Limitations in the Sample Size for the Internal Revenue Service's Employment Tax Study May Impact the Ability to Determine Compliance Levels

May 17, 2010

Reference Number: 2011-10-034

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LIMITATIONS IN THE SAMPLE SIZE FOR THE INTERNAL REVENUE SERVICE'S EMPLOYMENT TAX STUDY MAY IMPACT THE ABILITY TO DETERMINE COMPLIANCE LEVELS

Highlights

Final Report issued on May 17, 2011

Highlights of Reference Number 2011-10-034 to the Internal Revenue Service Director for the Office of Research, Analysis and Statistics.

IMPACT ON TAXPAYERS

The Internal Revenue Service (IRS) Office of Research, Analysis and Statistics initiated the Employment Tax Study (the Study) to update estimates of the Tax Gap (the difference between taxes owed and taxes timely paid) attributable to business employers. However, the audit results for the taxpayers included in the Study may not enable IRS management to fully estimate compliance levels for business taxpayers. Having a more complete understanding of these filers is essential for the IRS to focus its limited resources in areas where it could be most productive, which should ultimately reduce the burden on compliant taxpayers and result in more accurate Tax Gap data.

WHY TIGTA DID THE AUDIT

The audit was initiated because employment taxes are a major source of revenue for the Federal Government, and it has been more than 25 years since the IRS conducted a comprehensive review of employer tax compliance. Some IRS officials believe the current Tax Gap estimate is significantly understated. In February 2010, the IRS began its first Employment Tax Study to better estimate the Tax Gap for underreported employment taxes and determine compliance rates for business taxpayers.

Results from other studies indicate there are several underlying factors that contribute to the underreporting of employment taxes. As a result, the employment tax audits included in the Study are expected to be comprehensive in nature.

The overall objective of this review was to determine whether the sampling methodology developed by the Office of Research, Analysis and Statistics to conduct the Study will provide a valid representation of employment tax compliance rates for business taxpayers.

WHAT TIGTA FOUND

The IRS selected the sample of employers to include in the Study based on available resources. However, the audit results for the sampled taxpayers may not enable IRS management to fully estimate compliance levels for business taxpayers. As a result, IRS management indicated that additional audits may be required after the Study is completed.

In addition, the IRS plans to sample only 50 large/international business taxpayers in each year of the Study, which may be too small of a sample to provide meaningful compliance estimates for these taxpayers. Further, IRS management specifically excluded some larger employers due to the time necessary to complete these complex audits. As a result, the Study will not provide any information about the compliance levels of these employers.

WHAT TIGTA RECOMMENDED

TIGTA recommended that the IRS develop an action plan for any future employment tax study that outlines management's strategy to achieve their goal of updating the employment Tax Gap estimates, determine the percentage of the total population that the excluded entities represent, and evaluate whether future employment tax studies should include the large employers excluded in this Study.

In their response to the report, IRS officials agreed with our recommendations. IRS management agreed to develop goals and project plans during the design phase of every IRS reporting compliance research study. In addition, they plan to document the findings related to the excluded entities as companion data to the Study results. Finally, management agreed to reevaluate whether future employment tax studies should include the large employers.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

May 17, 2011

MEMORANDUM FOR DIRECTOR, RESEARCH, ANALYSIS AND STATISTICS

FROM: Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Limitations in the Sample Size for the Internal Revenue Service's Employment Tax Study May Impact the Ability to Determine Compliance Levels (Audit # 201110001)

This report presents the results of our review of the sampling methodology developed by the Internal Revenue Service (IRS) Office of Research, Analysis and Statistics (RAS) to conduct the Employment Tax Study. Our overall objective was to determine whether the sampling methodology developed by the IRS Office of RAS to conduct the Study will provide a valid representation of employment tax compliance rates for business taxpayers. This audit is part of the Treasury Inspector General for Tax Administration's Fiscal Year 2011 Annual Audit Plan and addresses the major management challenge of Tax Compliance Initiatives.

Management's complete response to the draft report is included as Appendix V.

Copies of this report are also being sent to the IRS managers affected by the report recommendations.

Please contact me at (202) 622-6510 if you have questions or Nancy A. Nakamura, Assistant Inspector General for Audit (Management Services and Exempt Organization), at (202) 622-8500.

Table of Contents

Abbreviations

FY	Fiscal Year
IRS	Internal Revenue Service
LB&I	Large Business and International
RAS	Office of Research, Analysis and Statistics
SB/SE	Small Business/Self-Employed
TE/GE	Tax Exempt and Government Entities

Background

In 2005, the Internal Revenue Service (IRS) released preliminary results of a major research effort to quantify the Tax Gap using data from Tax Year 2001 and before.[1] The IRS estimated the Tax Gap was $345 billion in 2001. This equates to a voluntary compliance rate of almost 84 percent. Late payments and IRS enforcement action reduced this to a net Tax Gap of $290 billion.

The three components of the Tax Gap are:

- **Underreporting –** Not reporting one's full tax liability on a timely filed return.
- **Nonfiling –** Not filing required returns on time.
- **Underpayment –** Not timely paying the full amount of tax reported on a timely filed return.

The last employment tax study was completed in 1984. Because of outdated information, the Tax Gap estimate attributed to underreporting of employment taxes of $15 billion may be significantly understated. In February 2010, the IRS began audits under a new Employment Tax Study. The IRS plans to audit approximately 2,200 employers annually.

Underreported tax liability ($285 billion) comprises 83 percent of the gross Tax Gap ($345 billion). Of this underreported amount, $54 billion (19 percent) is related to underreported employment taxes. This estimate is comprised of:

- Federal Unemployment Tax – $1 billion.
- Social Security and Medicare Taxes – $14 billion.
- Self-Employment Taxes – $39 billion.[2]

The $15 billion estimated Tax Gap for Federal Unemployment Tax and Social Security and Medicare Taxes is considerably outdated, and some IRS officials believe it is significantly understated.[3] The IRS has not conducted a comprehensive study of business taxpayers' compliance with employment taxes since 1984. Further, less than one-quarter of 1 percent (0.25) of employment tax returns were audited based on Calendar Year 2009 data.[4] In February 2010,

[1] The Tax Gap is the difference between taxes owed and taxes actually paid on a timely basis.
[2] Employment tax compliance related to self-employed taxpayers (with no employees) was not addressed in this Study. The underreporting of Self-Employment Taxes is estimated to be $39 billion based on studies of individual reporting compliance.
[3] The Self-Employment Taxes estimate is more current and is considered to be a more reliable estimate.
[4] Based on the number of returns examined in Fiscal Year 2009 as a percentage of all employers with a filing requirement in Calendar Year 2008.

the IRS began its first Employment Tax Study (hereafter referred to as the Study) in 25 years[5] to better estimate the Tax Gap for underreported employment taxes and determine compliance rates for business taxpayers. The overall goals of the Study are to:

- Secure statistically valid information to determine the employment Tax Gap.
- Determine compliance rates of employers to focus IRS resources on the most noncompliant areas.
- Improve examination workload selection models (for future audits).

The Study calls for audits of randomly selected employers who filed an Employer's Quarterly Federal Tax Return (Form 941) for any quarter during Calendar Years 2008, 2009, or 2010. The IRS plans to audit approximately 6,600 of the estimated 6.1 million employers filing Forms 941 beginning in Fiscal Year (FY) 2010.[6]

The sample of employers will be selected and the audit results will be compiled by the IRS Office of Research, Analysis and Statistics (RAS). At the conclusion of the Study, the IRS hopes to have a better understanding of which industries and employers are at the highest risk for underreporting their employment taxes. The methodology used to identify and select employers for the Study is important to achieve the most accurate results. The individual audits will be conducted by employees within three IRS operating divisions: Small Business/Self-Employed (SB/SE), Large Business and International (LB&I),[7] and Tax Exempt and Government Entities (TE/GE).

This review was performed at the IRS National Headquarters in Washington, D.C., in the Office of RAS during the period August 2010 through January 2011. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

We relied on published data and other information provided by the Office of RAS and the United States Department of the Treasury and audit reports issued by the Treasury Inspector General for Tax Administration and the Government Accountability Office. The information obtained from published data and provided directly by the Office of RAS was not independently verified or validated by the Treasury Inspector General for Tax Administration. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

[5] The IRS Headliner Volume 280, dated November 9, 2009.
[6] See Appendix IV for additional information on the sample size by type of employer.
[7] The Large and Mid-Size Business Division reorganized in FY 2010 and is now the LB&I Division.

Results of Review

The IRS selected the sample of employers to include in the Study based on available resources. However, the audit results for the sampled taxpayers may not enable IRS management to fully estimate compliance levels for business taxpayers. As a result, IRS management indicated that additional audits may be required after the Study is completed to improve the IRS's estimates of business taxpayers' reporting compliance.

Specifically, management will not fully know the usefulness of the Study's results until FY 2015, when all audits are completed and the results are compiled. As a result of the relatively small total sample size that can be addressed by IRS resources, there is a risk that the IRS may not collect sufficient data to provide reasonable estimates of compliance levels and the Tax Gap. In addition, the IRS plans to sample only 50 large/international business taxpayers in each year of the Study, which may be too small of a sample to provide meaningful compliance estimates for these taxpayers.

Further, IRS management specifically excluded some larger employers (e.g., the Federal Government; corporations with assets greater than $250 million, etc.) from the Study due to the time necessary to complete these more complex audits. As a result, the IRS will not obtain any data for these taxpayers related to trends and patterns of noncompliance.

Until the IRS obtains complete and updated data on areas of employment tax noncompliance, management will not have accurate information about the employers that are the most likely to underreport their taxes. Having a more complete understanding of these filers is essential for the IRS to focus its limited resources in areas where they could be most productive, which should ultimately reduce the burden on compliant taxpayers and result in more accurate Tax Gap data.

The Internal Revenue Service Is at an Early Stage in Its Efforts to Improve Compliance Estimates for Business Taxpayers

RAS management stated that, due to the lack of updated employment tax compliance data, they consider the Study a pilot project and will not definitively know the usefulness of the test results until after the audits are completed.[8] Because of the time needed to conduct the audits, it is likely the IRS will not fully know the usefulness of the Study until FY 2015, when all of the audits should be completed.

[8] A pilot project is typically a small-scale preliminary study conducted before the main research in order to check the feasibility or to improve the design of the research.

Results from prior studies indicate that there are several underlying factors that contribute to the underreporting of employment taxes. As a result, the employment tax audits that comprise the Study are expected to be comprehensive in nature, and auditors will focus on the underlying issues that ultimately determine the wages paid and employment tax liabilities. For example, since employers may incorrectly classify certain workers as independent contractors to avoid liability for employment taxes, auditors are expected to determine the worker's correct employment status so that the correct wages and taxes are reported. The IRS identified four areas that are considered high risk for noncompliance that auditors are expected to address when applicable:[9]

1) Worker classification issues.
2) Fringe benefits.
3) Reimbursed expenses.
4) Officer compensation.

To fully address these (and other) issues, auditors will need to expand the scope of the audits beyond the information provided on the Form 941 selected for the sample. For the employers selected, the audits will focus on the wages paid for an entire calendar year (this will include Forms 941 for all four quarters). Other (employment and nonemployment tax) returns will also be examined to support the amounts reported on the employment tax returns. This could include unemployment, corporate, partnership, nonprofit, and information returns.[10] As a result, each audit is expected to take approximately 2 years to complete. RAS management anticipates that the final results will not be available until FY 2015, as shown in Figure 1.

Figure 1: Fiscal Year Timeline for the Audits and Availability of Results

Year Selected Returns Are to Be Assigned to Auditors	Availability of Initial Audit Results	Availability of Final Audit Results
2010 (2008 Returns)	2012	2013
2011 (2009 Returns)	2013	2014
2012 (2010 Returns)	2014	2015

Source: RAS management, December 2010.

[9] Not all audits will involve all four focus areas, and some will address more issues.
[10] Information returns such as the Wage and Tax Statement (Form W-2) or the Miscellaneous Income (Form 1099-MISC.) are required to report various types of payments made by businesses throughout the calendar year.

The independent contractor employed by the IRS to review the sample design noted that the Study results will not be readily available for several years. As a result, the IRS will not have adequate data available during the course of the Study to refine the sampling methodology as needed to help identify the most noncompliant taxpayers. The contractor identified three options to address this issue:

1) Continue to sample returns under the current design for 1 to 2 years beyond the Calendar Year 2010 returns.
2) Refine the sampling methodology without using the initial results from the audits.
3) Suspend data collection after review of Calendar Year 2010 audit results until a satisfactory new design can be developed.

RAS management indicated it would be optimal to continue the Study to include additional years, much like a rolling study to achieve more precise results.[11] However, this will require the three IRS operating divisions involved in the Study to continue to provide the resources needed to perform additional audits beyond the current 3-year commitment.

The Study Will Not Enable the Internal Revenue Service to Fully Estimate Compliance for Large Employers

During the Study, the IRS plans to sample only 50 large/international business taxpayers in each year of the Study, which may be too small of a sample to provide meaningful compliance estimates for these taxpayers. Further, IRS management specifically excluded some larger employers (e.g., the Federal Government, corporations with assets greater than $250 million, etc.) from the Study due to the time necessary to complete these more complex audits. As a result, the IRS will not obtain any data for these taxpayers related to trends and patterns of noncompliance.

The Sample does not include a sufficient number of large employers to estimate compliance levels

Based on the Study's methodology, approximately 68 percent of the planned audits represent small business employers. In addition, over 25 percent of the planned audits relate to tax exempt employers. The Study will provide the most meaningful results to estimate compliance levels for these types of employers. However, only slightly more than 2 percent of the Study's planned audits (50 per year) relate to large employers. As a result, Study data will be of limited use in determining the compliance behavior for these employers.

[11] A rolling study is a multi-year project in which results are updated as more current data become available.

The original sample design broken out by IRS operating division is shown in Figure 2.

Figure 2: Proposed Annual Sample for Calendar Year 2008 (Year 1 of the Sample) by IRS Operating Division

IRS Operating Division	Sample Size	Percent of Sample
SB/SE Small Business/Self-Employed	1,500	68.97%
TE/GE Tax Exempt Organizations[12]	535	24.60%
TE/GE Government Entities[13]	90[14]	4.14%
LB&I Large Business & International	50	2.30%
Total	**2,175**	**100%[15]**

Source: RAS management, September 2010.

The IRS estimates there are over 5.5 million small businesses[16] with employees that represent 90 percent of the total employer population. In FY 2008, the IRS estimated that small business employers filed more than 85 percent of all employment tax returns. However, large employers accounted for over 45 percent of the total United States payroll.[17]

The outside research firm that RAS management consulted indicated that, although the overall sampling plan was adequate for a pilot Study, they were concerned about the small size of the LB&I and the TE/GE Government Entities samples. They expressed concern that "if compliance is as high as earlier estimates suggest, these samples will provide mere handfuls of noncompliant returns, too few to illuminate patterns or highlight significant new forms of noncompliance."[18]

While the IRS doubled the sample size for Government Entities for Calendar Year 2009, no additional plans have been made to increase the size of the LB&I Division sample from the 50 per year originally planned. As part of our review, we consulted with an independent

[12] Nonprofit organizations are exempt from income tax under Internal Revenue Code Section 501 and can include charities, religious organizations, business leagues, or social clubs.
[13] Government entities are exempt from income tax and are comprised of three distinct customers: Federal, State, and local governments; Indian Tribal governments; and Tax Exempt Bonds. Although not subject to Federal income tax, these entities are responsible for income tax withholding and employment taxes.
[14] The number of TE/GE government entities in the sample doubled for Calendar Year 2009.
[15] The total exceeds 100 percent due to rounding.
[16] A "small" business generally has total assets under $10 million.
[17] A "large" business has total assets greater than $10 million.
[18] *An Evaluation of the Sample Design and Methodology for the National Research Program Employment Tax Reporting Compliance Study*, Mathematica Policy Research, Inc., Final Report dated January 29, 2010.

statistician who confirmed the plan was adequate, but also expressed concern that the LB&I Division sample size might be too small to analyze and identify noncompliant employers.

RAS management agreed that the sample size is smaller than preferable; however, they advised us that since the IRS conducts ongoing audits of the largest businesses, many of these employers are already subject to review. As a result, RAS management indicated that they may use the results of ongoing audits to assist in estimating compliance levels for these taxpayers. They also stated that these taxpayers may be more compliant than smaller employers; however, they could not provide documentation to support their assumption.

While we concur that many of the larger businesses are already subject to ongoing examinations, it is not apparent how many of these audits actually involve employment tax issues or how results from these audits will be incorporated into the Study. Further, we have no basis to concur with the RAS assertion that larger employers are more likely to be compliant with their employment tax obligations. As such, we are concerned that the small LB&I Division sample size could prevent the IRS from identifying patterns of noncompliance among the largest employers. Consequently, this could impair the IRS's ability to measure compliance and effectively plan future audit studies for this segment of employers.

Recommendation

The Director, RAS, should:

Recommendation 1: Develop an action plan for any future employment tax study that outlines management's strategy to achieve their goal of updating the employment Tax Gap estimates and focusing IRS resources on the most noncompliant areas.

> ***Management's Response:*** Management agreed with this recommendation and indicated they plan to continue to develop goals and project plans during the design phase of every IRS reporting compliance research study. IRS management plans to monitor the delivery of the 3 tax years of the Study and incorporate any lessons learned into the plans for future research efforts.

The Study will not provide any information related to the compliance levels of some tax exempt and large employers

The Study will not give the IRS complete information about the employment tax community because some types of employers are excluded from the Study. Specifically, the IRS elected to exclude Federal Government agencies, the three largest State Governments,[19] and many of the largest corporations (which would require a team of IRS auditors to conduct the audits)[20] because

[19] The excluded State Governments are California, New York, and Texas.
[20] A team examination approach is required on "coordinated industry cases" assigned to the LB&I Division, which involve businesses (and their effectively controlled entities) with assets of $250 million or more.

of concerns about the audit resources required to complete these large-scale audits. In addition, Indian Tribal governments, foreign subsidiaries, and maritime employers are also excluded from the Study.

Figure 3 shows the segments of the population excluded from the Study.

Figure 3: Form 941 Employers Excluded From the Study

IRS Operating Division	Segment of the Population Excluded
SB/SE	No Specific Exclusions
TE/GE – Tax Exempt Entities	Church Entities (2008 only)[21]
TE/GE – Government Entities	Three Largest State Governments (California, New York, and Texas)
TE/GE – Government Entities	Federal Government
TE/GE – Government Entities	Indian Tribal Governments
LB&I (LMSB)	Coordinated Industry Cases
LB&I	Foreign Subsidiaries
LB&I	Maritime Industry

Source: RAS management.

As a result of the various exclusions, the Study will not address noncompliance within these groups of employers, and any conclusions drawn from the Study will be limited to the employer populations reviewed. RAS management agreed that any Tax Gap projections would be limited to the populations studied and that they would disclose any limitations in any reports summarizing the results of the Study.

We asked RAS management how many employers were excluded from the Study, but they were unable to provide this information. As a result, we were not able to quantify the percentage of the total population that the excluded entities represented (either as a percentage of the total number of employers or the total wages paid).

[21] IRS management indicated that 2009 and 2010 returns would be included in the Study.

Recommendations

The Director, RAS, should:

Recommendation 2: Determine the percentage of the total population that the excluded entities represent (either as a percentage of the total number of employers or the total wages paid) and ensure this information is documented in the Study results.

> ***Management's Response:*** Management agreed with this recommendation and plans to document the findings related to the excluded entities as companion data to the Study results.
>
> ***Office of Audit Comment:*** During our fieldwork, we reviewed a report from the independent contractor, indicating that all State Governments were excluded from the Study. When we discussed this with RAS management, they advised us that the three largest State Governments were excluded from the Study because of the time that would be required to conduct these audits. However, after we issued our draft report, RAS management informed us the information they had previously provided about the State Governments was incorrect. Management clarified that their sample design for the 50 largest businesses was inclusive of all State Governments, but none were selected for the sample.

Recommendation 3: Evaluate whether future employment tax studies should include the large employers excluded in this Study.

> ***Management's Response:*** Management agreed with the recommendation and plans to reevaluate whether future employment tax studies should include the large employers.

Appendix I

Detailed Objective, Scope, and Methodology

Our overall objective was to determine whether the sampling methodology developed by the IRS Office of RAS to conduct the Employment Tax Study (the Study) will provide a valid representation of employment tax compliance rates for business taxpayers. To accomplish the objective, we:

I. Interviewed RAS management to determine the goals and strategic objectives of the Study and how the results will be used to measure business taxpayers' compliance with employment taxes.

II. Interviewed RAS management to determine the specific sampling methodology used to select the employers for the Study.

   A. Determined the types of tax returns included in the population for the sample.

   B. Determined which segments of the population were intentionally excluded from the sample selection and why.

III. Evaluated the validity of the sampling process developed for the Study.

   A. Consulted with an independent statistician to determine whether the sampling methodology used by the Office of RAS is adequate for its stated objectives.

   B. Determined whether the sample methodology is statistically valid to project the results to the population of employment tax filers.

Internal controls methodology

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We did not assess internal controls because doing so was not applicable within the context of our audit objective.

We relied on published data and other information provided by the Office of RAS and the United States Department of the Treasury[1] and audit reports issued by the Treasury Inspector General for Tax Administration[2] and the Government Accountability Office.[3] The information obtained from published data and provided directly by the Office of RAS was not independently verified or validated by the Treasury Inspector General for Tax Administration.

[1] *Update on Reducing the Federal Tax Gap and Improving Voluntary Compliance,* United States Treasury Department Report (dated July 8, 2009).

[2] *An Appropriate Methodology Has Been Developed for Conducting the National Research Program Study to Measure the Voluntary Compliance of Individual Income Taxpayers* (Reference Number 2009-30-086, dated June 2009) and *An Improved Management Process Is Needed to Measure the Impact of Research Efforts on Tax Administration* (Reference Number 2009-10-095, dated July 21, 2009).

[3] *Better Compliance Data and Long-term Goals Would Support a More Strategic IRS Approach to Reducing the Tax Gap* (GAO-05-753, dated July 2005).

Appendix II

Major Contributors to This Report

Nancy A. Nakamura, Assistant Inspector General for Audit (Management Services and Exempt Organizations)
Jeffrey M. Jones, Director
Janice M. Pryor, Audit Manager
Mary F. Herberger, Lead Auditor
Theresa M. Berube, Senior Auditor
Mark A. Judson, Senior Auditor

Appendix III

Report Distribution List

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Audit Liaison: Director, Office of Research, Analysis and Statistics RAS

Appendix IV

Stratified Sample for Calendar Year 2008

The Office of Research, Analysis and Statistics designed the Calendar Year 2008 sample based on input from the IRS operating divisions. The sample size of each division is determined by the employees available to complete the audits.

Form 941 – Proposed Strata for SB/SE			
Strata Definition (Annual Wages Paid)	Number of Employees	Population	Initial Sample
Total Wages <= $20,000		1,441,792	175
$20,000 < Total Wages <= $50,000		1,044,511	175
$50,000 < Total Wages <= $100,000		864,670	200
$100,000 <Total Wages <= $200,000		780,522	225
$200,000 < Total Wages <= $500,000	< 50	733,580	200
	>= 50	8,046	50
Total Wages > $500,000	< 50	485,573	225
	>= 50	146,431	250
Total		5,505,125	1,500
Form 941 - Proposed Strata for TE/GE Exempt Organizations			
Total Wages <= $75,000		174,988	100
$75,000 < Total Wages <= $250,000		97,760	100
$250,00 < Total Wages <= $1,000,000		65,176	150
Total Wages > $1,000,000		44,785	185
Total		382,709	535
Form 941 - Proposed Strata for TE/GE Government Entities[1]			
All Government Entities		74,398	90
Form 941 - Proposed Strata for LB&I			
All LB&I		134,634	50

Source: RAS Management, September 2010.

[1] The number of TE/GE Government entities sampled doubled for Calendar Year 2009.

Appendix V

Management's Response to the Draft Report

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, DC 20224

April 22, 2011

RECEIVED
APR 22 2011

MEMORANDUM FOR MICHAEL R. PHILLIPS
DEPUTY INSPECTOR GENERAL AUDIT

FROM: Rosemary D. Marcuss 35RNB
Director, Research, Analysis and Statistics

SUBJECT: Draft Audit Report – Limitations in the Sample Size for the IRS's Employment Tax Study May Impact the Ability to Determine Compliance Levels (Audit # 201110001)

Thank you for the opportunity to review your draft report titled: "Limitations in the Sample Size for the IRS's Employment Tax Study May Impact the Ability to Determine Compliance Levels (Audit # 201110001)". Your report acknowledges NRP's efforts to conduct a multi-year research study of employment tax compliance, which should aid in informing Tax Gap estimation and support other research efforts. The report reflects our approach to balance the requirements of statistical precision and the resources available to generate these research data. The stakeholders recognized these limitations during the Employment Tax study design, as well as the impact on our resulting compliance estimates. We are exploring the possibility of expanding the overall sample size by adding additional tax years to the study. In addition to furthering the understanding of compliance research, NRP studies have additional benefits, e.g., this study has unified the tools the participating IRS Operating Divisions use to capture employment tax audit data and has led to important examination enhancements that will benefit any examination of employment tax issues.

We were unable to correct some additional points in the report during earlier discussions. First, although the design team considered excluding several larger states, the NRP sample does not exclude any state governments. Second, while we anticipate each study to last approximately two years; the individual audits within each study will vary from the average due to the complexity of the returns involved.

We have accepted your recommendations and will implement appropriate corrective actions.

2

Attached are our comments to your specific recommendations. If you have any questions, please contact me, or a member of your staff may contact Justin Allen of the National Research Program on 617-316-2265.

Attachment

Attachment

The Director, Research, Analysis and Statistics, should:

RECOMMENDATION 1:
Develop an action plan for any future employment tax study that outlines management's strategy to achieve their goal of updating the employment Tax Gap estimates and focusing IRS resources on the most noncompliant areas.

CORRECTIVE ACTION
We agree with this recommendation. We develop goals and project plans during the design phase of every IRS reporting compliance research study. We will continue to monitor the delivery of the three tax years of the employment tax study and will incorporate any lessons learned into the plans for future research efforts

RESPONSIBLE OFFICIAL
Director, Research, Analysis, and Statistics

IMPLEMENTATION DATE
Evaluation and project planning for future studies will occur at the inception of those studies.

RECOMMENDATION 2:
Determine the percentage of the total population that the excluded entities represent (either as a percentage of the total number of employers or the total wages paid), and ensure this information is documented in the Study results.

CORRECTIVE ACTION
We agree with this recommendation. We will document findings related to excluded entities as companion data to the NRP study results.

RESPONSIBLE OFFICIAL
Director, Research, Analysis, and Statistics

IMPLEMENTATION DATE
December 30, 2011

RECOMMENDATION 3:
Evaluate whether future employment tax studies should include the large employers excluded in this Study.

CORRECTIVE ACTION
We agree with the recommendation. We had this discussion during the design phase of this study. Factors to be considered include the availability of resources. For future employment tax studies, we will re-evaluate whether those studies should include the large employers

RESPONSIBLE OFFICIAL
Director, Research, Analysis, and Statistics

IMPLEMENTATION DATE
October 15, 2011