employees from the beginning of FY 1997



through FY 2006. The chart line for the number of field examiners does not start at zero because the number of examiners conducting examinations during FY 1997 decreased by almost 7 percent during the year.

A continued effort to increase examination coverage is important to maintaining the effectiveness of the voluntary tax compliance system. In 2006, the study of taxpayer attitudes about cheating on taxes showed a

decline, after showing improvements each year since 2003. In 2006, 12 percent of taxpayers believed it was acceptable to cheat on their tax returns. This is up from 10 percent in 2005.<sup>27</sup> Also, fear of examination is a major factor in influencing taxpayers to report taxes honestly. In 2002, 54 percent of taxpayers surveyed cited fear of examination as a factor that influenced their voluntary compliance. This increased to 62 percent in 2005 then decreased to 61 percent in 2006.

The following paragraphs summarize examination coverage for various types of tax returns.

- **Individual Income Tax Examinations** – Overall, the number of all types of individual income tax returns examined decreased from FY 1997 through FY 2000. However, the downward trend was reversed in FY 2001, when the number of examinations in most categories increased from the prior years. During FY 2000, only 617,765 (1 in 202) individual income tax returns were examined. Since then the number examined has continuously increased; 1,283,950 (1 in 103) were examined in FY 2006, with 82 percent of those being done by correspondence.<sup>28</sup>

<sup>27</sup> IRS Oversight Board 2006 Taxpayer Attitude Survey.

<sup>28</sup> See Appendix V, Figure 24.



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- The number of individual income tax returns with income under \$100,000 examined increased from 518,218 (1 in 221 tax returns filed) in FY 2000 to 1,026,333 (1 in 114 tax returns filed) in FY 2006.<sup>29</sup> This increase was almost entirely due to a rise in the number of correspondence examinations, which accounted for 87 percent of the examinations in this income category in FY 2006. Only 1 in 895 individual income tax returns filed with income under \$100,000 received a face-to-face examination, while 1 in 130 received a correspondence examination.
- The number of individual income tax returns with income of \$100,000 and over (high-income taxpayers) examined increased from 99,547 (1 in 104 tax returns filed) in FY 2000 to 257,617 (1 in 60 tax returns filed) in FY 2006.<sup>30</sup> Most (74 percent) of this increase was due to a rise in the number of correspondence examinations, which accounted for 62 percent of the examinations in this income category in FY 2006. Only 1 in 159 individual income tax returns filed with income of \$100,000 and over received a face-to-face examination, while 1 in 96 received a correspondence examination.

In a report issued last year, we noted that correspondence examinations of high-income taxpayers may have only a limited impact on compliance.<sup>31</sup> Taxpayers did not always respond to these examinations. About 86 percent of the amount assessed on these no-response cases was either reversed or not collected after an average of 608 calendar days (almost 2 years) from the date of the assessment.

Earned Income Tax Credit issues accounted for between 55 percent and 83 percent of the examinations of individual income tax returns with income under \$25,000 for FYs 2000 through 2006 and accounted for 28 percent of the examinations of individuals overall during FY 2006. Excluding examinations in which the Earned Income Tax Credit was an issue, from FYs 2000 to 2006, the number of examinations of individual tax returns with income under \$100,000 increased 166 percent (from 250,248 to 666,400) and the number with income of \$100,000 and over increased 158 percent (from 98,983 to 255,002).

- *Corporate Income Tax Examinations* – The number of corporate income tax returns examined (excluding returns for foreign and S Corporations) decreased 1 percent in FY 2006, after increasing 71 percent in FY 2005. Even with the increase in FY 2005, the number of examinations has still decreased 59 percent since FY 1997. In FYs 1997 to

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<sup>29</sup> See Appendix V, Figures 24 and 25.

<sup>30</sup> See Appendix V, Figures 24 and 25.

<sup>31</sup> *While Examinations of High-Income Taxpayers Have Increased, the Impact on Compliance May Be Limited* (Reference Number 2006-30-105, dated July 25, 2006).



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## *Trends in Compliance Activities Through Fiscal Year 2006*

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2006, the total number of corporate tax returns examined decreased from 69,295 (1 out of 37 returns filed) to 28,427 (1 out of 80 returns filed).<sup>32</sup>

The number of corporate tax returns with assets of under \$10 million examined was unchanged in FY 2006. During the same period, the number of corporate tax returns with assets of \$10 million and over examined decreased just over 2 percent. However, a much higher percentage of these larger corporations are examined than those with assets of under \$10 million.

- *S Corporation Return Examinations* – After declining 75 percent from FYs 1998 to 2004, the number of S Corporation tax returns examined increased 63 percent in FY 2005 and another 34 percent in FY 2006. Since FY 2004, the number of S Corporation returns filed has increased 10 percent. During that period, the number of tax returns examined increased from 1 out of 526 returns filed to 1 out of 266 returns filed.<sup>33</sup> The increase in examination coverage can be partly attributed to the IRS research project studying the compliance of S Corporation entities. The results of this project could lead to changes in the selection of these tax returns for examination. For additional information, see our recently issued audit report on the research project.<sup>34</sup>
- *Partnership Return Examinations* – The number of partnership returns examined increased by almost 15 percent in FY 2006 and has increased 92 percent since the 10-year low experienced in FY 2001. The number of returns filed increased by about 32 percent between FYs 2001 and 2006.<sup>35</sup> About 1 out of every 408 returns filed in FY 2001 was examined; this increased to 1 out of every 279 for this year.

*Other Tax Types Examinations (Fiduciary, Employment, Excise, Estate, and Gift Taxes)* – The overall number of examinations in these 5 classes increased almost 7 percent during FY 2006 and was up almost 72 percent from the 10-year low experienced in FY 2003. The ratio of tax returns examined to tax returns filed was higher for each class, compared to FY 2003, except fiduciaries. While the ratio for fiduciaries had a spike in FY 2005, there was an overall decrease of 40 percent from FYs 2003 to 2006.<sup>36</sup>

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<sup>32</sup> See Appendix V, Figures 37, 38, and 50 for coverage by size of corporation.

<sup>33</sup> See Appendix V, Figures 40 and 50.

<sup>34</sup> *The National Research Program Study of S Corporations Has Been Effectively Implemented, but Unnecessary Information Was Requested From Taxpayers* (Reference Number 2007-30-027, dated January 30, 2007).

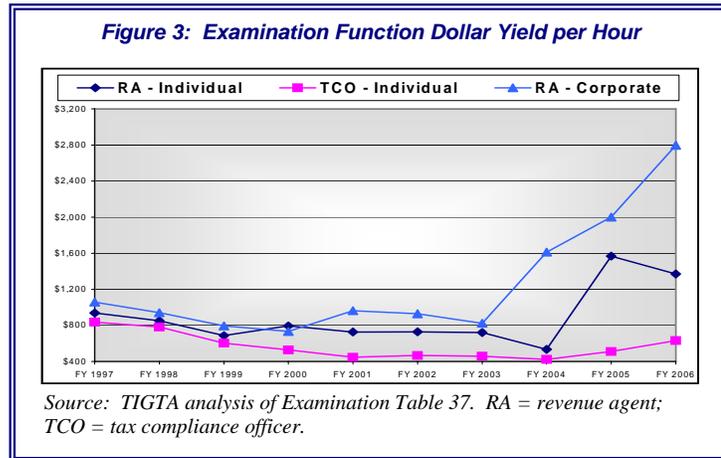
<sup>35</sup> See Appendix V, Figures 41 and 50.

<sup>36</sup> See Appendix V, Figures 42 through 46 and 50.



### Examination function dollar yield per hour has mixed results

Figure 3 shows the impact on the dollar yield per hour for FYs 1997 to 2006 for revenue agents and tax compliance officers on individual and corporate tax returns. The dollar yield per hour improved just over 23 percent for tax compliance officer individual tax return examinations and almost 40 percent for revenue agent corporate tax return examinations during FY 2006. However, the yield decreased almost 13 percent for revenue agent individual tax return examinations.



The Examination function dollar yield per hour for individual income tax return examinations was lower in FY 2004 than in FY 1997.<sup>37</sup> During FYs 2005 and 2006, the yield increased for tax compliance officers. The yield per hour increased significantly for revenue agents during FY 2005 but then decreased slightly this year. Only the yield per hour for revenue agents is above the FY 1997 level. The dollar results per individual income tax return examined fluctuated during the period; the number of hours used to examine each tax return increased substantially through FY 2004 then decreased in FYs 2005 and 2006.

The dollar yield per hour spent examining corporate tax returns has increased each year since FY 2003. The total increase for the 3 years was 239 percent.<sup>38</sup> During the same time period, the average hours spent examining each tax return and the average dollar amounts assessed per return fluctuated. The net effect was the increase in the dollar yield per hour. While there was an overall increase in average assessments per return, there were significant increases in average assessments for larger corporations (those with assets of \$5 million and over).

<sup>37</sup> See Appendix V, Figures 20 and 23.

<sup>38</sup> See Appendix V, Figure 21.



## **Appendix I**

### *Detailed Objective, Scope, and Methodology*

The overall objective of this review was to provide statistical information requested by the IRS Oversight Board and trend analyses of that information.

To accomplish our objective, we analyzed information obtained from the IRS' management information system reports to determine the trends and changes in the major areas of compliance. Because we relied on information accumulated by the IRS in established reports, we did not verify its accuracy. The major issues we focused on included:

- Enforcement revenue<sup>1</sup> and gross accounts receivable.
- Collection and Examination function staffing.
- Collection and Examination function direct time.
- Collection function delinquent account inventories and unfiled return investigations.
- Collection function enforcement actions (liens, levies, and seizures).
- Examination function coverage of individual and business tax returns compared to the number of returns filed in each category.
- Examination function productivity results for individual and business tax returns.
- Other activities resulting in improvement to the accuracy of filed tax returns and the filing of delinquent returns.

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<sup>1</sup> See Appendix IV for a glossary of terms used in this report.



## **Appendix II**

### *Major Contributors to This Report*

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## **Appendix III**

### *Report Distribution List*

Commissioner C  
Office of the Commissioner – Attn: Chief of Staff C  
Commissioner, Large and Mid-Size Business Division SE:LM  
Commissioner, Small Business/Self-Employed Division SE:S  
Commissioner, Wage and Investment Division SE:W  
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    Commissioner, Large and Mid-Size Business Division SE:LM  
    Commissioner, Small Business/Self-Employed Division SE:S  
    Commissioner, Wage and Investment Division SE:W



## Appendix IV

### *Glossary of Terms*

**Automated Collection System** – A telephone contact system through which telephone assistants collect unpaid taxes and secure tax returns from delinquent taxpayers who have not complied with previous notices.

**Automated Substitute for Return system** – A system designed to assess taxes on wage earners who fail to file tax returns. It analyzes information submitted to the IRS and historical tax return information.

**Balance Sheet** – A statement of the financial assets and liabilities of a business at a given date filed with a corporate income tax return; it is used by the IRS to group businesses by the size of their assets.

**Campus** – The data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.

**Collection Field function** – The unit in the field offices consisting of revenue officers who handle personal contacts with taxpayers to collect delinquent accounts or secure unfiled tax returns.

**Computing Center** – Computing Centers support tax processing and information management through a data processing and telecommunications infrastructure.

**Corporate Income Tax Returns** – U.S. Corporation Income Tax Returns (Form 1120) are used by corporations to report the corporate income tax.

**Earned Income Tax Credit** – A tax credit for certain people who work and have income under established limits.

**Employment Tax Returns** – Various Form 940 return series (primarily Employer's Annual Federal Unemployment (FUTA) Tax Return (Form 940) and Employer's QUARTERLY Federal Tax Return (Form 941)) filed by businesses to report things such as employer's Federal unemployment taxes and Federal taxes withheld.

**Enforcement Revenue** – Any tax, penalty, or interest received from a taxpayer as a result of an IRS enforcement action (usually an examination or a collection action).

**Estate Tax Return** – United States Estate (and Generation-Skipping Transfer) Tax Return (Form 706) is filed for certain estates of deceased persons.

**Examination (Face-to-Face)** – Field examinations of individuals, partnerships, and corporations that occur either at the taxpayer's place of business or through interviews at an IRS office.



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## *Trends in Compliance Activities Through Fiscal Year 2006*

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**Excise Tax Return** – Quarterly Federal Excise Tax Return (Form 720) is used to report and pay certain taxes, such as those on transportation and fuel.

**Fiduciary Income Tax Returns** – Income tax returns filed for estates and trusts.

**Gift Tax Return** – United States Gift (and Generation-Skipping Transfer) Tax Return (Form 709) is used to report transfers subject to the Federal gift taxes and to calculate the tax due on those transfers.

**Gross Accounts Receivable** – Includes all unpaid tax, with accrued penalties and interest, on taxpayers' delinquent accounts.

**Individual Income Tax Returns** – U.S. Individual Income Tax Returns (Form 1040 series) are annual income tax returns filed by citizens or residents of the United States.

**Levy** – A method used by the IRS to collect outstanding taxes from sources such as bank accounts and wages.

**Lien** – An encumbrance on property or rights to property as security for outstanding taxes.

**Math Error** – A program in which the IRS contacts taxpayers through the mail or by telephone when it identifies mathematical errors or mismatches of taxpayer information that would result in a tax change.

**National Research Project** – Research conducted by the IRS to determine filing, payment, and reporting compliance by taxpayers for different types of taxes.

**Partnership Return** – U.S. Return of Partnership Income (Form 1065) is used to report the income and expenses of domestic partnerships and the share distributed to each partner.

**Queue** – An automated holding file for unassigned inventory of delinquent cases for which the Collection function does not have enough resources to immediately assign for contact.

**Revenue Agent** – Employees in the Examination function that conduct face-to-face examinations of more complex tax returns such as businesses, partnerships, corporations, and specialty taxes (e.g., excise tax returns).

**Revenue Officer** – Employees in the CFf who attempt to contact taxpayers and resolve collection matters that have not been resolved through notices sent by the IRS campuses (formerly known as service centers) or the ACS.

**Revenue Officer Examiner** – Revenue officers that have been trained to conduct examinations of employment tax returns.

**S Corporation Tax Return** – U.S. Income Tax Return for an S Corporation (Form 1120S) is filed by qualifying small business corporations and includes amounts distributed to shareholders.

**Schedule C** – A schedule filed with Forms 1040 to report Profit or Loss From Business.

**Schedule F** – A schedule filed with Forms 1040 to report Profit or Loss From Farming.



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## *Trends in Compliance Activities Through Fiscal Year 2006*

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**Seizure** – The taking of a taxpayer’s property to satisfy his or her outstanding tax liability.

**Service Center Collection Branch** – Mails the balance-due and return-delinquency notices to taxpayers and analyzes and responds to taxpayer correspondence.

**Shelved or Surveyed Cases** – Delinquent unpaid accounts or investigations of unfiled tax returns that have been taken out of the Collection function’s inventory because they are of lower priority than other available inventory.

**Tax Compliance Officer/Tax Auditor** – Employees in the Examination function that primarily conduct examinations of individual taxpayers through interviews at IRS field offices. The position title was changed in 2002 from tax auditor to tax compliance officer.

**Tax Examiner** – Employees in field offices that conduct examinations through correspondence.

**Taxpayer Delinquent Account** – A balance-due account of a taxpayer. A separate TDA exists for each tax period.

**Taxpayer Delinquency Investigation** – An unfiled tax return for a taxpayer. One TDI exists for all tax periods.

**Tax Gap** – The difference between what taxpayers should have paid and what they actually paid timely.

**Tax Period** – Refers to each tax return filed by the taxpayer for a specific period (year or quarter) during a calendar year for each type of tax.

**Total Gross Receipts** – The categories used for individual income tax returns with Profit or Loss From Business (Schedule C) or Profit or Loss From Farming (Schedule F) income based on the total receipts reported.

**Underreporter** – The Underreporter Program matches items reported on an individual’s income tax return to information supplied to the IRS from outside sources (such as from employers, banks, and credit unions) to determine if the taxpayer’s tax return reflected the correct amounts, ensuring the tax amount is correct.



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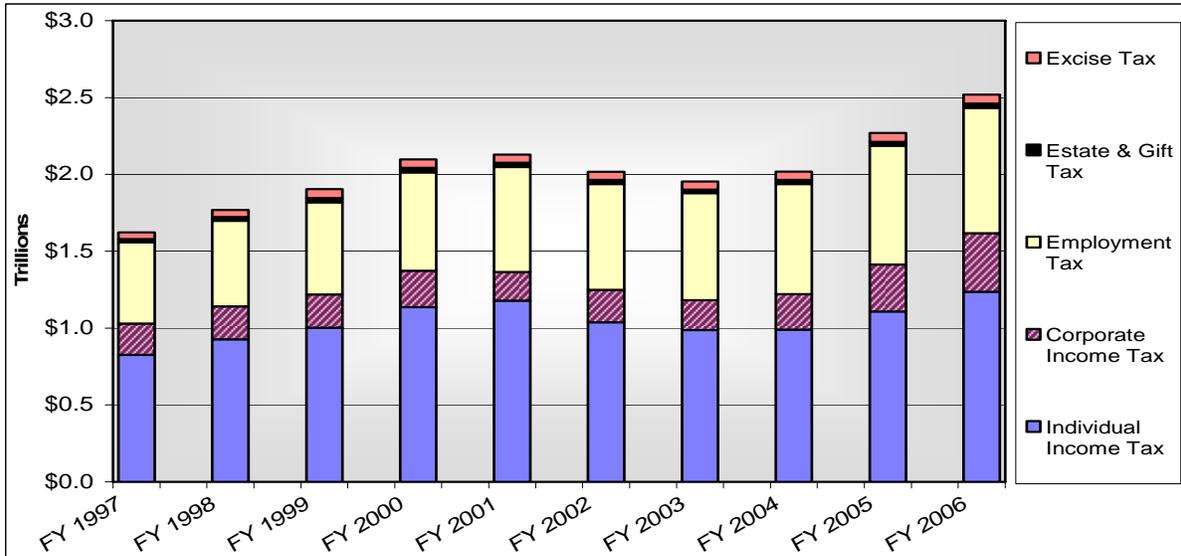
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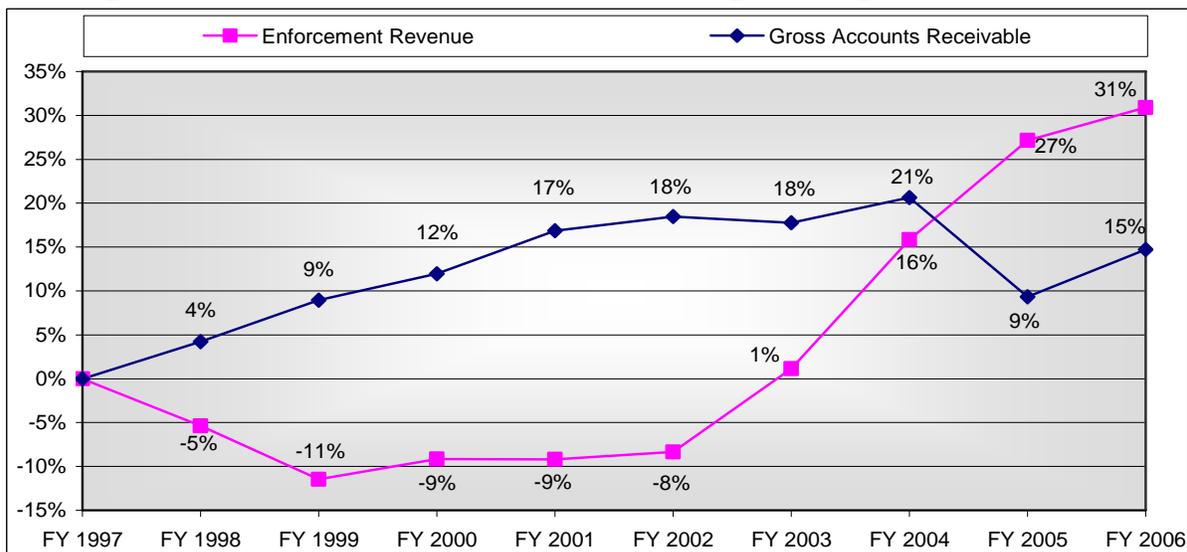
*Trends in Compliance Activities Through Fiscal Year 2006*

**Figure 1. Gross Collections by Type of Tax Since FY 1997.** Overall, gross tax collections rose in FY 2006 to the highest level of the 10-year analysis. Since the low experienced in FY 2003, corporate income tax collections increased by 96 percent, individual income tax collections increased by 25 percent, and employment tax collections increased by 17 percent.



Source: TIGTA analysis of IRS Data Book.

**Figure 2. Change in Enforcement Revenue and Gross Accounts Receivable – Percentage Change From FY 1997.** Enforcement revenue has been increasing sharply since FY 2002; for FY 2006, it was 31 percent higher than it was for FY 1997. After decreasing sharply during FY 2005, gross accounts receivable increased to a level 15 percent higher than that in FY 1997.

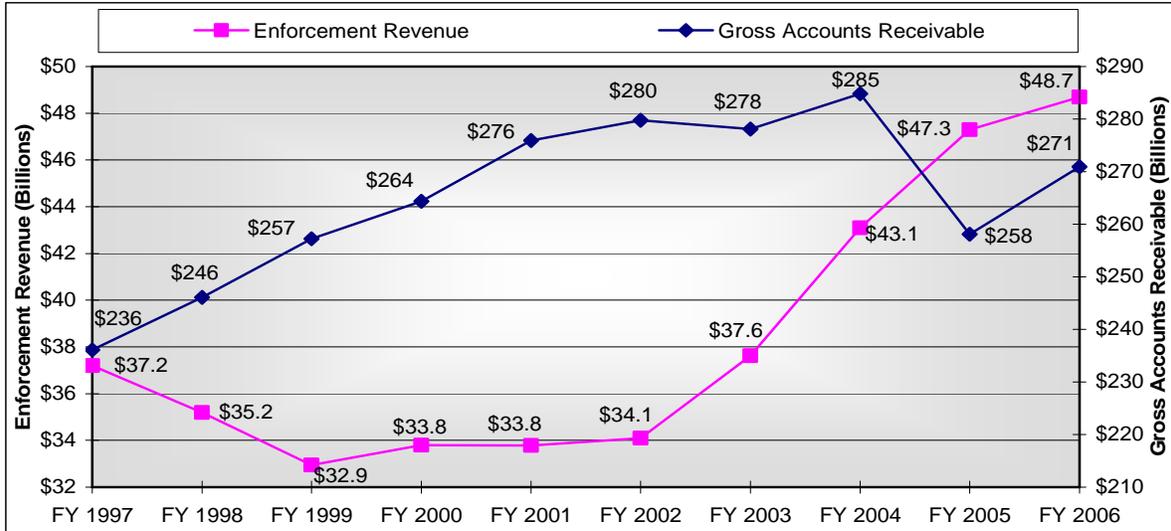


Source: Office of Research, Analysis, and Statistics and Chief Financial Officer information.



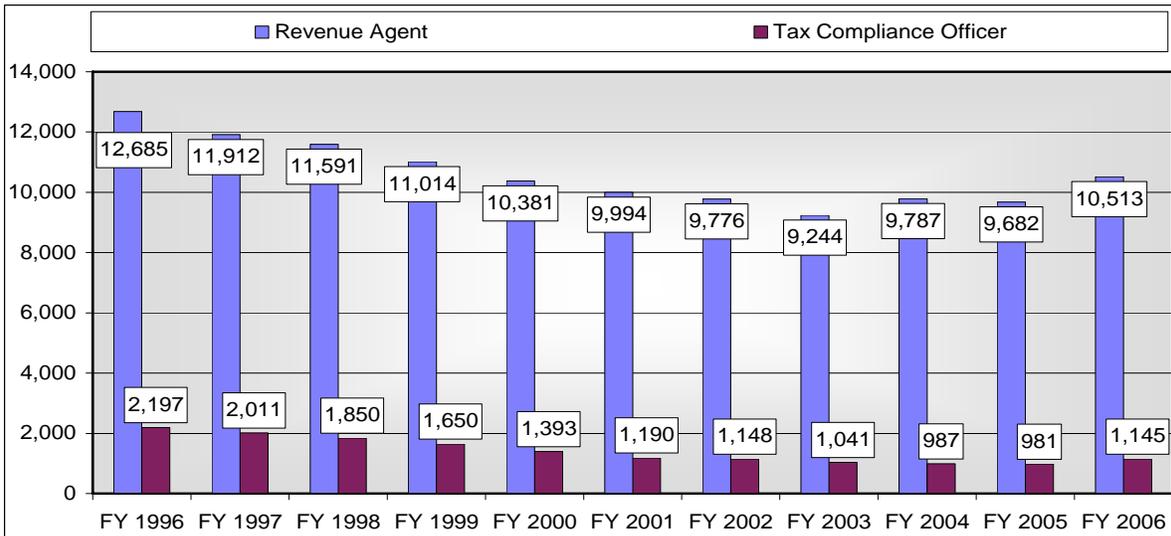
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**Figure 3. Amounts of Enforcement Revenue Collected Compared to Growth in Gross Accounts Receivable.** After several years of remaining relatively constant, enforcement revenue collected has increased 43 percent since FY 2002. Gross accounts receivable increased 5 percent during FY 2006 alone.



Source: Office of Research, Analysis, and Statistics and Chief Financial Officer information.

**Figure 4. Examination Function Staffing at the End of Each Fiscal Year.** The numbers in this chart represent the Examination function staff conducting examinations of tax returns (excludes management and overhead staff). During FY 2006, revenue agent and tax compliance officer (formerly referred to as tax auditor) staffing increased, but the combined total is almost 22 percent lower than it was at the beginning of FY 1997.

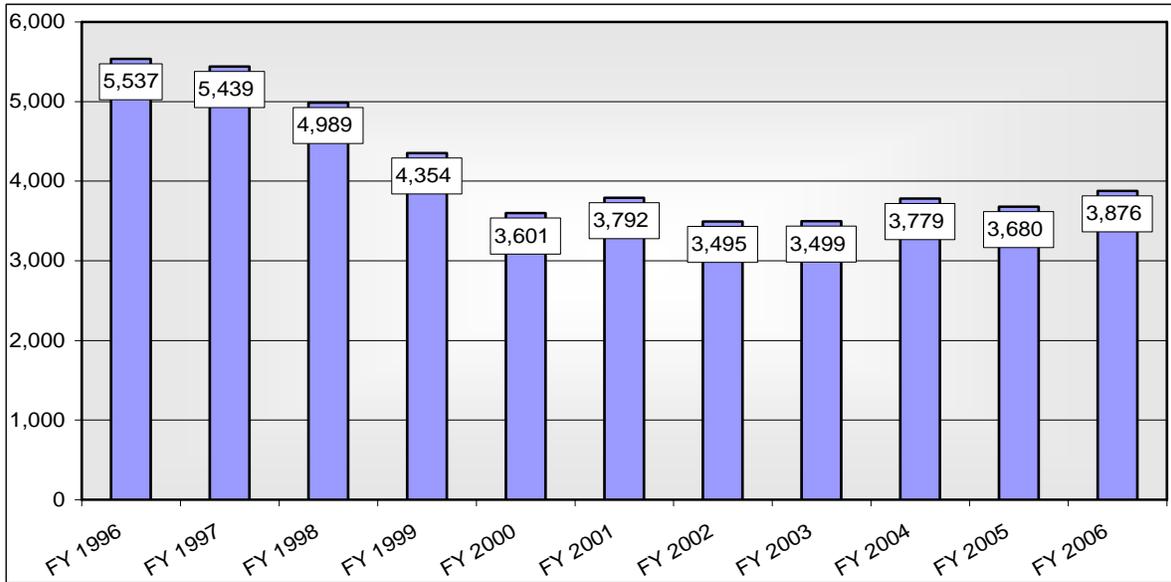


Source: TIGTA analysis of Examination Table 37.



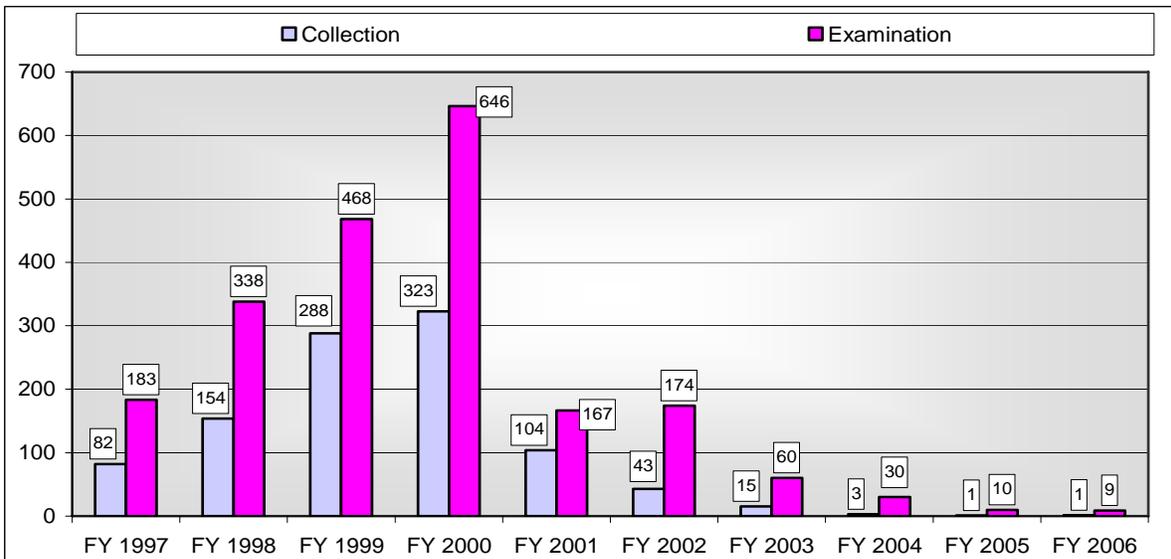
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**Figure 5. Cff Staffing at the End of Each Fiscal Year.** The number of revenue officers working assigned delinquent cases (excludes management and overhead staff) increased slightly during the year but is almost 30 percent fewer than at the start of FY 1997.



Source: Collection Report 5000-23.

**Figure 6. Staff Years Detailed to Customer Service.** The number of staff years detailed to customer service decreased again in FY 2006 and remained lower than the number detailed during FY 1997.

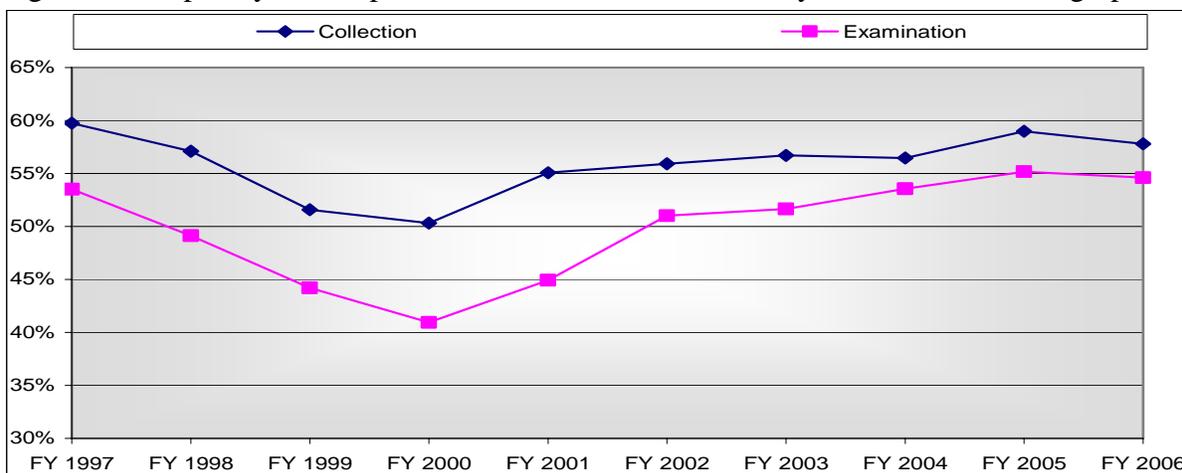


Source: TIGTA analysis of Collection Report 5000-23 and Examination Table 37.



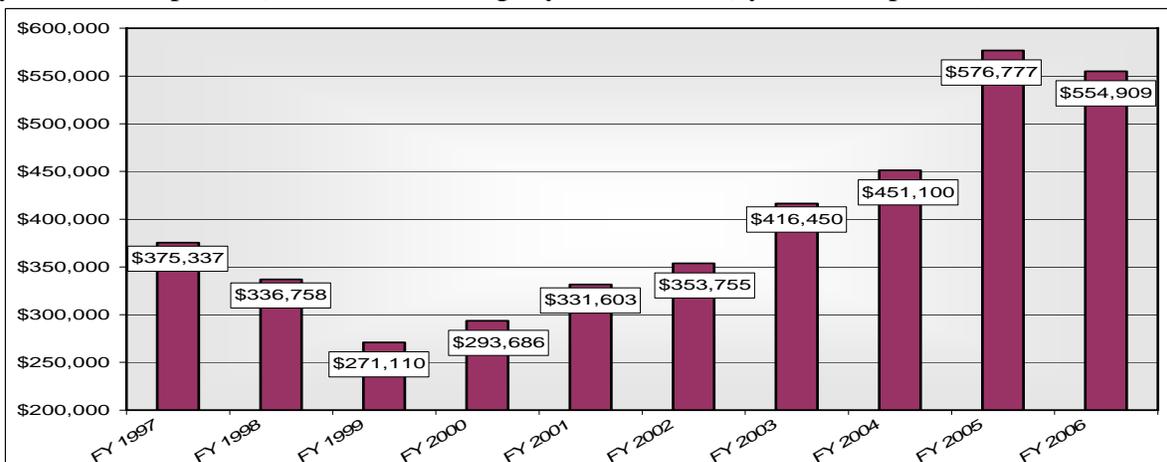
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**Figure 7. Changes in Direct Time Percentages.** The Collection and Examination functions had both increased the percentage of overall time charged to their direct tax-related responsibilities (collecting taxes, securing tax returns not timely filed, and examining tax returns) since FY 2000, but the direct time percentages decreased for both functions during FY 2006. This decrease can be partly attributed to the increase in training time spent on newly hired employees. The Examination and Collection functions changed what types of time they capture as direct and indirect in recent years, including capturing some of the previous indirect time as direct time. The chart below depicts our recalculation of direct time based on direct time categories from prior years, to present consistent data for the 10 years included in the graph.



Source: TIGTA analysis of Collection Report 5000-23 and Examination Table 37.

**Figure 8. Average Dollars Collected per Staff Year on TDAs by the CFf.** The average amount collected by the CFf for each staff year has increased significantly since FY 1999 (by almost 105 percent) but decreased slightly in FY 2006 (by almost 4 percent).

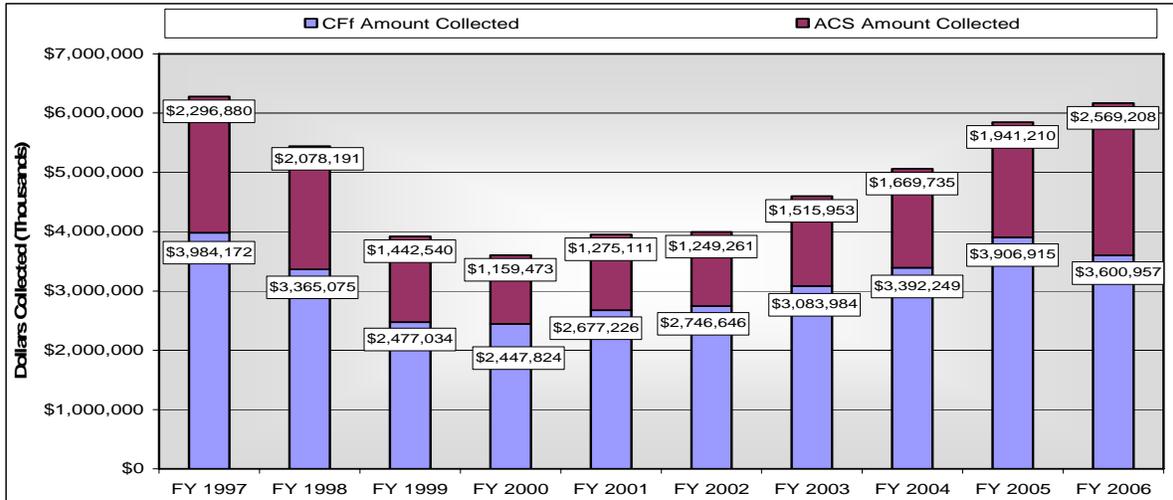


Source: TIGTA analysis of Collection Reports 5000-2 and 5000-23.



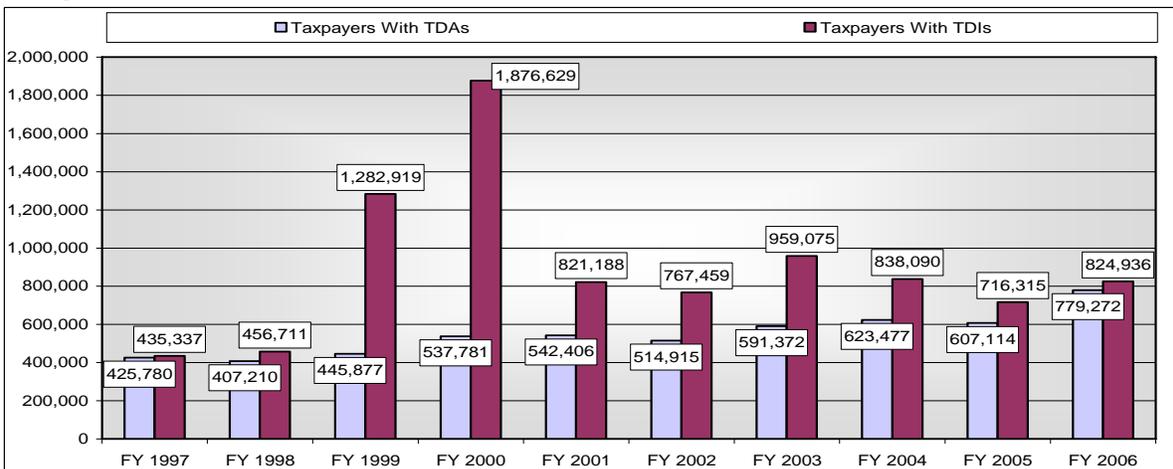
*Trends in Compliance Activities Through Fiscal Year 2006*

**Figure 9. Total Dollars Collected on TDAs by the Cff and ACS.** The combined amount collected by the Cff and ACS has increased constantly since FY 2000, even though the amount collected by the Cff decreased by almost 8 percent during FY 2006. The overall increase occurred because of the large increase in the amount collected by the ACS (just over 32 percent) during FY 2006.



Source: Collection Report 5000-2.

**Figure 10. TDAs and TDIs in the Queue.** The number of taxpayers with TDIs in the Queue increased from FYs 1997 to 2000, with significant spikes during FYs 1999 and 2000, then decreased to remain at relatively constant levels. However, the overall trend showed an increase in the number of taxpayers with TDAs in the Queue from FYs 1997 through 2006. This occurred even though, in recent years, the IRS removed from the Queue a large number of cases that were considered to be potentially less productive than other Queue inventory (see Figure 11).

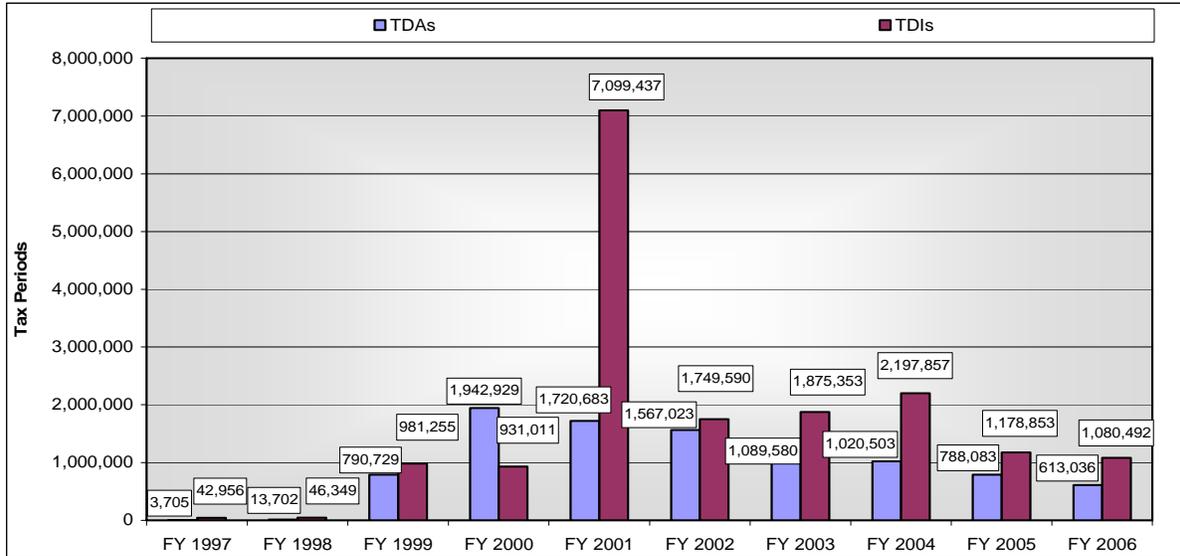


Source: Collection Reports 5000-2 and 5000-4.



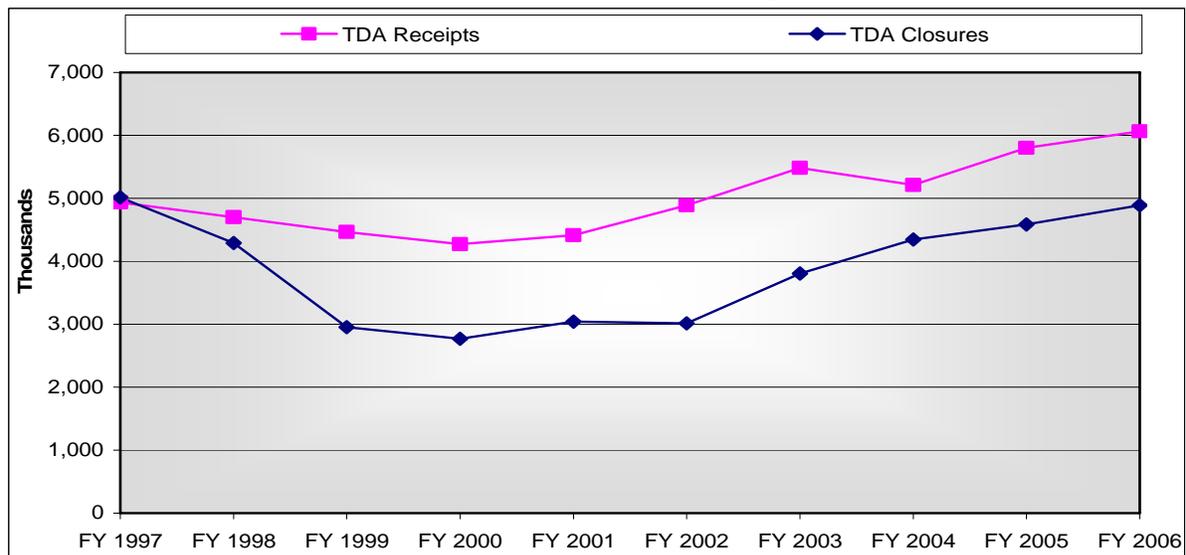
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**Figure 11. TDAs and TDIs Shelved or Surveyed Each Year.** While the total volume of TDA and TDI tax periods shelved or surveyed decreased significantly (by just over 47 percent) from FYs 2004 to 2006, the IRS has removed millions of TDA and TDI tax periods from the Queue inventory in recent years.



Source: TIGTA analysis of Collection Reports 5000-2 and 5000-4.

**Figure 12. Gap Between TDA Receipts and Closures.** The gap between TDA receipts and closures narrowed slightly after widening in FY 2005. However, the number of receipts has been greater than the number of closures each year since FY 1997. The closures shown in this chart do not include the TDAs shelved, which are shown in Figure 11.

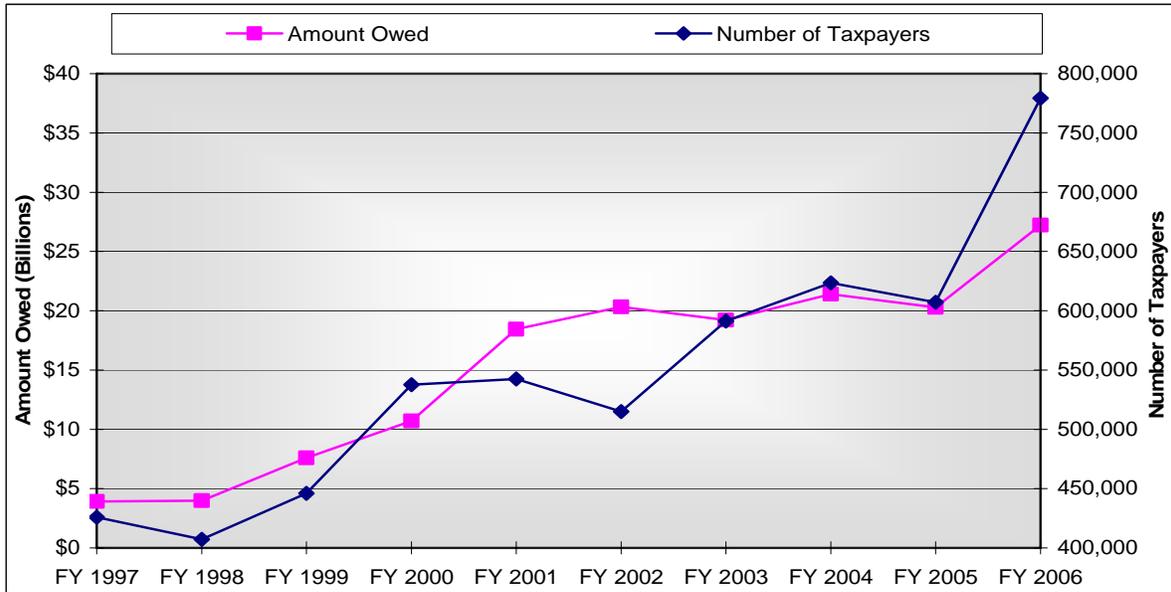


Source: TIGTA analysis of Collection Report 5000-2.



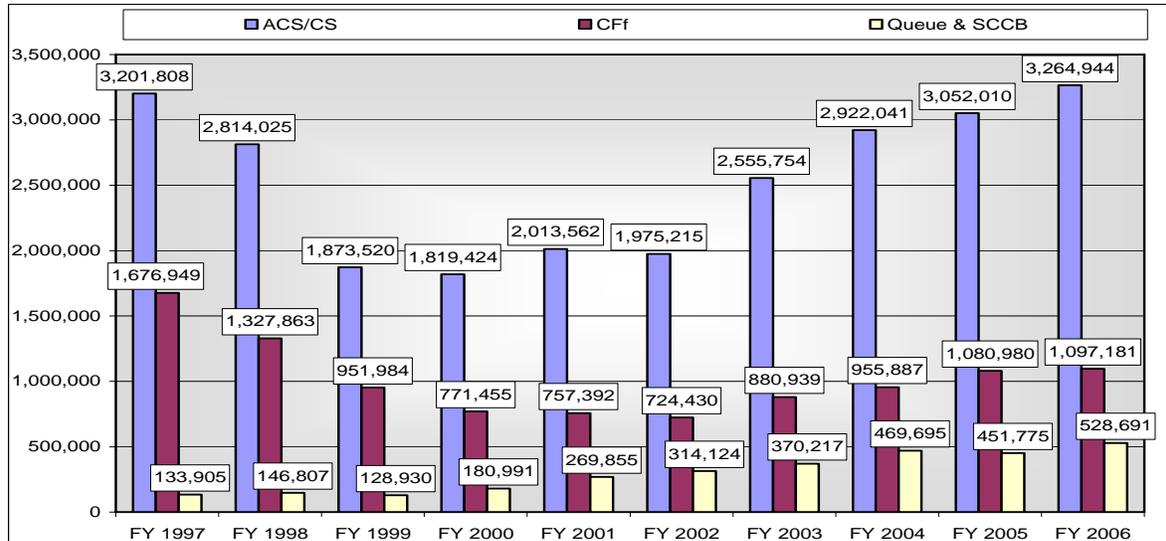
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**Figure 13. Number of Taxpayers and Amounts Owed in the Queue.** Between FYs 2005 and 2006, the number of taxpayers with TDAs in the Queue inventory increased by just over 28 percent, and the amount owed on those accounts increased by just over 34 percent.



Source: Collection Report 5000-2.

**Figure 14. Number of TDAs Closed, Excluding Shelved Accounts.** The number of TDAs closed increased for the ACS/CS, Cff, Queue, and Service Center Collection Branch in FY 2006.

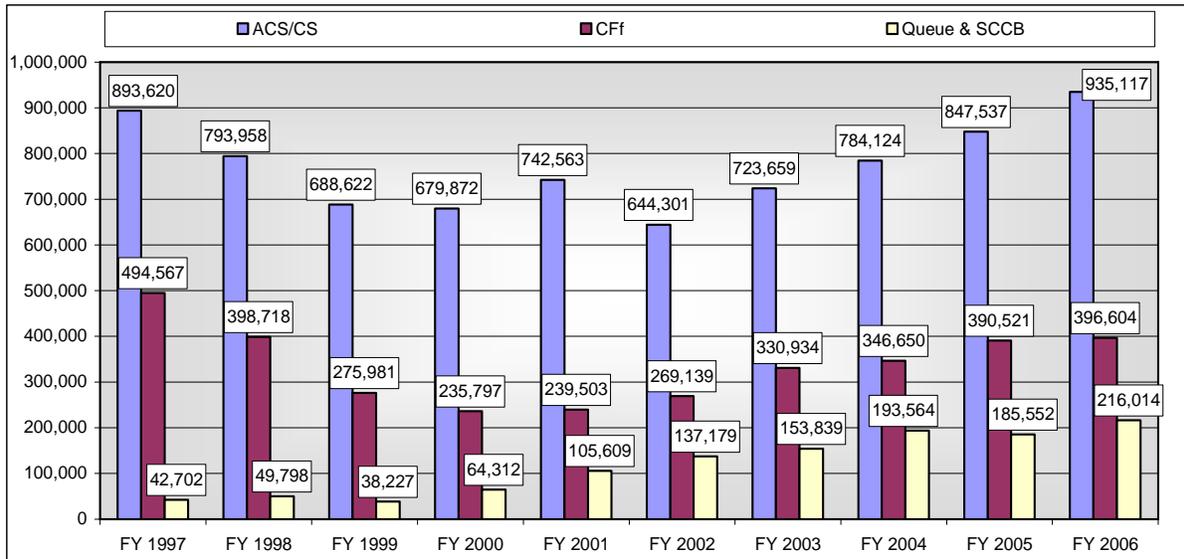


Source: TIGTA analysis of Collection Report 5000-2. SCCB = Service Center Collection Branch; CS = Customer Service.



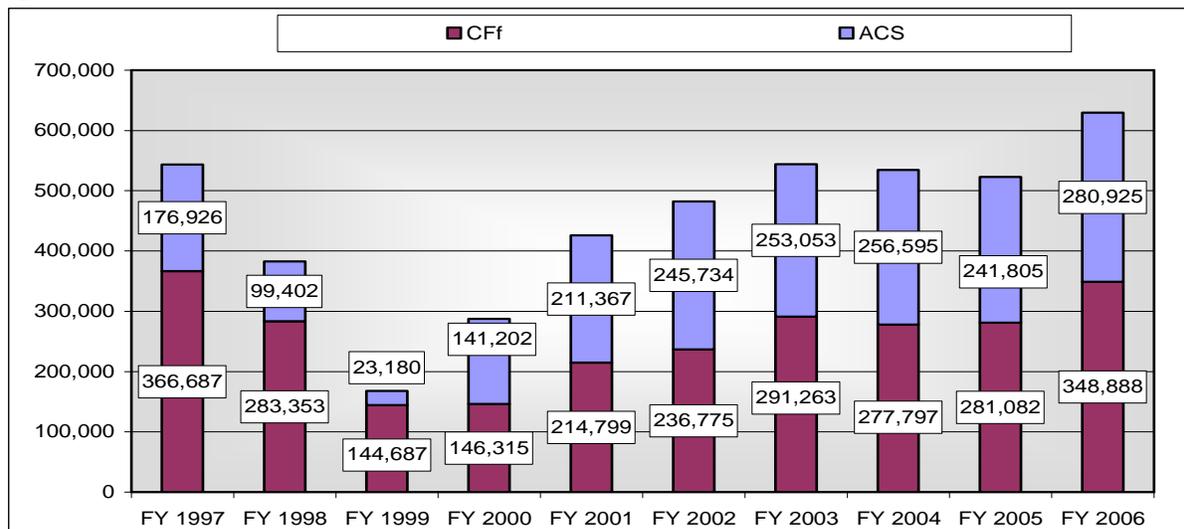
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**Figure 15. Number of TDAs Closed by Full Payment.** The total number of TDAs closed by full payment increased by 8.7 percent in FY 2006. Since FY 2002, there has been a steady increase in the number of accounts closed by full payment by the ACS/CS and CFf.



Source: TIGTA analysis of Collection Report 5000-2. SCCB = Service Center Collection Branch; CS = Customer Service.

**Figure 16. Liens Filed by the CFf and ACS.** During the year the total number of liens filed increased by 20 percent. This followed a decrease in each of the 2 previous fiscal years. The number of liens filed by the ACS increased 16 percent, and those filed by the CFf increased 24 percent.

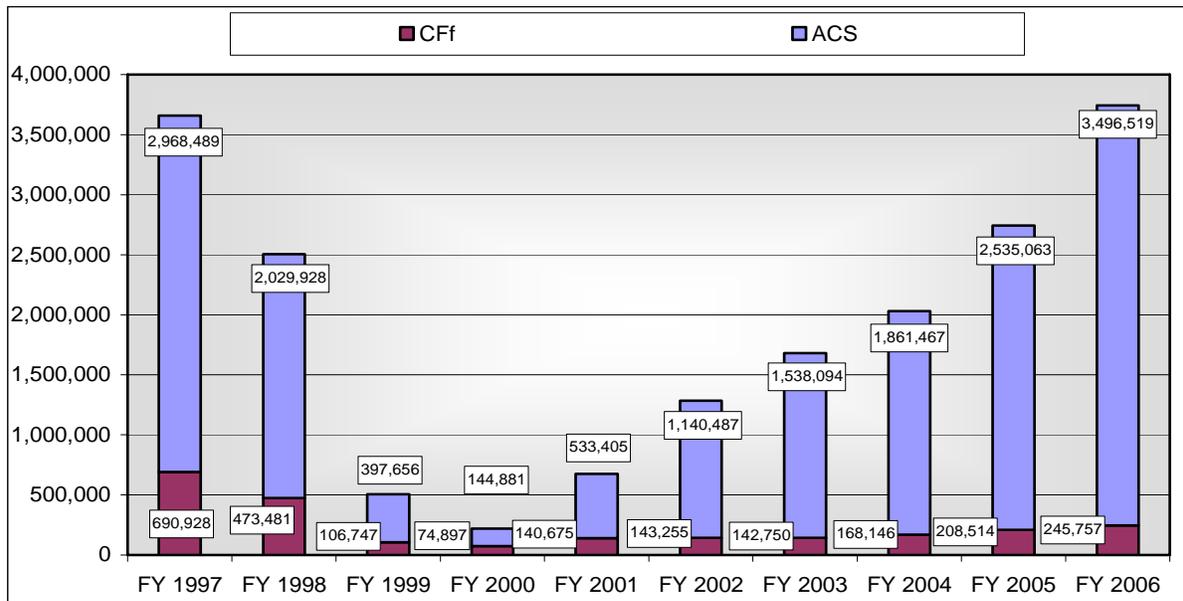


Source: Small Business/Self-Employed Division Collection Planning and Analysis, Collection National Reports.



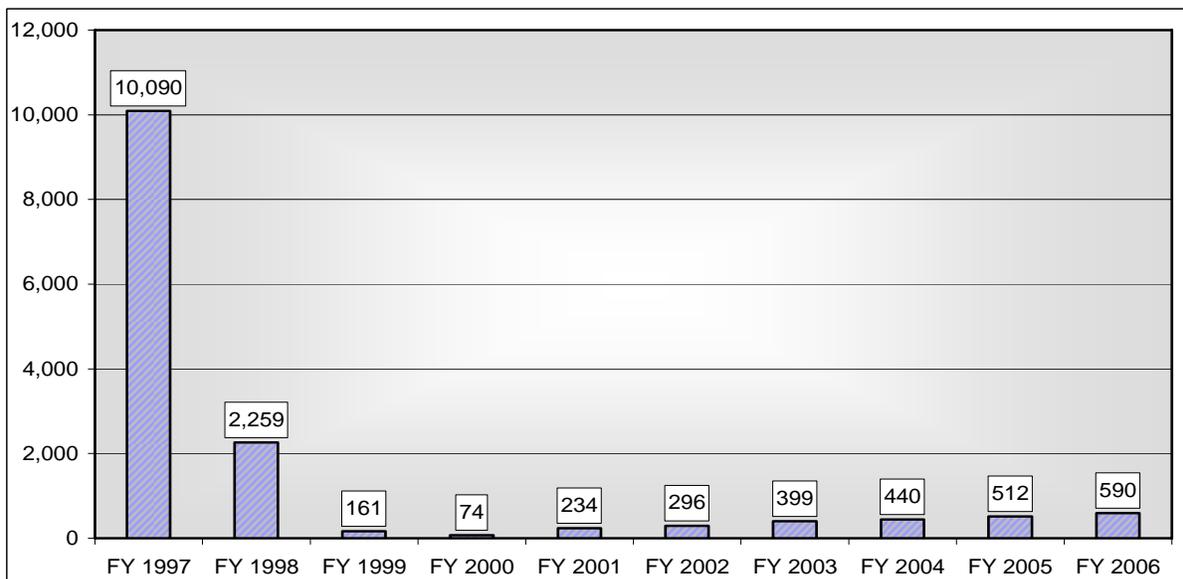
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**Figure 17. Levies Issued by the Cff and ACS.** Increasing numbers of levies have been issued by the Cff and ACS since FY 2000. Compared to FY 2005, the total number of levies issued during FY 2006 increased by slightly over 36 percent.



Source: *Small Business/Self-Employed Division Collection Planning and Analysis, Collection National Reports.*

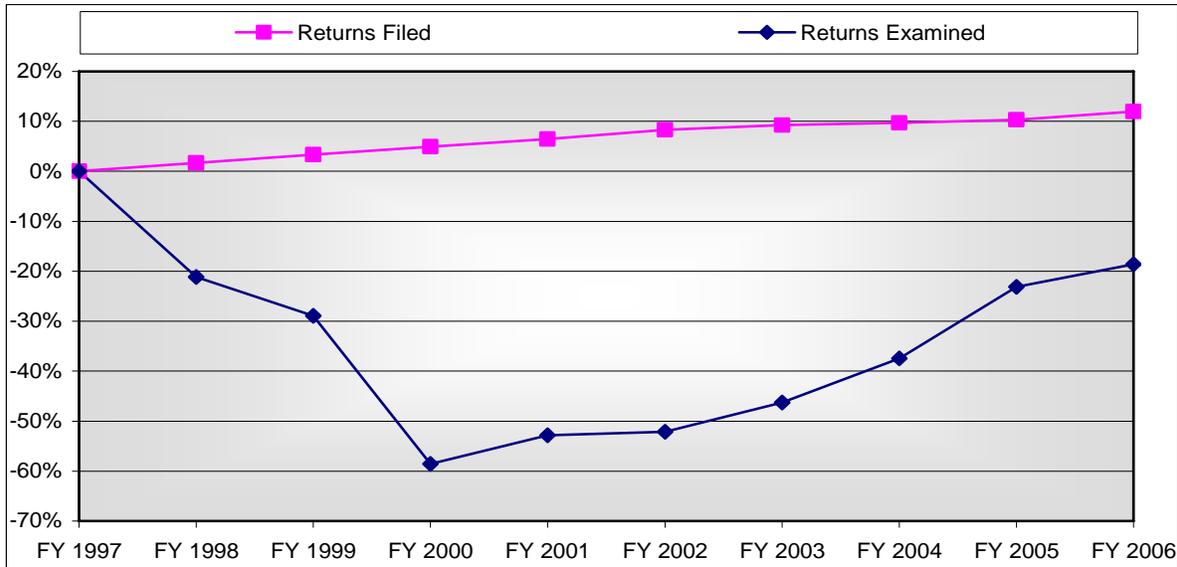
**Figure 18. Number of Seizures Made Each Fiscal Year.** The number of seizures made continued the upward trend that has occurred since FY 2000, but it is still only about 6 percent of the seizures made in FY 1997.



Source: *IRS Data Book.*

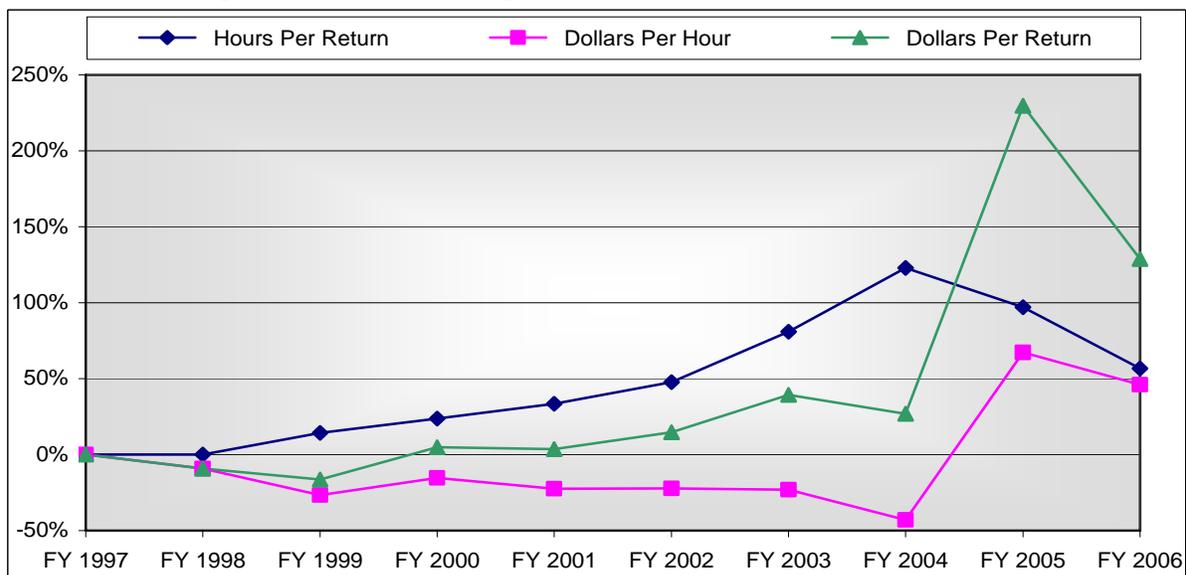


**Figure 19. Examination Coverage of All Tax Returns – Percentage Change From FY 1997.** While the examination coverage of tax returns is still below the level in FY 1997, the growth in examination coverage again outpaced the growth in returns filed during FY 2005.



Source: TIGTA analysis of IRS Data Book.

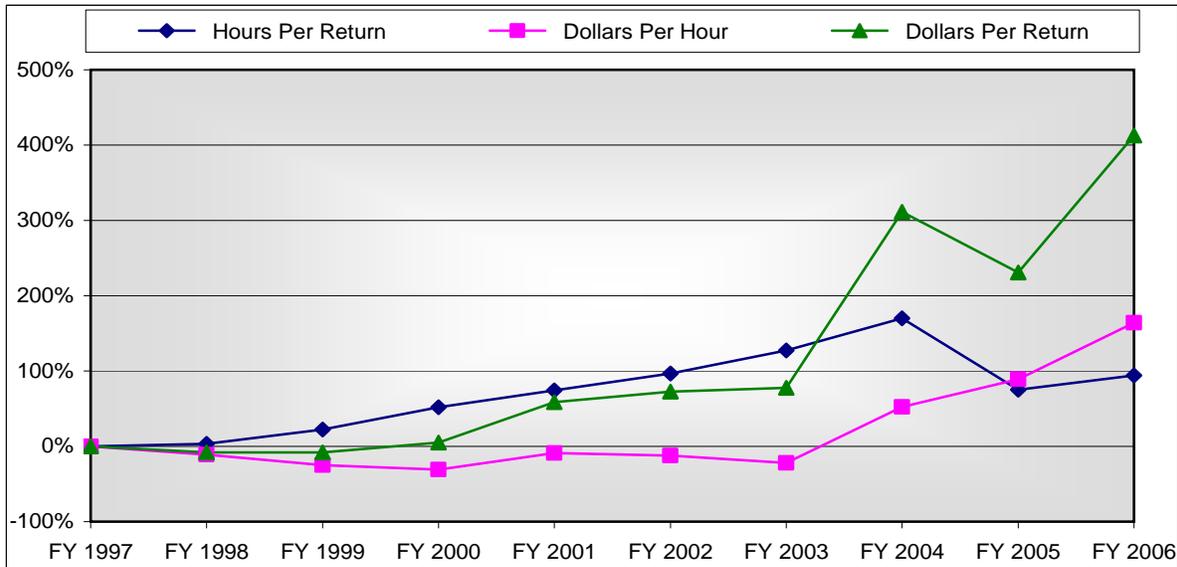
**Figure 20. Revenue Agent Results on U.S. Individual Income Tax Returns (Form 1040), Excluding Training Returns – Percentage Change From FY 1997.** The hours and dollars per return both had a significant decrease during FY 2006. The combined effect resulted in a decrease in dollars per hour of almost 13 percent.



Source: TIGTA analysis of Examination Table 37.

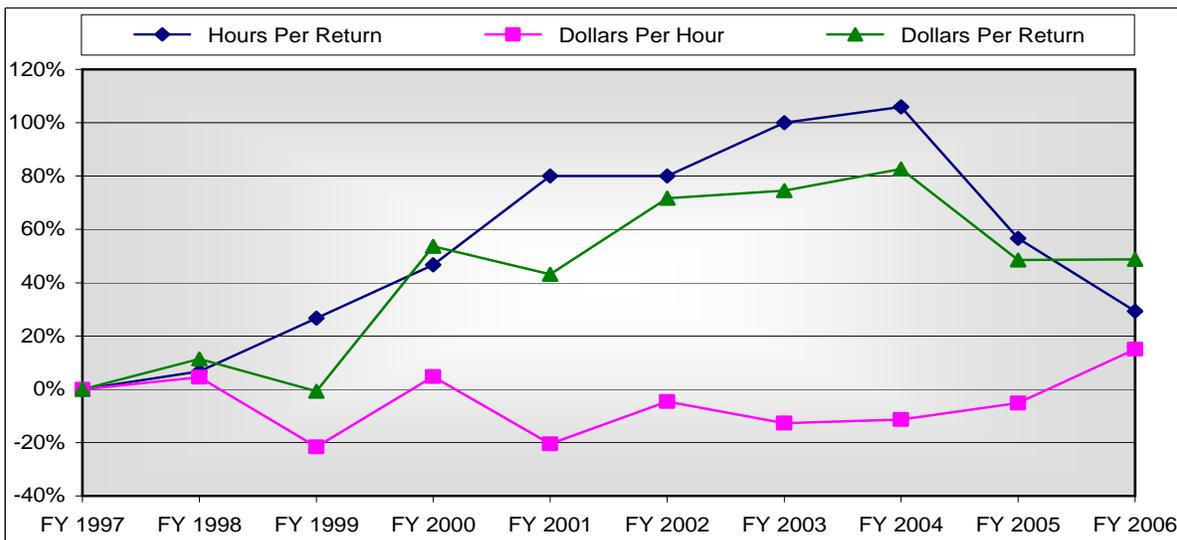


**Figure 21. Revenue Agent Results on Corporate Income Tax Returns, Excluding Training Returns – Percentage Change From FY 1997.** The hours and dollars per return both increased during the year. However, the increase in dollars per return was substantial enough that the combined effect resulted in an increase in dollars per hour of almost 40 percent.



Source: TIGTA analysis of Examination Table 37.

**Figure 22. Revenue Agent Results on Other Types of Tax Returns, Excluding Training Returns – Percentage Change From FY 1997.** The hours per return decreased significantly during the year, while the dollars per return was unchanged. However, due to the decrease in the hours per return, the combined effect was that dollars per hour increased by just over 21 percent.

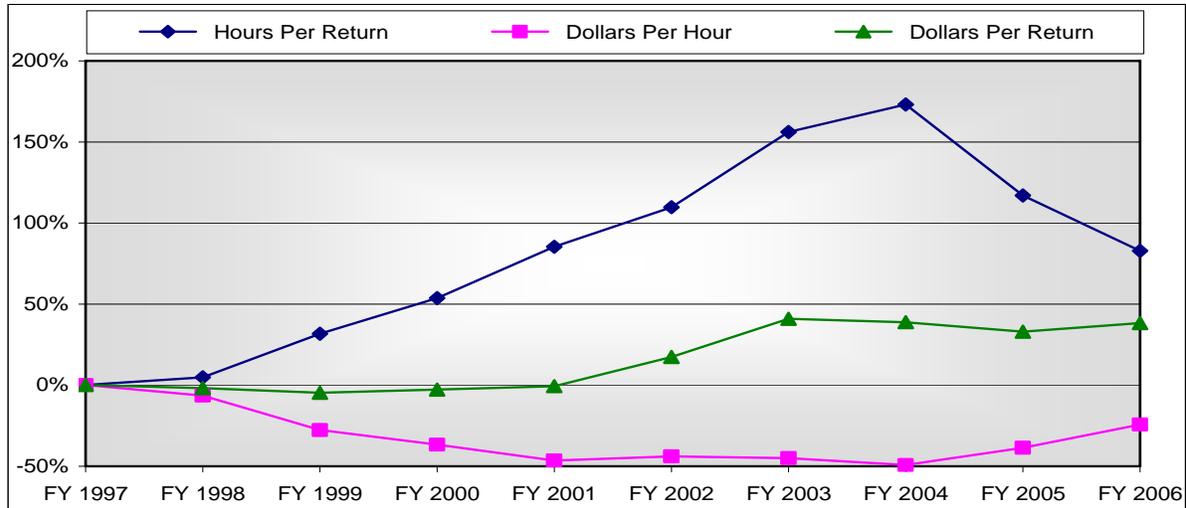


Source: TIGTA analysis of Examination Table 37.



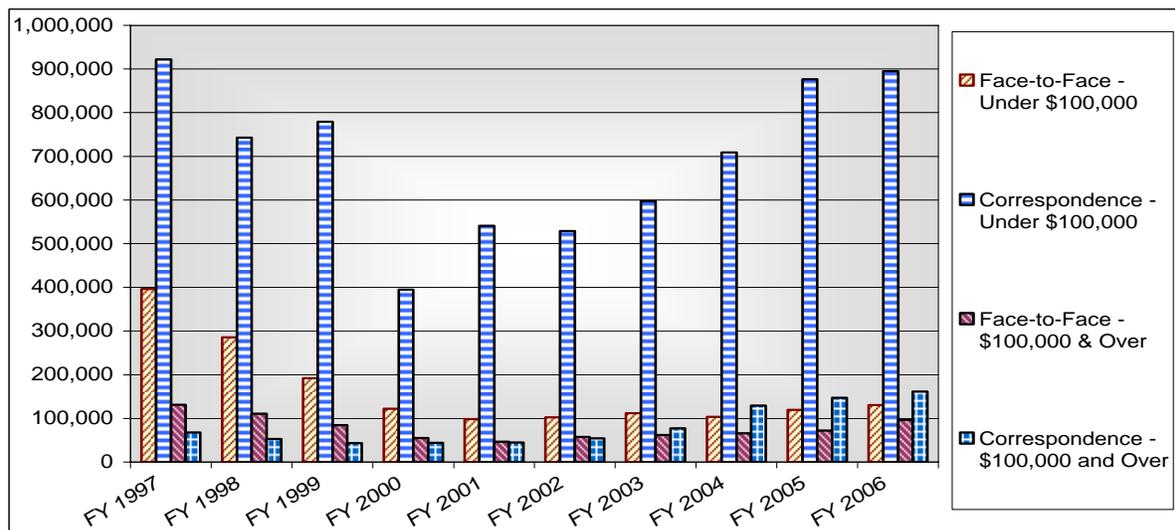
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**Figure 23. Tax Compliance Officer Results on Forms 1040, Excluding Training Returns – Percentage Change From FY 1997.** The hours per return decreased and the dollars per return increased slightly during the year. The combined effect was that dollars per hour increased by just over 23 percent.



Source: TIGTA analysis of Examination Table 37.

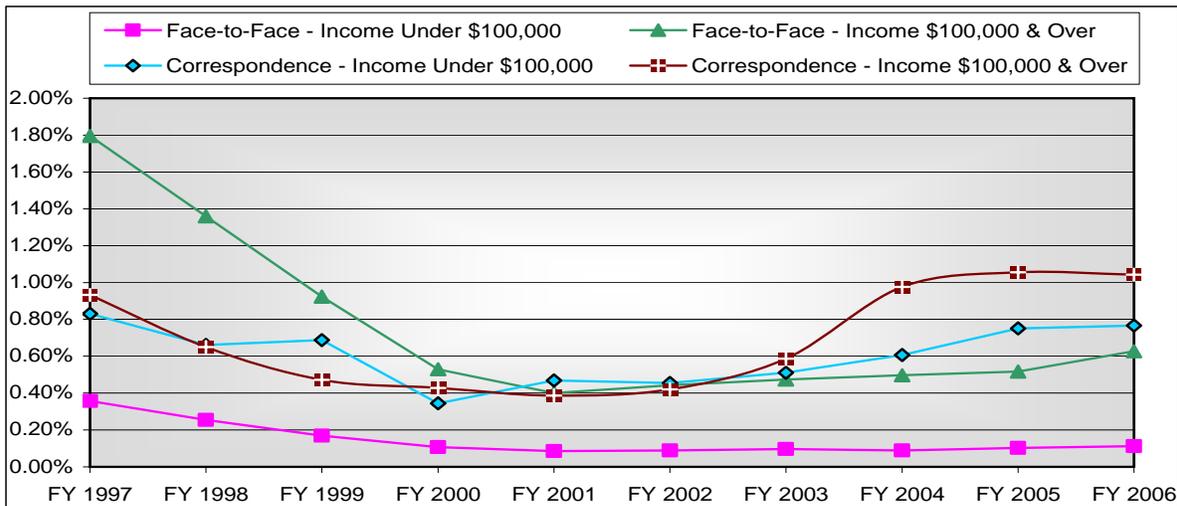
**Figure 24. Number of Forms 1040 Examined Face-to-Face or Through Correspondence.** The total number of face-to-face examinations of individuals increased by almost 19 percent, and those conducted through correspondence increased by just over 3 percent in FY 2006. A much greater percentage of change occurred for individuals with income of over \$100,000; those increased just over 34 percent for face-to-face examinations and 9 percent for correspondence examinations.



Source: TIGTA analysis of Examination Table 37 and IRS Data Book.

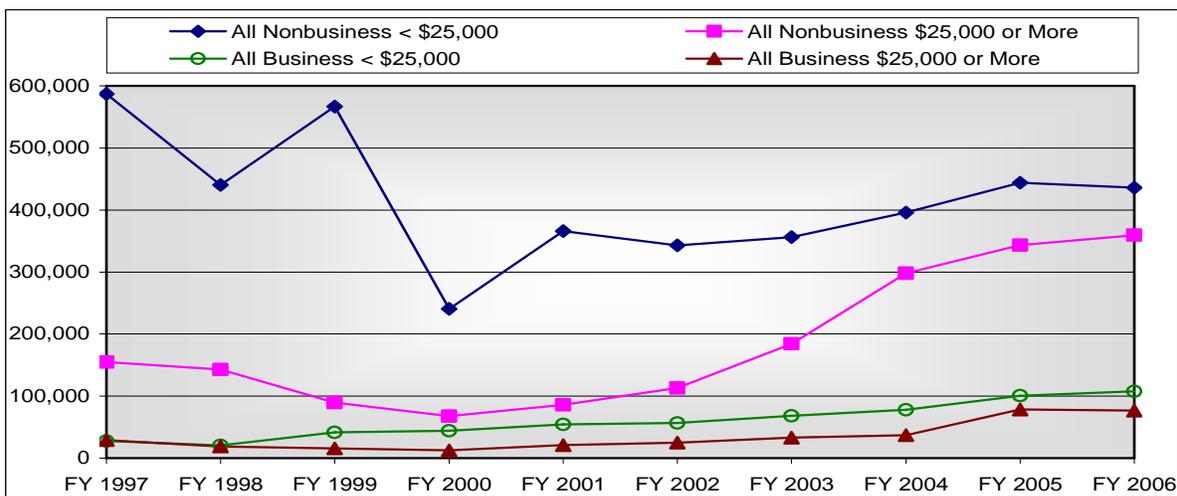


**Figure 25. Percentage of Forms 1040 Examined Face-to-Face or Through Correspondence.** During FY 2006, the coverage rate for face-to-face and correspondence examinations of nonbusiness and business individual income tax returns increased for most of the income categories but decreased for individual income tax returns with farm income. However, the rate increased substantially for business Forms 1040 with high income, resulting in the increase in face-to-face examinations of high-income individual taxpayers overall.



Source: TIGTA analysis of Examination Table 37.

**Figure 26. Number of Forms 1040 Examined by Correspondence Examination (Excluding Those With Farm Income).** During FY 2006, the number of examinations conducted by correspondence increased for two of the four categories. The fluctuation in examinations of nonbusiness tax returns with income under \$25,000 for FYs 1998 to 2001 was largely based on fluctuations in the number of Earned Income Tax Credit examinations.

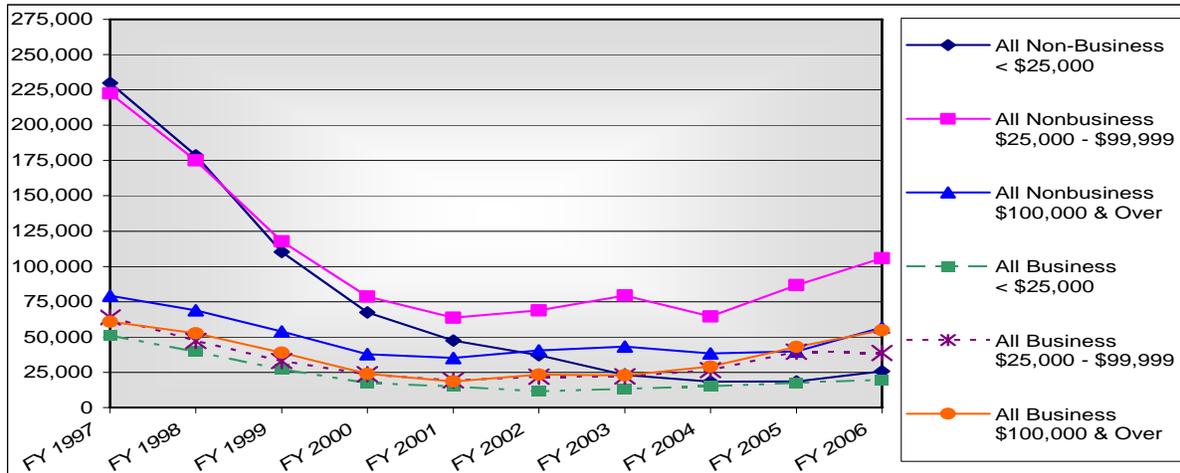


Source: TIGTA analysis of IRS Data Book.



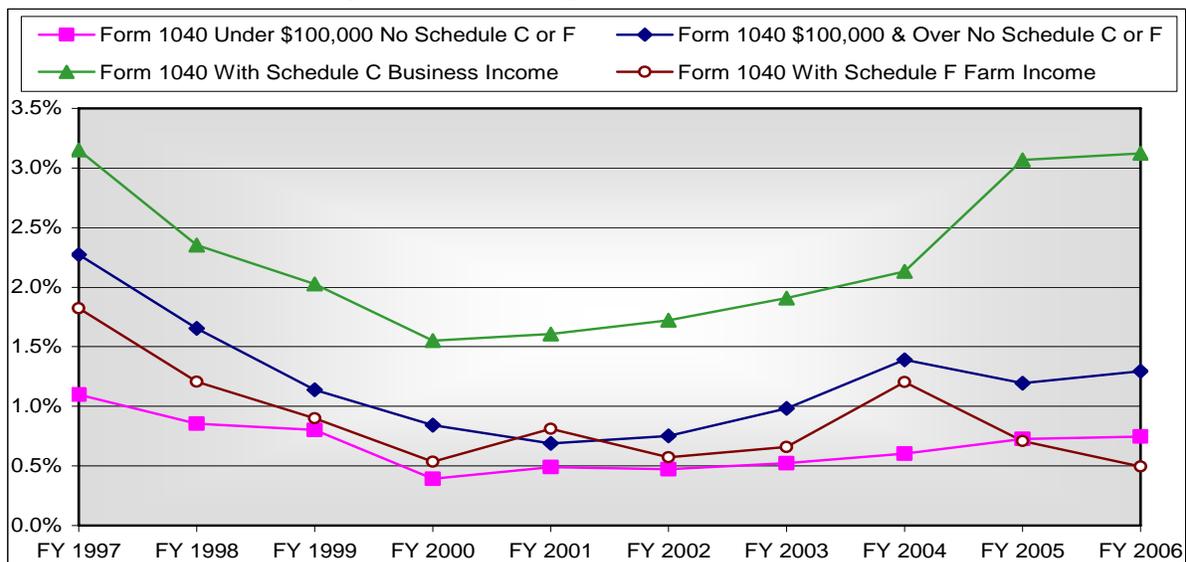
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**Figure 27. Number of Forms 1040 Examined by Field Offices (Excluding Those With Farm Income).** Field offices conduct a combination of face-to-face and correspondence examinations. During the year, the number of examinations conducted by field offices increased for all categories of tax returns except for businesses with income between \$25,000 and \$100,000.



Source: TIGTA analysis of IRS Data Book.

**Figure 28. Percentage of Forms 1040 Examined.** This chart shows a comparison of examination rates (total correspondence and face-to-face) for tax returns with business or farm income and those with incomes of under \$100,000 and \$100,000 and over without business or farm income. During FY 2006, the percentage examined decreased only for Forms 1040 with farm income. The other categories showed slight increases.

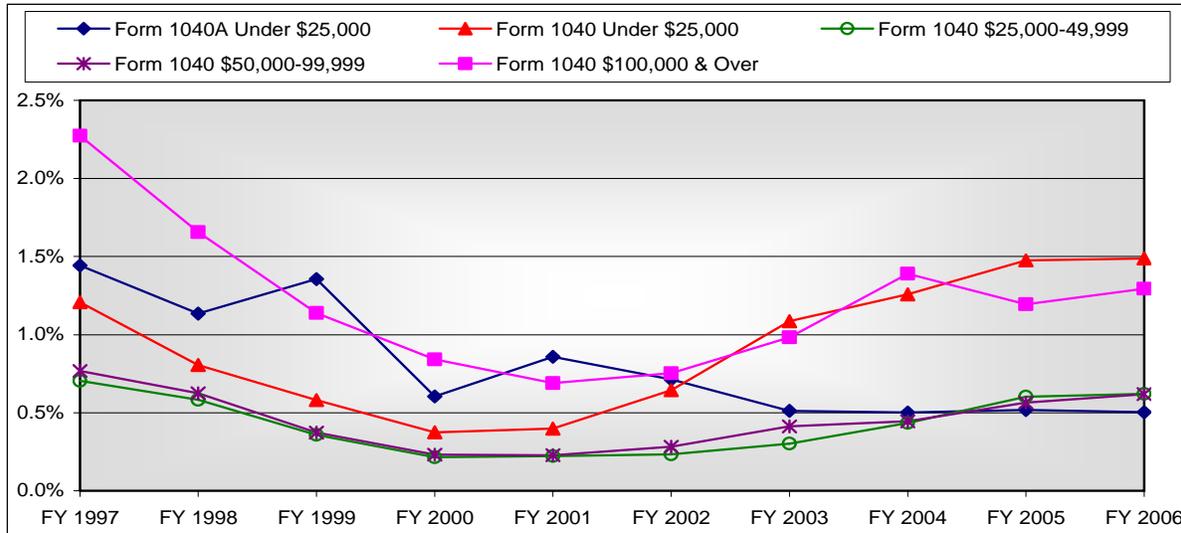


Source: TIGTA analysis of IRS Data Book.



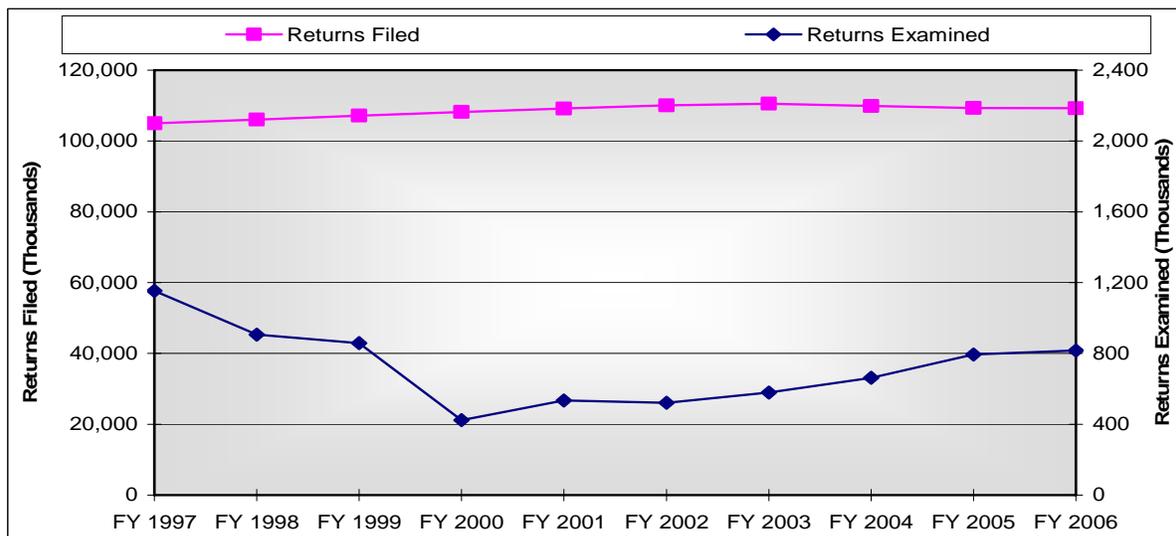
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**Figure 29. Percentage Examined – Forms 1040 With No Business or Farm Income.** The percentage of Forms 1040 examined increased for all income categories except the simpler Forms with income under \$25,000 during the year. The increases were largely due to a rise in the percentage of Forms 1040 examined by field employees.



Source: TIGTA analysis of IRS Data Book.

**Figure 30. Examination Coverage of Nonbusiness Forms 1040 – Under \$100,000.** The number of nonbusiness tax returns filed with income of under \$100,000 has decreased slightly in each of the last 3 fiscal years. During FY 2006, the examination coverage rate for these returns increased by almost 3 percent. This increase was entirely due to an increase in field examinations.

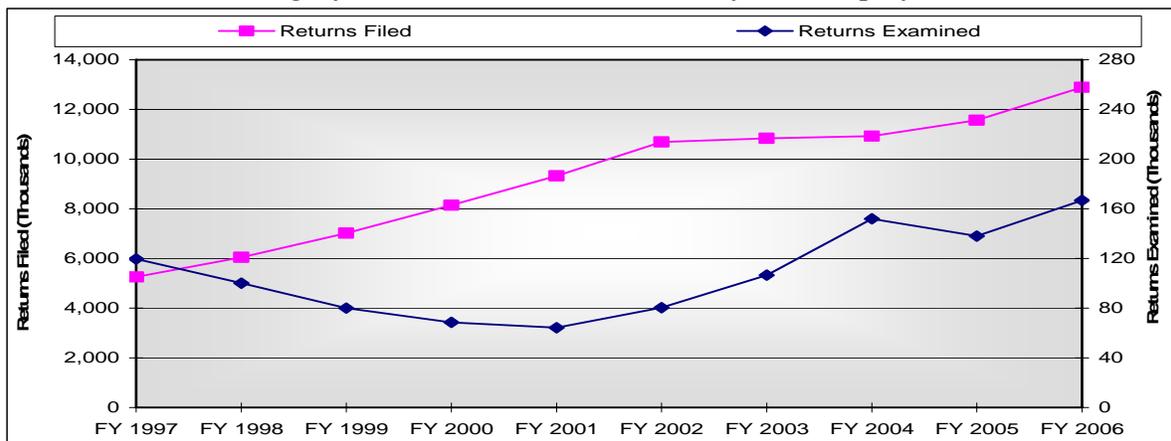


Source: TIGTA analysis of IRS Data Book.



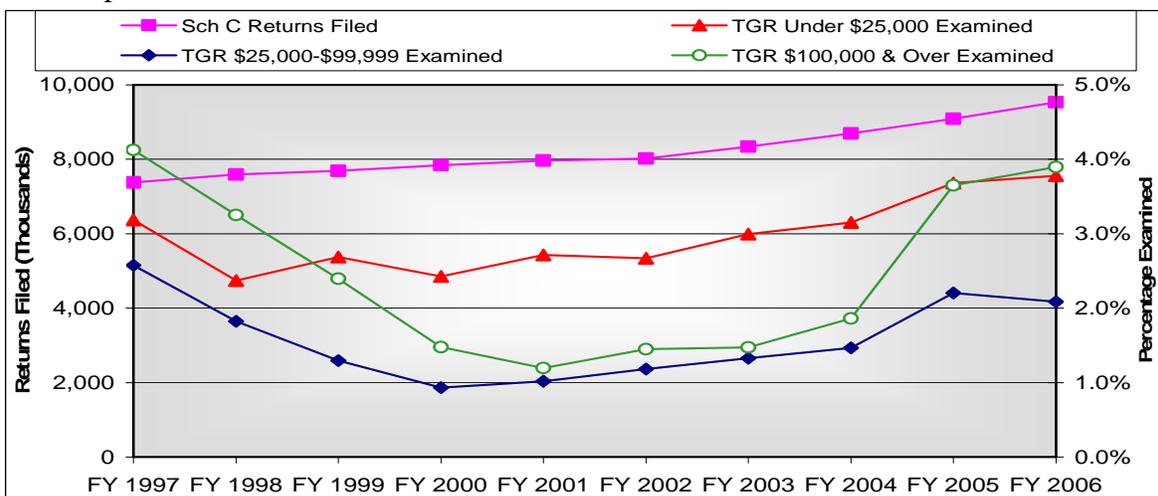
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**Figure 31. Examination Coverage of Nonbusiness Forms 1040 – \$100,000 and Over.** The number of nonbusiness tax returns filed with income of \$100,000 and over increased in FYs 2005 and 2006 after being relatively constant since FY 2002. During FY 2006, the examination coverage rate for these returns increased by just over 8 percent after decreasing by just over 14 percent in FY 2005. Almost 59 percent of the increase in the number of examinations in this category was due to those conducted by field employees.



Source: TIGTA analysis of IRS Data Book.

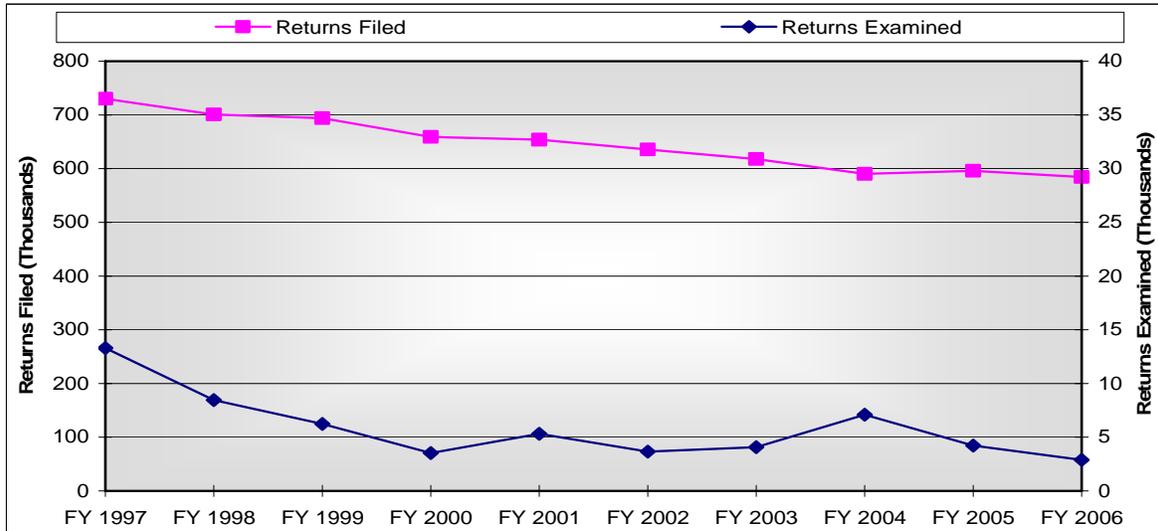
**Figure 32. Examination Coverage of Forms 1040 With Business Income (Excluding Farms).** The total number of individual income tax returns filed with business income continued to increase, as did the percentage examined in each of the categories except those with total gross receipts of from \$25,000 to \$99,999. Campus employees accounted for a larger portion of the increase in examination of returns for which total gross receipts were under \$25,000; field employees accounted for a larger portion of the increase in examination of returns for which total gross receipts were \$100,000 and over.



Source: TIGTA analysis of IRS Data Book. TGR = total gross receipts. Sch C = Form 1040 Schedule C.

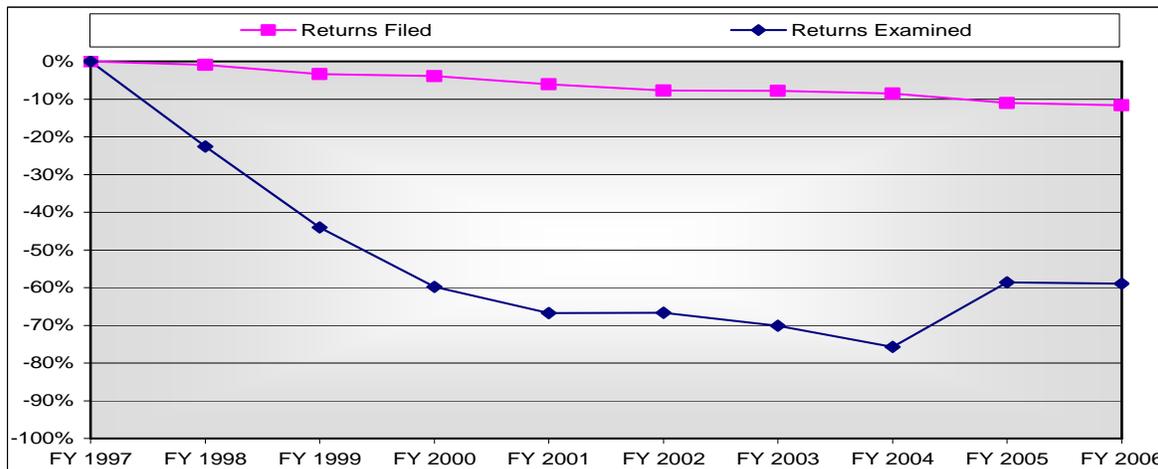


**Figure 33. Examination Coverage of Forms 1040 With Farm Income.** The number of Forms 1040 filed with farm income decreased in FY 2006, as did the number of examinations of these returns by both field and campus employees. The net effect was a 30 percent decrease in examination coverage in this category.



Source: TIGTA analysis of IRS Data Book.

**Figure 34. Examination Coverage of Corporate Income Tax Returns – Percentage Change From FY 1997.** Overall, the number of corporate tax returns filed (excluding U.S. Income Tax Return for an S Corporation (Form 1120S) and U.S. Income Tax Return for a Foreign Corporation (Form 1120-F)) continued to decrease during FY 2006. The percentage of tax returns examined increased for most of the small- to medium-size corporate tax return categories but decreased for the 3 largest corporate tax return categories (those with assets of \$50 million and over). Overall, 1 in 80 corporate tax returns was examined.

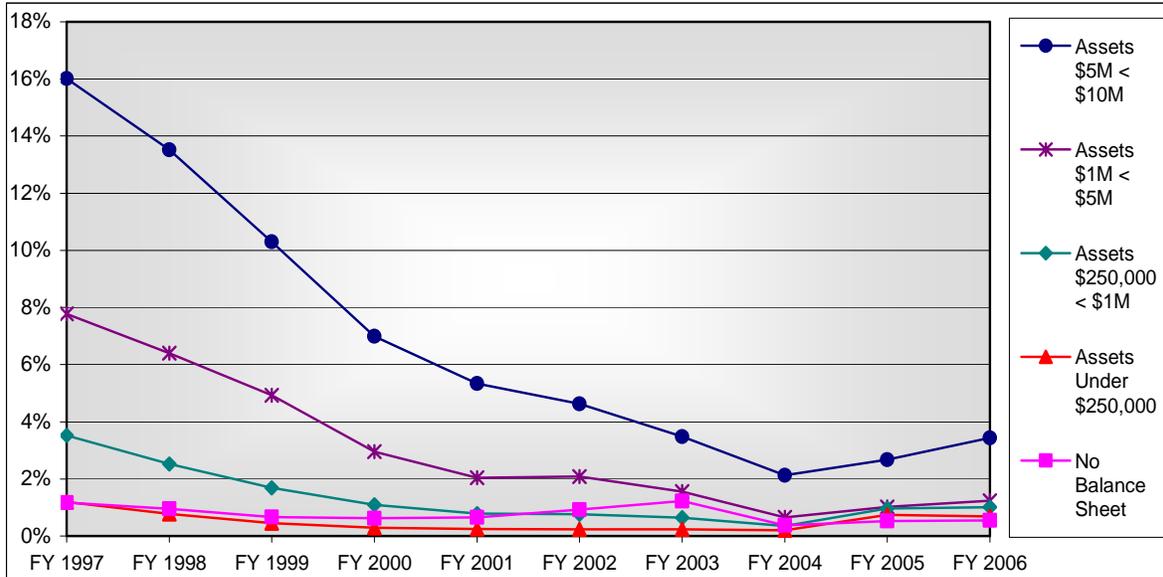


Source: TIGTA analysis of IRS Data Book.



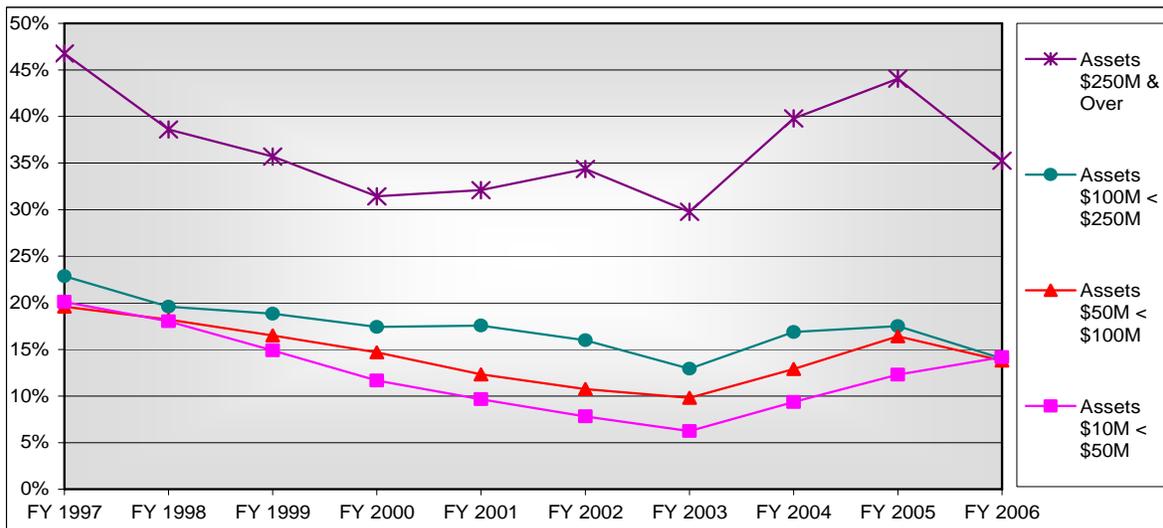
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**Figure 35. Percentage of Corporate Income Tax Returns Examined – Corporations With Assets of Under \$10 Million.** The overall examination coverage rate for corporate tax returns with no balance sheet or assets of under \$10 million increased by less than 1 percent during the year.



Source: TIGTA analysis of IRS Data Book.

**Figure 36. Percentage of Corporate Income Tax Returns Examined – Corporations With Assets of \$10 Million and Over.** During FY 2006, the overall examination coverage rate for corporate tax returns with assets of \$10 million and over decreased by slightly over 7 percent. However, the rate for those returns with assets of \$250 million and over decreased 20 percent.

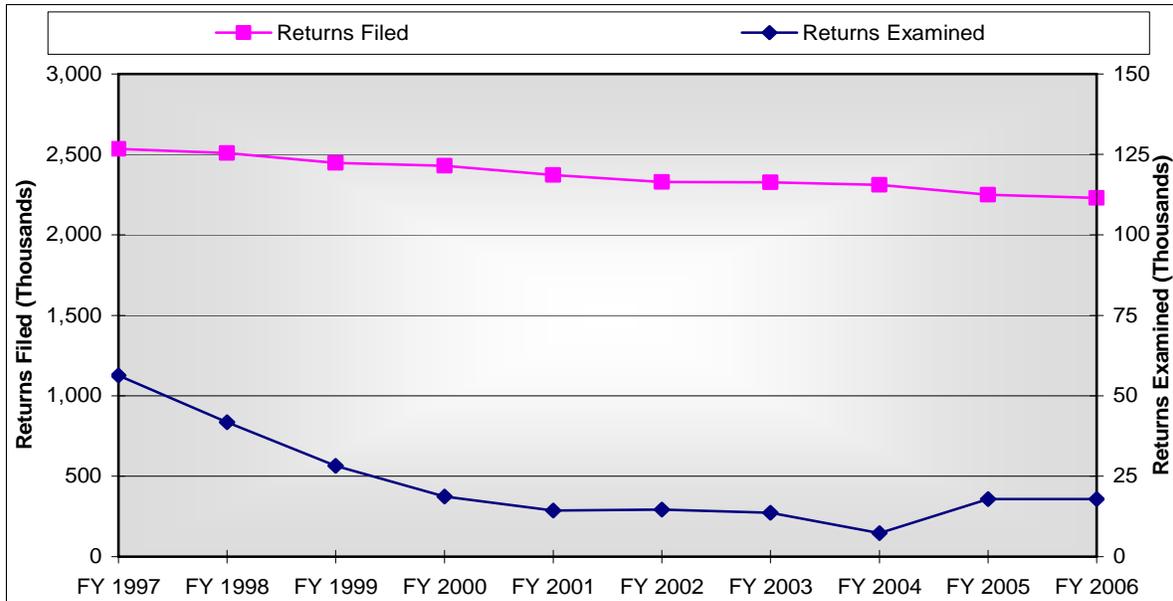


Source: TIGTA analysis of IRS Data Book.



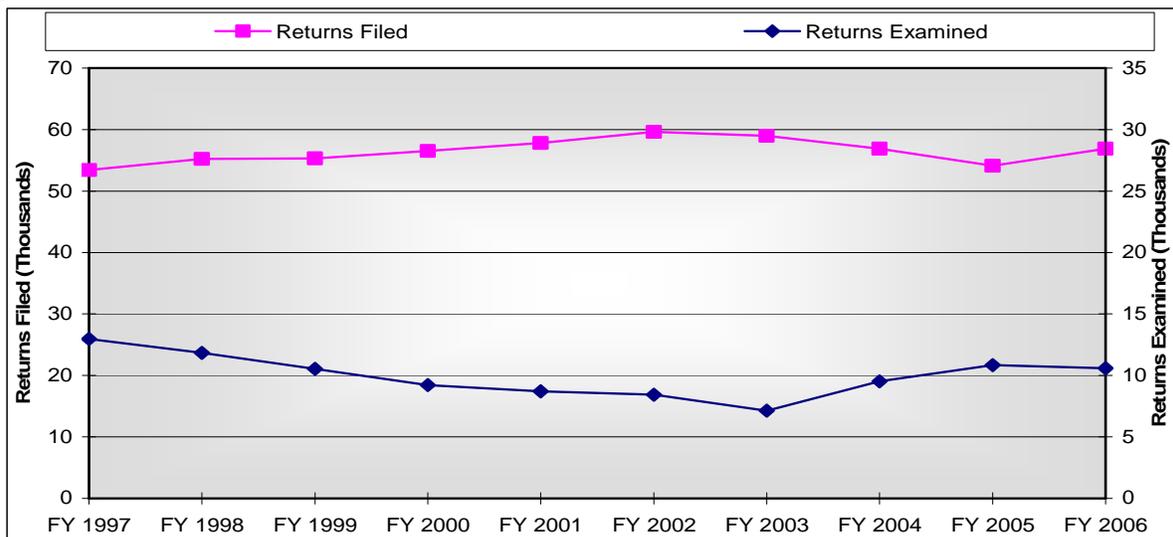
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**Figure 37. Examination Coverage of Corporations With Assets of Under \$10 Million.** The number of corporate tax returns filed with assets of under \$10 million dropped by almost 1 percent during the year, while the number of tax returns examined was unchanged.



Source: TIGTA analysis of IRS Data Book.

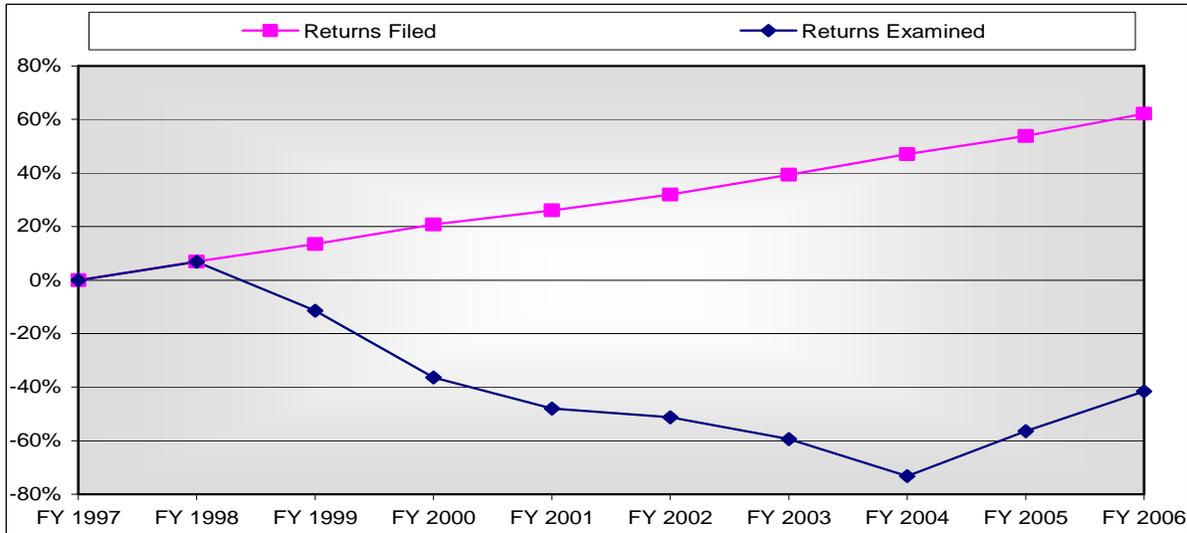
**Figure 38. Examination Coverage of Corporations With Assets of \$10 Million and Over.** During FY 2006, the number of corporate tax returns filed with assets of \$10 million and over increased by just over 5 percent, while the number of returns examined decreased by just over 2 percent.



Source: TIGTA analysis of IRS Data Book.

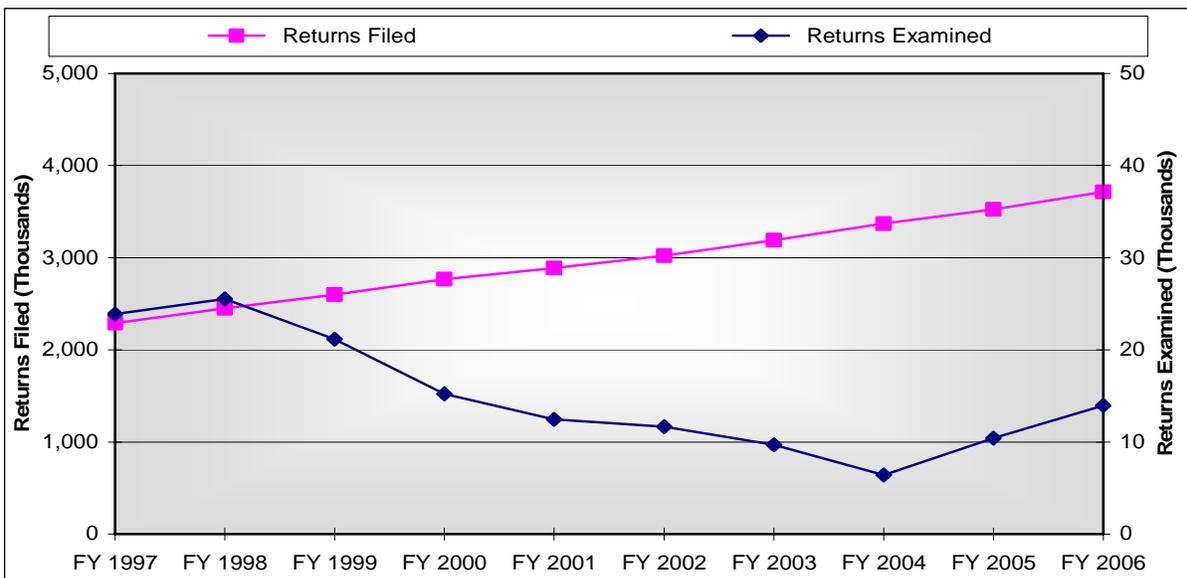


**Figure 39. Examination Coverage of Forms 1120S – Percentage Change From FY 1997.** After decreasing each year since FY 1998, the percentage of Forms 1120S examined increased 98 percent during FYs 2005 and 2006. The increase can be partly attributed to examinations of Forms 1120S as part of an ongoing National Research Project studying tax compliance.



Source: TIGTA analysis of IRS Data Book.

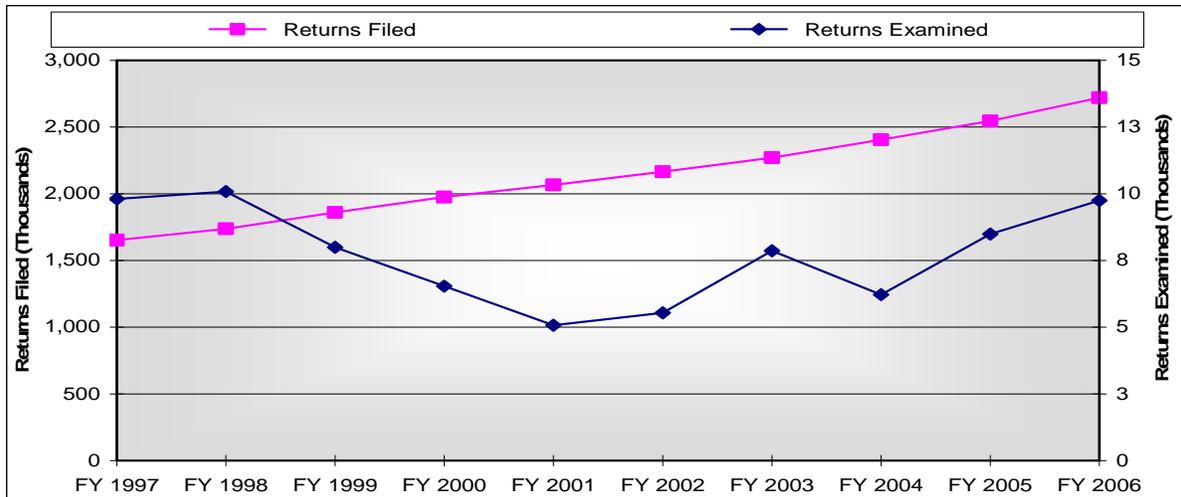
**Figure 40. Examination Coverage of Forms 1120S.** The number of Forms 1120S filed has increased at an average rate of nearly 160,000 per year since FY 1997, to just over 3.7 million in FY 2006. While the number of examinations increased the last 2 years, only about 1 out of every 266 Forms 1120S was examined.



Source: IRS Data Book.

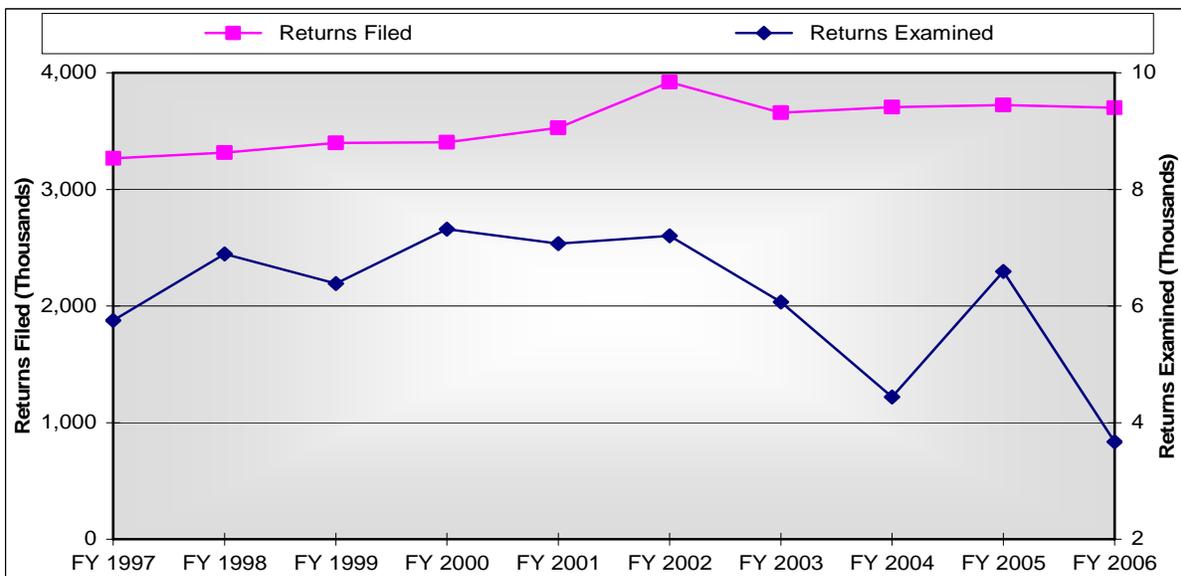


**Figure 41. Examination Coverage of Partnership Income Tax Returns.** The number of partnership tax returns filed has increased at an average rate of nearly 120,000 per year since FY 1997, to just over 2.7 million in FY 2006. The number of returns examined increased by almost 15 percent this year, but only about 1 out of every 279 partnership returns was examined.



Source: IRS Data Book.

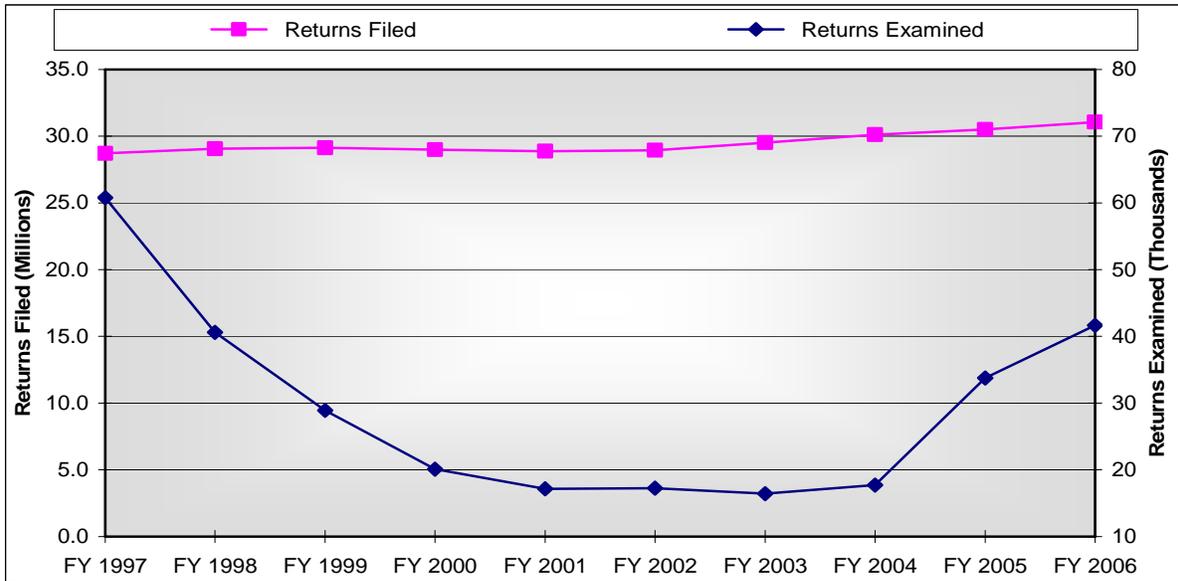
**Figure 42. Examination Coverage of Fiduciary Income Tax Returns.** During FY 2006, the number of income tax returns filed by estates and trusts decreased slightly, but the number of tax returns examined decreased by just over 44 percent. Only about 1 out of every 1,008 fiduciary income tax returns was examined.



Source: IRS Data Book.

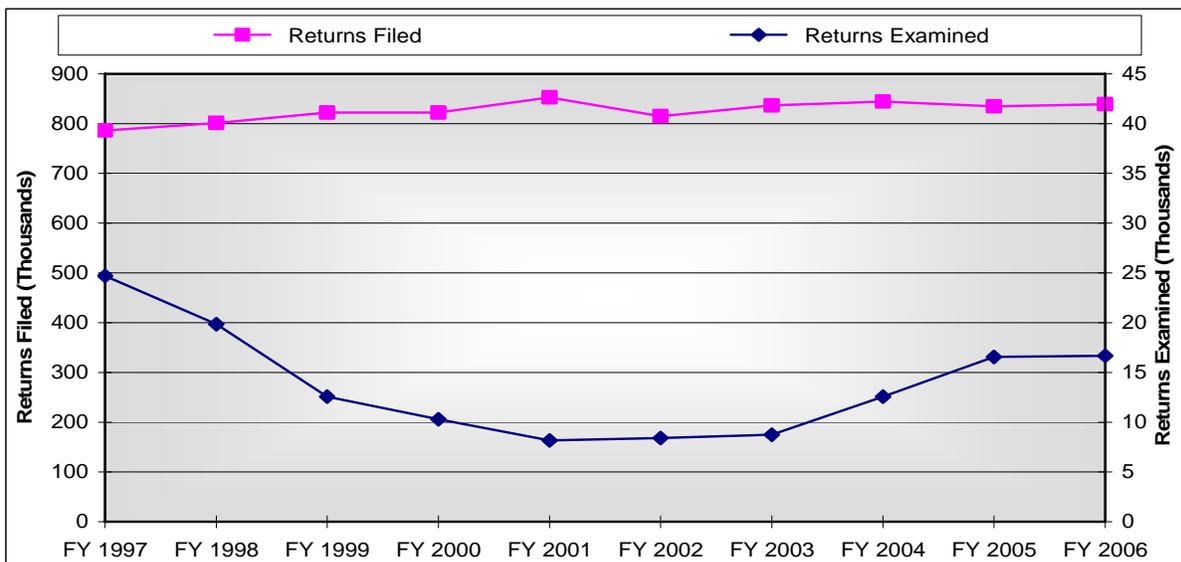


**Figure 43. Examination Coverage of Employment Tax Returns.** The number of employment tax returns filed increased by almost 2 percent this year, but the number of tax returns examined increased by just over 23 percent. About 1 out of every 746 employment tax returns was examined.



Source: IRS Data Book.

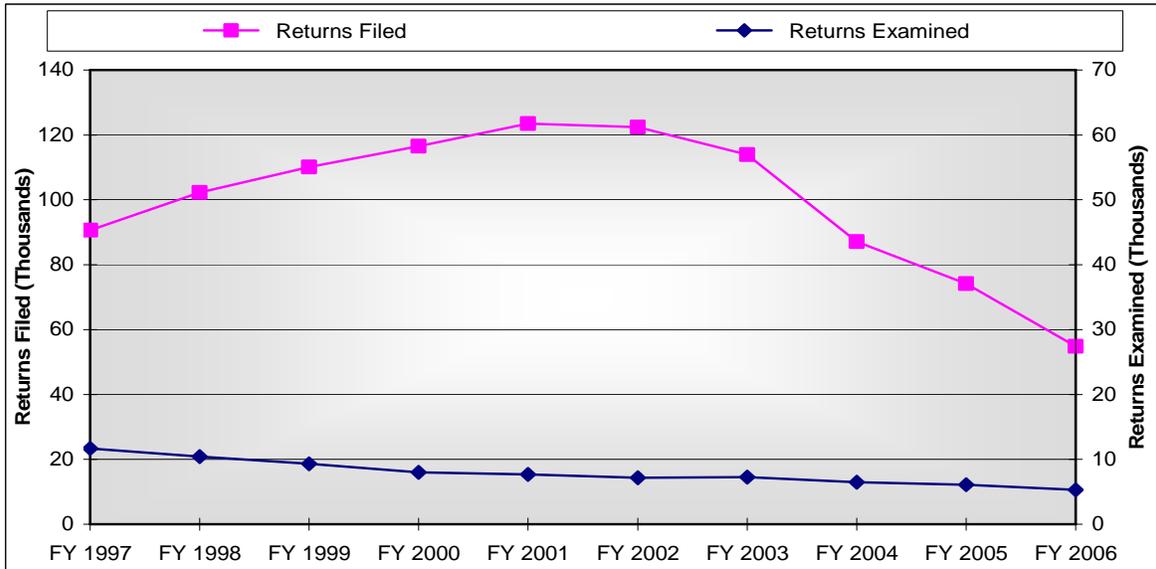
**Figure 44. Examination Coverage of Excise Tax Returns.** The number of excise tax returns filed and examined remained relatively steady, increasing by less than 1 percent each during FY 2006.



Source: IRS Data Book.

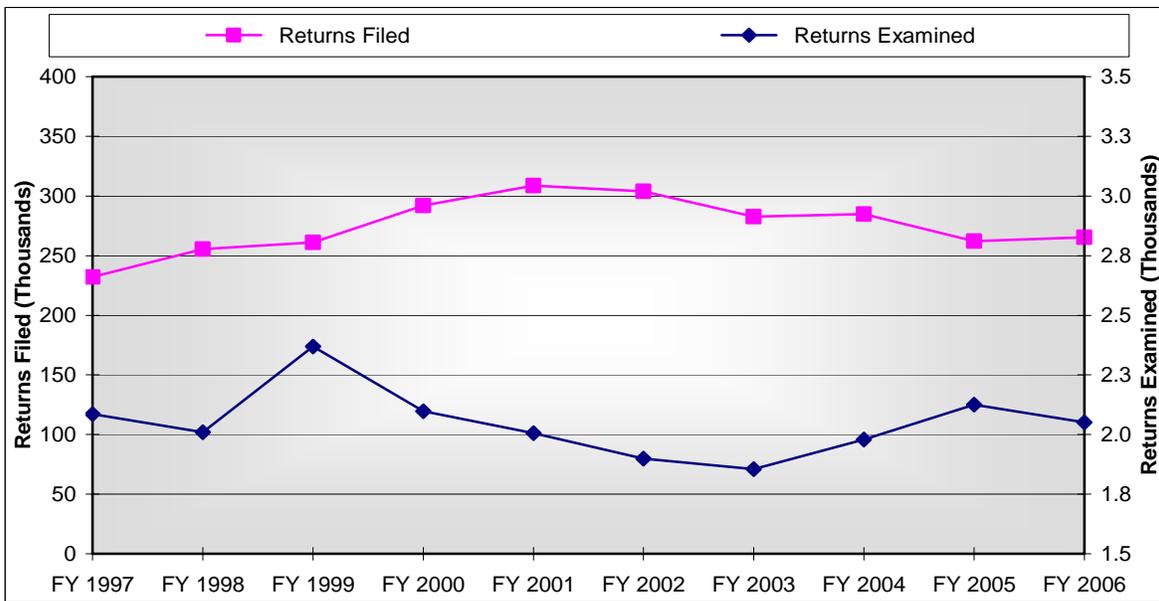


**Figure 45. Examination Coverage of Estate Tax Returns.** During FY 2006, the number of estate tax returns filed decreased by 26 percent, and the number of returns examined decreased by almost 13 percent. About 1 out of every 10 estate tax returns was examined.



Source: IRS Data Book.

**Figure 46. Examination Coverage of Gift Tax Returns.** The number of gift tax returns filed increased by just over 1 percent this year, but the number of returns examined decreased by over 3 percent.

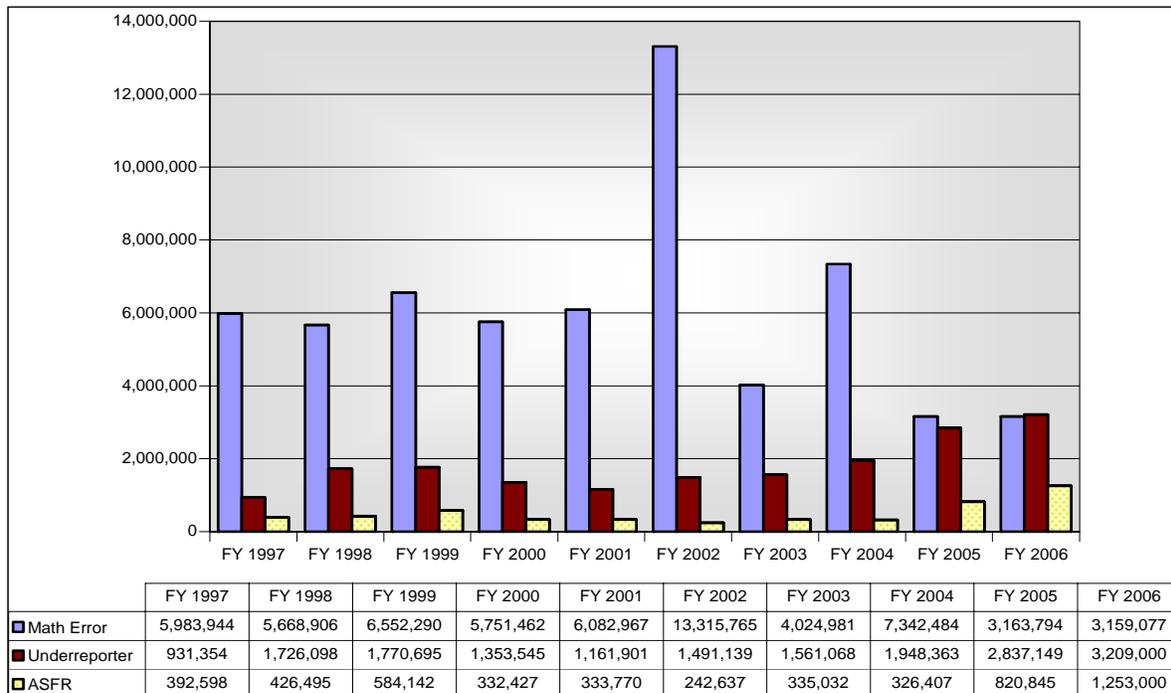


Source: IRS Data Book.



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**Figure 47. Other Compliance Contacts on Forms 1040.** The number of contacts for math error cases was virtually unchanged from FY 2005, while underreporter and Automated Substitute for Return system<sup>46</sup> cases increased. The spike in math error cases for FY 2002 was the result of taxpayer confusion over the Rate Reduction Credit. Much of the spike in FY 2004 was due to Child Tax Credit issues.



Source: IRS Data Book. ASFR = Automated Substitute for Return system.

**Figure 48. Other Compliance Contacts – Percentage of Form 1040 Coverage.** The level of coverage for math error cases was virtually unchanged from FY 2005, while it increased for underreporter and Automated Substitute for Return system cases. The math error aberrations in FYs 2002 and 2004 are explained in Figure 47.

	FY 1997	FY 1998	FY 1999	FY 2000	FY 2001	FY 2002	FY 2003	FY 2004	FY 2005	FY 2006
<b>Math Error</b>	5,983,944	5,668,906	6,552,290	5,751,462	6,082,967	13,315,765	4,024,981	7,342,484	3,163,794	3,159,077
Coverage Rate	4.97%	4.63%	5.25%	4.53%	4.70%	10.22%	3.08%	5.59%	2.38%	2.36%
<b>Underreporter</b>	931,354	1,726,098	1,770,695	1,353,545	1,161,901	1,491,139	1,561,068	1,948,363	2,837,149	3,209,000
Coverage Rate	0.79%	1.43%	1.44%	1.08%	0.91%	1.15%	1.20%	1.49%	2.16%	2.42%
<b>ASFR</b>	392,598	426,495	584,142	332,427	333,770	242,637	335,032	326,407	820,845	1,253,000
Coverage Rate	0.33%	0.35%	0.48%	0.27%	0.26%	0.19%	0.26%	0.25%	0.63%	0.94%

Source: TIGTA analysis of IRS Data Book. ASFR = Automated Substitute for Return system.

<sup>46</sup> The IRS adjusted how these cases are captured for FY 2006. We used revised numbers for FYs 2003 through 2005 to be consistent with FY 2006 and FYs 1997 through 2002.



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**Figure 49. Numbers and Percentages of Forms 1040 Examined.** This chart shows the numbers and percentages of examination coverage.

	FY 1997	FY 1998	FY 1999	FY 2000	FY 2001	FY 2002	FY 2003	FY 2004	FY 2005	FY 2006
<b>Forms 1040A – &lt; \$25,000</b>										
Returns Examined	659,094	515,015	600,949	256,650	357,954	289,136	182,222	168,887	170,317	159,561
Coverage Rate	1.44%	1.14%	1.36%	0.60%	0.86%	0.71%	0.51%	0.50%	0.52%	0.50%
<b>Forms 1040 – Nonbusiness</b>										
Returns Examined < \$25,000	157,978	104,050	76,215	51,567	55,624	90,781	197,005	245,470	292,033	302,168
Coverage Rate	1.21%	0.81%	0.58%	0.37%	0.40%	0.64%	1.09%	1.26%	1.48%	1.49%
Returns Examined \$25,000 & < \$50,000	196,489	165,168	103,340	63,742	67,109	71,966	94,825	135,041	185,965	191,150
Coverage Rate	0.70%	0.58%	0.36%	0.21%	0.22%	0.23%	0.30%	0.43%	0.60%	0.62%
Returns Examined \$50,000 & < \$100,000	140,330	121,384	77,698	51,954	53,433	69,620	105,400	113,944	145,641	163,711
Coverage Rate	0.77%	0.62%	0.37%	0.23%	0.23%	0.28%	0.41%	0.44%	0.57%	0.62%
Returns Examined \$100,000 and over	119,575	100,079	80,038	68,616	64,259	80,483	106,565	151,969	138,085	166,839
Coverage Rate	2.27%	1.66%	1.14%	0.84%	0.69%	0.75%	0.98%	1.39%	1.19%	1.29%
<b>Forms 1040 – Schedule C</b>										
Returns Examined < \$25,000	78,553	60,023	68,450	61,695	69,332	67,876	81,541	92,855	117,999	127,603
Coverage Rate	3.19%	2.37%	2.69%	2.43%	2.72%	2.67%	3.00%	3.15%	3.68%	3.78%
Returns Examined \$25,000 & < \$100,000	80,861	58,877	42,391	31,226	34,650	40,530	46,927	53,477	82,542	80,792
Coverage Rate	2.57%	1.82%	1.30%	0.93%	1.02%	1.18%	1.33%	1.47%	2.21%	2.09%
Returns Examined \$100,000 and over	73,049	59,728	44,945	28,781	24,080	29,848	30,738	39,124	78,497	89,231
Coverage Rate	4.13%	3.25%	2.40%	1.48%	1.20%	1.45%	1.47%	1.86%	3.65%	3.90%
<b>Forms 1040 – Schedule F</b>										
Returns Examined < \$100,000	5,868	3,949	2,832	1,384	2,104	1,709	1,997	3,104	1,603	1,348
Coverage Rate	1.28%	0.93%	0.68%	0.35%	0.55%	0.47%	0.57%	0.91%	0.48%	0.42%
Returns Examined \$100,000 and over	7,446	4,507	3,415	2,150	3,211	1,932	2,076	4,003	2,626	1,547
Coverage Rate	2.75%	1.63%	1.23%	0.80%	1.18%	0.72%	0.78%	1.61%	1.01%	0.58%

Source: TIGTA analysis of IRS Data Book.



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**Figure 50. Numbers and Percentages of Business Tax Returns Examined.** This chart shows the numbers and percentages of examination coverage.

	FY 1997	FY 1998	FY 1999	FY 2000	FY 2001	FY 2002	FY 2003	FY 2004	FY 2005	FY 2006
<b>Corporations – Assets &lt; \$10 Million</b>	56,323	41,818	28,268	18,623	14,332	14,655	13,608	7,294	17,858	17,849
Coverage Rate	2.22%	1.67%	1.16%	0.77%	0.60%	0.63%	0.58%	0.32%	0.79%	0.80%
<b>Corporations – Assets \$10 Million and Over</b>	12,972	11,830	10,537	9,212	8,718	8,443	7,125	9,523	10,829	10,578
Coverage Rate	24.29%	21.43%	19.05%	16.30%	15.08%	14.17%	12.08%	16.74%	20.02%	18.60%
<b>Form 1120S</b>	23,898	25,522	21,169	15,200	12,437	11,646	9,695	6,402	10,417	13,970
Coverage Rate	1.04%	1.04%	0.81%	0.55%	0.43%	0.39%	0.30%	0.19%	0.30%	0.38%
<b>Partnership</b>	9,811	10,082	7,991	6,539	5,070	5,543	7,871	6,226	8,489	9,752
Coverage Rate	0.59%	0.58%	0.43%	0.33%	0.25%	0.26%	0.35%	0.26%	0.33%	0.36%
<b>Fiduciary</b>	5,753	6,890	6,382	7,318	7,070	7,206	6,068	4,438	6,591	3,669
Coverage Rate	0.18%	0.21%	0.19%	0.22%	0.20%	0.18%	0.17%	0.12%	0.18%	0.10%
<b>Employment</b>	60,799	40,595	28,898	20,074	17,163	17,252	16,408	17,698	33,748	41,646
Coverage Rate	0.21%	0.14%	0.10%	0.07%	0.06%	0.06%	0.06%	0.06%	0.11%	0.13%
<b>Excise</b>	24,701	19,858	12,562	10,294	8,169	8,426	8,756	12,560	16,563	16,678
Coverage Rate	3.14%	2.48%	1.53%	1.25%	0.96%	1.03%	1.05%	1.49%	1.98%	1.99%
<b>Estate</b>	11,686	10,451	9,319	8,024	7,707	7,151	7,265	6,455	6,081	5,299
Coverage Rate	12.90%	10.22%	8.46%	6.89%	6.24%	5.84%	6.38%	7.41%	8.20%	9.66%
<b>Gift</b>	2,085	2,010	2,369	2,097	2,005	1,899	1,855	1,979	2,125	2,051
Coverage Rate	0.90%	0.79%	0.91%	0.72%	0.65%	0.63%	0.66%	0.69%	0.81%	0.77%

Source: TIGTA analysis of IRS Data Book



## **Appendix VI**

### *Prior Treasury Inspector General for Tax Administration Compliance Trends Reports*

*Management Advisory Report: Evaluation of Reduction in the Internal Revenue Service's Compliance Activities* (Reference Number 2000-30-075, dated May 2000).

*Management Advisory Report: Tax Return Filing and Examination Statistics* (Reference Number 2001-30-175, dated September 2001).

*Management Advisory Report: Analysis of Trends in Compliance Activities Through Fiscal Year 2001* (Reference Number 2002-30-184, dated September 2002).

*Trends in Compliance Activities Through Fiscal Year 2002* (Reference Number 2003-30-078, dated March 2003).

*Trends in Compliance Activities Through Fiscal Year 2003* (Reference Number 2004-30-083, dated April 2004).

*Trends in Compliance Activities Through Fiscal Year 2004* (Reference Number 2005-30-055, dated March 2005).

*Trends in Compliance Activities Through Fiscal Year 2005* (Reference Number 2006-30-055, dated March 2006).