



April 2017

EMPLOYMENT TAXES

Timely Use of
National Research
Program Results
Would Help IRS
Improve Compliance
and Tax Gap
Estimates

Why GAO Did This Study

Employers report employment taxes for Social Security, Medicare, unemployment insurance, and income taxes to IRS. In fiscal year 2016, these totaled almost \$2.28 trillion. Each year, IRS examines a small percentage of employment tax returns to check employer compliance (known as operational examinations).

GAO was asked to review how practices from NRP examinations could improve operational examinations. This report (1) evaluates how IRS plans to analyze the NRP results, (2) describes GAO's review of available NRP data, and (3) describes NRP practices IRS applied to operational examinations and assesses whether additional improvements could be made to operational examinations. GAO reviewed documentation, interviewed officials, and reviewed the NRP results. GAO also surveyed all IRS examiners who completed both NRP and operational examinations on ideas for improving operational examinations.

What GAO Recommends

GAO recommends that IRS develop plans to analyze the NRP results in 2017 to address areas of noncompliance identified, and update its employment tax gap estimates; determine whether and when to provide certain data upfront before an examination starts; and periodically remind IRS examiners how they can access certain tools. IRS agreed with GAO's recommendations.

View [GAO-17-371](#). For more information, contact Jessica Lucas-Judy at (202) 512-9110 or LucasJudyJ@gao.gov.

EMPLOYMENT TAXES

Timely Use of National Research Program Results Would Help IRS Improve Compliance and Tax Gap Estimates

What GAO Found

The Internal Revenue Service (IRS) uses its National Research Program (NRP) to study tax compliance issues. These NRP studies generally rely on detailed examinations of a random sample of tax returns and use different practices (including tools and procedures) than IRS's routine operational examinations. IRS recently completed the examinations for an NRP study on employment tax returns filed from tax years 2008 to 2010. This study was the first IRS had done on employment taxes in over 30 years. Based on IRS guidance, NRP results are intended to factor into IRS decisions about compliance areas and to be used to estimate the tax gap—the difference between taxes owed and those voluntarily paid on time. Although the examinations for the study are done, IRS has not developed formal plans to analyze the results to (1) identify areas of noncompliance, (2) address such noncompliance, or (3) update its employment tax gap estimate. IRS officials said they have not developed such formal plans due to competing research priorities and limited resources, and because the NRP results have not yet been finalized. Without completed analysis of the NRP employment tax results, IRS risks using outdated data to make decisions about compliance and areas of the tax gap to pursue.

GAO reviewed the available NRP study results on noncompliance and found that taxable wages for worker classification and fringe benefits were among the most frequently misreported and led to the highest wage adjustment amounts on average. Worker classification issues arise when employers misclassify employees as independent contractors or other nonemployees. If employees are misclassified, the employer's obligation to withhold and pay employment taxes is not established and goes unpaid. Fringe benefits issues involve property, a service, or cash received that should be treated as taxable wages but are not.

IRS carried over certain NRP practices to operational employment tax examinations, including tools to help plan, document, and report the results of examinations but IRS examiners who responded to GAO's survey identified additional improvements that could be made to operational examinations.

- More than 90 percent of examiners said that they would like to have a certain tool—electronic data on the information returns of employers—when operational examinations start instead of on request, which they said would help identify issues to examine sooner and put fewer burdens on taxpayers. Although IRS officials said that providing the tool when all examinations start would not be a good use of IRS resources, they did not have data to evaluate whether and when providing this tool would improve examinations.
- Half of IRS examiners who were asked about two specific NRP tools in GAO's survey were not aware of how to request them for use during operational examinations. According to IRS officials, these tools may only be used infrequently during employment tax examinations. However, ensuring IRS examiners are aware of how to access them would be in line with IRS's strategic goal of empowering employees with tools and training. Without examiners being aware of these tools and able to utilize them when needed, they may be limited in their ability to effectively examine employment tax returns.

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Abbreviations

CDW	Compliance Data Warehouse
DCI	Data Collection Instrument
ETLS	Employment Tax Lead Sheet
EO	Exempt Organizations
FICA	Federal Insurance Contribution Act
FSLG	Federal, State, and Local Governments
FUTA	Federal unemployment insurance
GS	General Schedule
IRAS	Information Return Analysis System
IRM	Internal Revenue Manual
IRS	Internal Revenue Service
LB&I	Large Business & International
NRP	National Research Program
RAAS	Office of Research, Applied Analytics, and Statistics
SB/SE	Small Business/Self-Employed division
TE/GE	Tax Exempt and Government Entities
TIN	Taxpayer Identification Number

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April 18, 2017

The Honorable Orrin G. Hatch
Chairman
The Honorable Ron Wyden
Ranking Member
Committee on Finance
United States Senate

Every year, the federal government forgoes hundreds of billions of dollars of tax revenue through the gross tax gap—the difference between taxes owed and taxes voluntarily paid on time. The Internal Revenue Service (IRS) estimated that the annual average gross tax gap for tax years 2008 to 2010, the most recent estimate, totaled \$458 billion. One portion of the gross tax gap, estimated to be \$16 billion (3.5 percent), is due to taxpayers underreporting employment taxes that employers are to withhold and remit to cover liabilities for Social Security, Medicare, and federal unemployment insurance. In fiscal year 2016, federal revenue from employment taxes to cover these liabilities totaled more than \$1 trillion. Employers also withheld federal income tax totaling almost \$1.27 trillion. IRS examines only a small fraction of the employment tax returns that employers file given its resource limitations.¹ In fiscal year 2016, IRS examined about 54,600 employment tax returns, which covered 0.2 percent of all employment tax returns filed in calendar year 2015. Because such a small percentage of employment returns are examined, IRS must especially ensure that the examinations are as efficient and effective as possible.

One source for improving examinations is IRS’s National Research Program (NRP). IRS carries out detailed NRP studies to measure different types of taxpayer compliance.² The NRP study of employment tax returns from tax years 2008 through 2010 represents its first effort to measure employment tax reporting compliance in over three decades. This NRP study involved detailed examinations of a random,

¹An examination is a review of an organization’s or individual’s accounts and financial information to ensure information is reported correctly on the tax return according to the tax laws and to verify the reported amount of tax is correct.

²For example, IRS carries out NRP studies of individual tax returns. See GAO, *Tax Administration: IRS Could Improve Examinations by Adopting Certain Research Program Practices*, [GAO-13-480](#) (Washington, D.C.: May 24, 2013).

representative sample of Form 941, Employers Quarterly Federal Tax Return, which IRS selected from employers who filed at least one return for tax years 2008 through 2010.³ The in-depth NRP examinations provide crucial data for measuring noncompliance. The NRP examinations also provide IRS an opportunity to review the practices (i.e., tools, data, information systems, procedures, and lessons learned) used during NRP examinations that can then be applied to improve IRS's everyday employment tax examinations—known as operational examinations.

You asked us to assess IRS's actions to apply examination practices from the NRP employment tax study to operational employment tax examinations. In this report, we (1) evaluate how IRS plans to analyze the NRP data (2) review the NRP data available on areas of noncompliance, (3) describe NRP examination practices that IRS applied to operational employment tax examinations, and (4) assess additional NRP examination practices that could be applied to operational employment tax examinations.

To evaluate IRS's plans to analyze the NRP data and use the NRP results on noncompliance areas, we interviewed IRS research and examination officials about their plans to analyze and use the NRP data. We gathered documentation, such as research and analysis plans, when available. We compared IRS's plans to analyze and use the NRP data to IRS's strategic plan and the Internal Revenue Manual (IRM).⁴

To review NRP data available, we compared the noncompliance for issues on employment tax returns in terms of the frequency by which the issues examined were adjusted and the resulting wage adjustment amounts. We also reviewed the data by characteristics that help identify reporting noncompliance, such as the payroll size, number of employees,

³IRS's NRP Employment Tax Study excluded certain employer groups (see appendix I). The resulting sample sizes were 2,507, 2,387 and 2,318 employers for tax years 2008, 2009 and 2010, respectively.

⁴IRM is an official compilation of internal guidelines for IRS personnel. It is available at: <https://www.irs.gov/irm/> (last visited Feb. 27, 2017). Internal Revenue Service, *Strategic Plan: FY2014-2017* (Washington, D.C.: 2014).

and IRS business unit. We discussed our results with relevant IRS officials.⁵

To describe NRP examination practices that IRS applied to operational employment tax examinations, we interviewed examination staff from the Small Business/Self-Employed division (SB/SE) and Tax Exempt and Government Entities (TE/GE) business units who were responsible for NRP examinations during the employment tax study.⁶ To confirm the application of those NRP practices to operational employment tax examinations, we gathered available documentation. We also collected available documentation on the costs and benefits of carrying over NRP practices to operational employment tax examinations, and discussed the costs and benefits with the SB/SE and TE/GE staffs.

To assess additional NRP examination practices that could be applied to operational employment tax examinations, we conducted four group discussions with examiners who had completed both types of examinations. During these discussions, we gathered input on NRP examination practices that examiners thought could be applied to operational employment tax examinations. We discussed differences between NRP and operational employment tax examinations with program staff in SB/SE and TE/GE. Based on the list of additional NRP examination practices, we developed and fielded a web-based survey of all IRS examiners who had completed both NRP and operational employment tax examinations. The survey obtained their views on having access to the NRP examination practices during their operational employment tax examinations, if and why they found them helpful, and if they were aware of how to access them on operational examinations. The survey was sent to the complete list of 269 examiners identified by IRS officials as of July 2016 that were thought to meet the criteria of examiners with NRP and operational examination experience. Of those examiners, 23 were determined to not meet this criteria according to their responses to screening questions (1) on if they had completed both NRP and non-NRP examinations and (2) if they had completed a non-NRP

⁵See appendix I for a further discussion of our analysis of the NRP results as well as the steps we took to assess the reliability of the data and identify errors that were communicated to IRS.

⁶The Large Business & International (LB&I) business operating division was initially responsible for a small portion of the sample in the study. In 2012, IRS merged the employment tax functions within LB&I and within SB/SE. All open NRP and operational tax examinations were moved with the examiners to SB/SE.

examination since completing a non-NRP examination. We received a response rate of 85 percent, with 209 of the 246 examiners completing the survey who met our criteria. We discussed summary survey responses with relevant IRS officials. Where appropriate information was available, we compared the NRP practices with criteria on whether the practices would help IRS identify noncompliance, improve examination efficiency, reduce taxpayer burden, and meet other needs. We also compared the utility of the NRP practices identified to IRS's strategic plan.⁷

We assessed the reliability of the NRP study data by reviewing relevant documentation, interviewing knowledgeable IRS officials, and electronic testing of the data to identify obvious errors or outliers.⁸ We determined that the data used in our analysis were sufficiently reliable for our objectives. For additional details on our scope and methodology, see appendix I.

We conducted this performance audit from April 2016 to April 2017 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 objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

⁷Internal Revenue Service, *Strategic Plan: FY2014-2017* (Washington, D.C.: 2014).

⁸The NRP study includes about 7,200 observations over the tax years 2008 through 2010. The results for our analysis reflect NRP study data as of July 18, 2016.

Background

Employment Taxes

For federal tax purposes, employers generally are required to withhold and remit two types of taxes from their employees' salaries:

1. Federal income tax withholding. Income tax is withheld from the pay of most employees. Pay includes regular pay, bonuses, commissions, and vacation allowances as well as reimbursements and other expense allowances paid. The amount of income tax that employers withhold depends on the amount earned and the information on the employee's Form W-4.⁹
2. Federal Insurance Contribution Act (FICA) taxes. These taxes include Old-Age, Survivors and Disability Insurance (Social Security) and hospital insurance (Medicare) taxes. In 2016, the FICA taxes to be withheld consisted of 6.2 percent of an employee's taxable earnings up to \$118,500 for Social Security taxes and an additional 1.45 percent of the taxable earnings for Medicare not subject to a wage cap.¹⁰ Employers are required to match the amounts withheld from an employee's salary for Social Security and Medicare taxes.

Employers must also pay a federal unemployment insurance (FUTA) payroll tax. This tax is equal to 6 percent of the total wages of (up to \$7,000) each employee.¹¹ This tax is not withheld and remitted from an employee's wages. Taken all together, federal income tax withholding, FICA, and FUTA comprise employment taxes.

In general, employers who withhold federal income tax and Social Security and Medicare taxes report to IRS either quarterly on Form 941

⁹Other individual income tax payments are received from individuals as part of their annual tax return filings. In fiscal year 2016, these totaled almost \$519 billion.

¹⁰Beginning January 1, 2013, employers are responsible for withholding the 0.9 percent additional Medicare tax on an employee's wages and compensation that exceeds a threshold amount based on the employee's filing status. The threshold amount, not indexed for inflation, is \$250,000 for a jointly-filed return, \$125,000 for a married individual filing a separate return, and \$200,000 for other filing statuses (unmarried individual, head of household, or surviving spouse).

¹¹Federal unemployment insurance payroll taxes are to be used to fund programs maintained by states to benefit unemployed workers. Additionally, these taxes were designed to encourage the states to enact unemployment insurance plans that would provide benefits to workers during periods of temporary unemployment.

(Employer's Quarterly Federal Tax Return) or annually on Form 944 (Employer's Annual Federal Tax Return).¹² Form 941 includes the tax liabilities of the employers (the employer share of FICA) as well as the tax liabilities of employees (withheld income tax and the employee share of FICA) that are required to be withheld by the employer and paid to the government on the employee's behalf. Employers report their annual FUTA tax to IRS on Form 940, (Employer's Annual Federal Unemployment Tax Return). In fiscal year 2016, almost 30.5 million employment tax returns were filed.

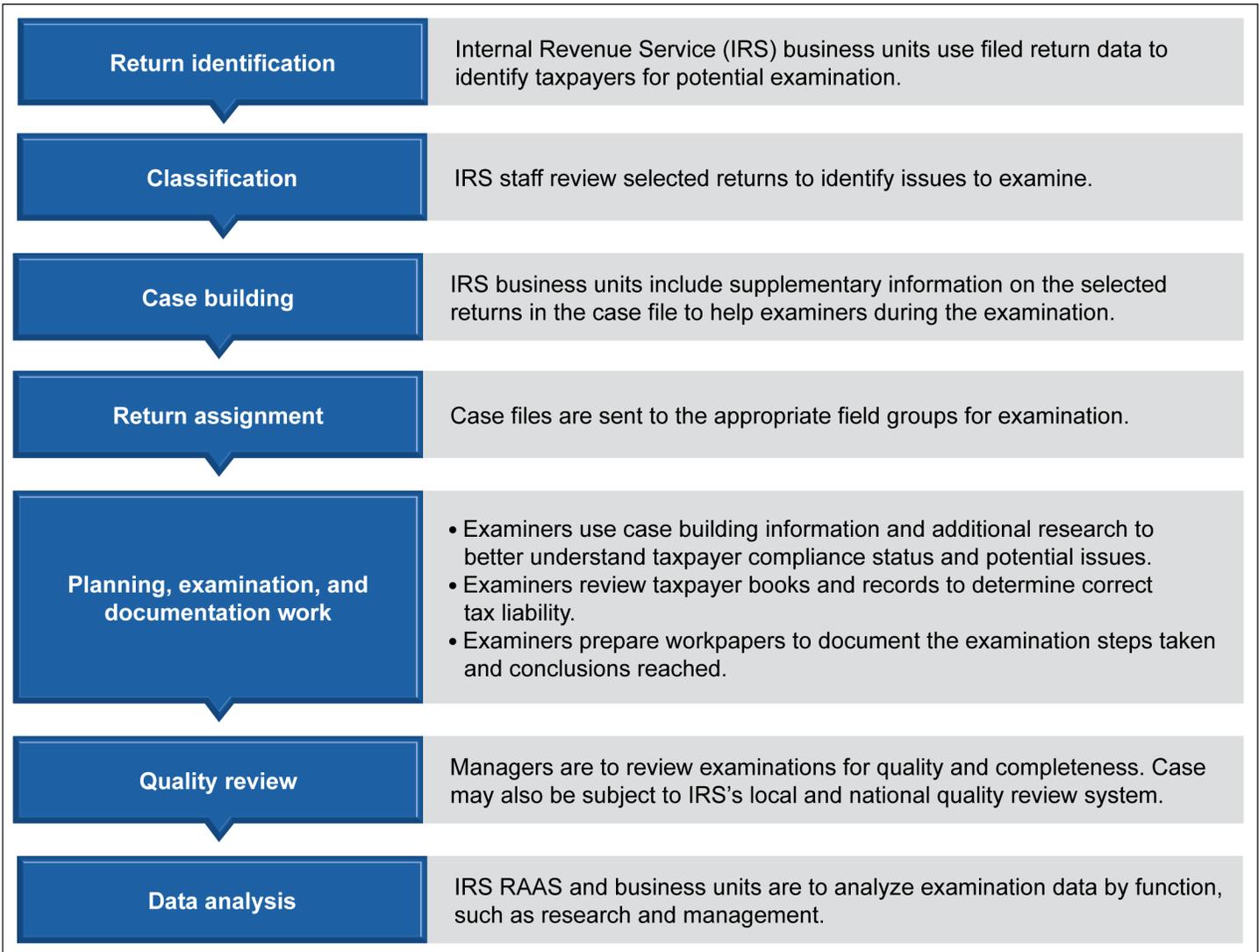
Taxes withheld by employers are a significant portion of federal revenue. In fiscal year 2016, of revenue remitted by employers, almost \$1.27 trillion came from income taxes, \$1 trillion came from FICA employment taxes, and \$8 billion from FUTA taxes.

Operational Employment Tax Examinations

IRS's SB/SE and TE/GE divisions both have responsibility for ensuring that employers comply with employment taxes. While some differences exist for how operational employment tax examinations take place in SB/SE and TE/GE, they generally follow the steps in figure 1.

¹²Agricultural employers file Form 943-*Employer's Annual Federal Tax Return for Agricultural Employees*.

Figure 1: Key Steps in Employment Tax Examination Process



Source: GAO analysis of Internal Revenue Service information. | GAO-17-371

Note: RAAS stands for the Office of Research, Applied Analytics, and Statistics.

These represent the key steps in the IRS employment tax examination process, but differences exist in the process between the TE/GE-Exempt Organizations (EO), TE/GE-Federal, State, and Local Governments (FSLG), and SB/SE business units. For example, TE/GE-EO focuses its examinations on the Form 990 (Return of Organization Exempt From Income Tax) and does not select returns exclusively for employment tax

examinations. Returns are inspected and a separate employment tax examination may be necessary if the inspection does not reveal compliance. By contrast, TE/GE-FSLG examinations of government entities focus only on employment tax issues and SB/SE has a specialty group that focuses exclusively on employment tax issues.

Other differences exist between the latter two business units. The key difference tends to be the extent to which SB/SE and TE/GE-FSLG “build the case file” for examiners before the examination starts. TE/GE-FSLG tends to include more information upfront whereas SB/SE offers the information on request, noting that examiners are able to determine if they need additional information for specific identified issues.

National Research Program Studies and Examinations

IRS carries out detailed research studies of different types of taxpayer compliance through NRP. For example, IRS completes an annual NRP study of individual income tax returns, which we have previously evaluated.¹³ Data for the NRP studies come from detailed examinations that strive to verify information reported on filed returns in addition to taxes that may have been under- or over-reported. According to the IRM, IRS seeks to use NRP data to increase public confidence in the fairness of the tax system by helping identify compliance problems and direct resources to efficiently address them.¹⁴ The IRM also states that IRS is supposed to use NRP data to better estimate the tax gap, update methods for selecting returns for examination, and improve strategic planning, among other benefits.

IRS’s NRP study of employment taxes for tax years 2008, 2009, and 2010 was its first on employment taxes since a study for tax year 1984. IRS started the NRP study in February 2010 and IRS officials said that they completed most of the examinations by May 2016. IRS selected a random sample of about 7,200 taxpayers that filed Form 941 employment tax returns from tax years 2008 to 2010. The NRP data are therefore a representative sample of only certain types of employer entities, which includes exempt organizations, government entities, and businesses (appendix I lists types of entities not included in the sample). NRP estimates can be analyzed to learn about the level of taxpayer

¹³GAO, *Tax Administration: IRS Could Improve Examinations by Adopting Certain Research Program Practices*, [GAO-13-480](#) (Washington, D.C.: May 24, 2013).

¹⁴Internal Revenue Manual (IRM) Part 4, Chapter 22, Section 1.3.

compliance on filed returns, such as the difference between the correct amount of employment taxes and the amount reported on employment tax returns.

IRS's Office of Research, Applied Analytics, and Statistics (RAAS) is responsible for the NRP, which includes designing the studies, collecting and housing the data, and analyzing the results of the studies. The two business units that administered the NRP employment tax examinations, TE/GE and SB/SE, also have internal research functions that could analyze the NRP results.

RAAS houses various types of compliance data, including the results from its NRP studies, in the Compliance Data Warehouse (CDW). Data in CDW are made available to staff across IRS and the Department of the Treasury for research and analysis purposes. RAAS is responsible for ensuring that the final NRP dataset provided to CDW is consistent and accurate, and represents the examination results. According to IRS officials, ensuring that the data meet these outcomes is an iterative process, meaning data from an NRP study might be initially posted to CDW, but could continue to change as staff working with the data identify inconsistencies and errors. RAAS began this iterative process for the NRP employment tax study in the spring of 2016.

The NRP employment tax examination process generally follows the same process as operational employment tax examinations, discussed in figure 1 above. Given the purpose of NRP and its data-driven nature, NRP examinations differ from operational examinations by examining a wider breadth of issues, documenting all adjustments and using the data differently as shown in table 1.¹⁵

¹⁵The differences in table 1 do not apply to TE/GE-Exempt Organizations, as it focuses on the Form 990 in the examination rather than on employment taxes.

Table 1: Key Differences between National Research Program (NRP) and Operational Employment Tax Examinations

Differences	NRP Examinations	Operational Examinations ^b
Classification ^a	NRP examinations cover all employment tax issues.	Identifies issues that examiners must review, using their professional judgment on the depth and scope of their examination.
Case building	Examiners are provided a case file built before the examination starts. It includes information such as the taxpayer's compliance history, information returns, and cash transactions.	Tax Exempt and Government Entities -Federal, State, and Local Governments case building largely mirrors that for NRP while Small Business/Self-Employed provides limited information upfront.
Documentation of examination adjustments	All adjustments are recorded.	Adjustments to a taxpayer's return below certain amounts generally do not apply.
Quality review	Examinations are to have in-depth reviews of: <ul style="list-style-type: none"> whether all NRP examinations met NRP requirements, the accuracy of the examination data, and examination and data quality. 	Examinations are to be reviewed to ensure they are procedurally and technically correct.
Data analysis	Data are to be used to make statistically valid estimates for the population of the NRP study.	Data are generally used to measure program effectiveness and achievement of goals.

Source: GAO analysis of Internal Revenue Service information. | GAO-17-371

^aClassification identifies the examination potential of returns and issues on the return to be examined.

^bThese differences do not apply to the Internal Revenue Service's Tax Exempt and Government Entities-Exempt Organizations group, as it focuses on the Form 990 in the examination.

IRS Has Not Finished Analyzing the NRP Data or Used the Results to Improve Employment Tax Compliance Efforts

Neither RAAS nor the business units (TE/GE and SB/SE) that completed the NRP examinations have finished analyzing the results from the study, according to IRS officials. They also do not have specific documented plans to analyze the NRP employment tax study data or use the results to improve employment tax compliance programs. Instead, IRS officials described high-level concepts of what they would like to do with the NRP results in 2017 or beyond. For example, RAAS officials said that they intend to complete and release the next tax gap estimates by 2019, and conduct other research on employment tax compliance that responds to recommendations from our prior report.¹⁶

Similarly, TE/GE and SB/SE officials said they plan to partner to explore and summarize the NRP data and are developing analysis plans for this work, but had no timeline for when the plans would be ready. According

¹⁶GAO, *Tax Gap: IRS Could Do More to Promote Compliance by Third Parties with Miscellaneous Income Reporting Requirements*, [GAO-09-238](#) (Washington, D.C.: Jan. 28, 2009). According to RAAS officials, these tax gap estimates will cover tax year 2011 to 2013.

to officials, TE/GE has a statistician on detail who will be devoted almost exclusively to summarizing and analyzing study results. TE/GE officials said they are updating the programming code developed after year 1 of the study to analyze all 3 years of the NRP results. SB/SE officials said that after an NRP study, their normal process has been to identify emerging compliance issues, update return selection criteria and processes, explore ways to refine classification, and evaluate the need for research projects as well as for reallocation of examination resources. SB/SE officials also said they intend to use the NRP data to enhance examiner training, edit audit technique guides, and clarify or reinforce examiner procedures as necessary.

However, for the efforts and plans described above, IRS did not have documentation outlining the detailed objectives and the specific NRP data to be analyzed and used. IRS officials described these efforts and plans to us in meetings and then provided a list of them in writing with little additional detail. RAAS officials said they have not developed specific plans to analyze the data due to competing priorities and limited resources. TE/GE officials cited similar reasons for not developing such plans, but TE/GE and SB/SE officials added they are waiting for the final NRP data to be made available before they develop detailed analysis plans.¹⁷ RAAS officials noted that the data initially were available as of fall 2016, and that as of February 2017 the data were still being evaluated and corrected for inconsistencies, such as duplicate numbers, missing information, and other errors, which according to IRS has delayed its ability to analyze the results.¹⁸ According to RAAS officials, updated study data are expected to be delivered in 2017. RAAS officials said they likely will continue to evaluate and correct the data as staff in RAAS, SB/SE, and TE/GE begin to work with the data.

Analyzing and using the NRP study results is important for various reasons. The NRP's primary benefit, according to the IRM, is to improve workload selection systems, such as how IRS selects returns to examine. The IRM notes that the NRP program seeks to increase public confidence in the fairness of our tax system by helping IRS identify where compliance problems occur so that IRS can efficiently use its resources to address

¹⁷Upon request, we provided a copy of our plan for analyzing the NRP employment tax data to IRS in January 2017.

¹⁸Those data inconsistencies were identified in part because of our work cleaning and reviewing the NRP data set. See appendix I for details regarding our cleaning of the NRP data.

those problems. IRS also uses the NRP data to help update its estimate of the tax gap. IRS's most recent employment tax gap for FICA and FUTA are projections based on compliance data from 1984.¹⁹ In addition, analyzing the NRP employment tax study results would align with IRS's strategic plan, which includes an objective to identify trends, detect high-risk areas of noncompliance and prioritize enforcement approaches by applying research and advanced analytics.²⁰

By not developing detailed plans to analyze and use the results of NRP, IRS is missing an opportunity to identify compliance problems on employment tax returns as well as identify solutions to address these problems. Implementing those detailed plans can guide IRS efforts to identify and correct data inconsistencies. For example, IRS found a number of errors within the data as a result of our attempts to analyze the NRP data. Moreover, by not analyzing these data, IRS will not have current tax gap estimates, continuing to rely on outdated information.

Noncompliance Varied across Employment Tax Issues and Employer Size

Given that IRS has not completed its own analysis, we reviewed the NRP employment tax results for tax years 2008 through 2010 to identify areas—known as issues—of noncompliance in terms of the examination proposing adjustments to the amount of taxable wages. We reviewed 1) issues that were most frequently adjusted, 2) the amounts by which wages were adjusted for these issues, and 3) employer groups that were more noncompliant.

¹⁹See *Federal Tax Compliance Research: Gross and Net Employment Tax Gap Estimates for 1984-1997*, Internal Revenue Service (Washington, D.C.: October 1993).

²⁰Internal Revenue Service, *Strategic Plan: FY2014-2017* (Washington, D.C.: 2014).

Worker Classification and Fringe Benefits Were Among the Most Frequent Issues of Noncompliance and Led to Highest Percentage of Wage Adjustments

By reviewing the results from the NRP employment tax examinations for tax years 2008 through 2010, we identified issues where employers were noncompliant in reporting taxable wages. We analyzed the frequently examined issues through NRP, which are described in table 2.

Table 2: Overview of Frequently Examined National Research Program Employment Tax Issues

Issue	Description
Fringe benefits	A fringe benefit is any property, service or cash received from the employer in addition to regular compensation, such as an employer paying for an employee’s moving expenses. Whether a fringe benefit is taxable depends on whether a statutory exclusion applies to the benefit. The fair market value of taxable fringe benefits must be included in the pay of employees in the Form W-2 as well as reported for independent contractors on Form 1099-MISC and for partners on Schedule K-1 (Form 1065).
Backup withholding	Generally, any payor must withhold a tax of 28 percent on reportable payments of interest, dividends, and other compensation if the payee fails to furnish his or her correct taxpayer identification number to the payor, as required, at the time the reportable threshold is met.
Payment re-characterization	Certain payments made from employers to employees should have been reported on the Form W-2. These payments may have been reported using Form 1099. Once payments are recharacterized as wages, the employer also becomes liable for the taxes they previously failed to withhold and their own portion that are assessed during the examination. Future wages would be subject to withholding. An example of payment re-characterization is when employers pay employees for overtime using Form 1099, instead of on the employees’ W-2.
Worker classification	Worker classification issues arise when employers misclassify employees as independent contractors or other nonemployees such as shareholders and corporate officers. When employees are misclassified, the employer’s obligation to withhold and pay employment taxes is not established and therefore, goes unpaid.
Tip income	Tips are considered wages for purposes of the Federal Insurance Contributions Act (FICA) and federal income tax withholding for cash tips of \$20 or more received in a calendar month. Once an employee reports tips received to the employer, they are considered wages for purposes of FICA and federal income tax withholding. The employer is to withhold the employee’s share of FICA and federal income tax withholding, and deposit those shares with the employer’s share of FICA.

Source: Internal Revenue Service information. | GAO-17-371

Our review of such issues focused on employer noncompliance in reporting the correct amount of taxable wages and proposed adjustments to the reported taxable wage amount for employees.²¹ These wage

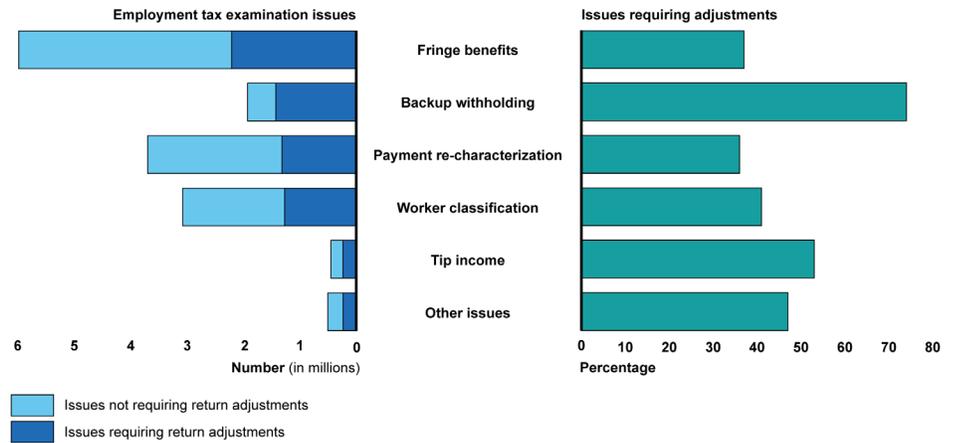
²¹These results from the NRP employment tax study represent estimates for the employer population. Certain segments of the employer population are not represented by the NRP employment tax study, including certain exempt organizations and large federal agencies and corporations as discussed in appendix I.

adjustments, in turn, affect the amount of taxes withheld and paid by employers and employees.²² Overall, the NRP study examined an estimated 15.7 million employment tax issues, of which an estimated 6.7 million issues resulted in wage adjustments.

Based on our review of the NRP examination results for tax years 2009 through 2010, figure 2 shows the employment tax issues that were the most frequently examined and adjusted. For example, fringe benefits, payment recharacterization, and worker classification issues were the most frequently examined issues (see table 6), representing 38 percent, 24 percent, and 20 percent of all issues that were examined. These issues were also among those most frequently requiring adjustments (see table 8)—representing an estimated 33 percent, 20 percent, and 19 percent of issues that required adjustments, respectively. The issue most likely to result in an adjustment when examined was backup withholding, where an estimated 1.4 million (74 percent) of the 1.9 million backup withholding issues required adjustments (see table 10).

²²Wage adjustments from the NRP employment tax study include all taxable wage adjustments, including de minimis adjustments.

Figure 2: Frequency of Certain Employment Tax Issues and Percentage of Issues Requiring Tax Adjustments for Tax Years 2009 through 2010



Source: GAO analysis of Internal Revenue Service National Research Program data. | GAO-17-371

Notes: Certain National Research Program employment tax examination issues are excluded from the estimated 15.7 million issues because they may have been temporary, could have resulted in double counting of issues, and did not directly adjust employment tax liability. For example, we exclude 2.4 million issues examined by Internal Revenue Service (IRS) to determine whether employers were protected from paying tax adjustments for worker classification issues through the safe harbor provision of Section 530 of the Revenue Act of 1978, as amended, Pub. L. No. 95-600, 92 Stat. 2763 (Nov. 6, 1978). Also, we exclude 4.6 million issues IRS examined to determine whether taxpayers met the reasonable cause and good faith exception, which would allow taxpayers to avoid certain penalties associated with their noncompliance.

We combined some employment tax examination issues. For instance, fringe benefits represent both executive and nonexecutive fringe benefits. Therefore, if the same employer was examined for both executive and nonexecutive fringe benefits, then the employer would be counted as having two fringe benefits issues.

Other issues include alien employment, U.S. citizens and residents living abroad, and excess benefit transactions.

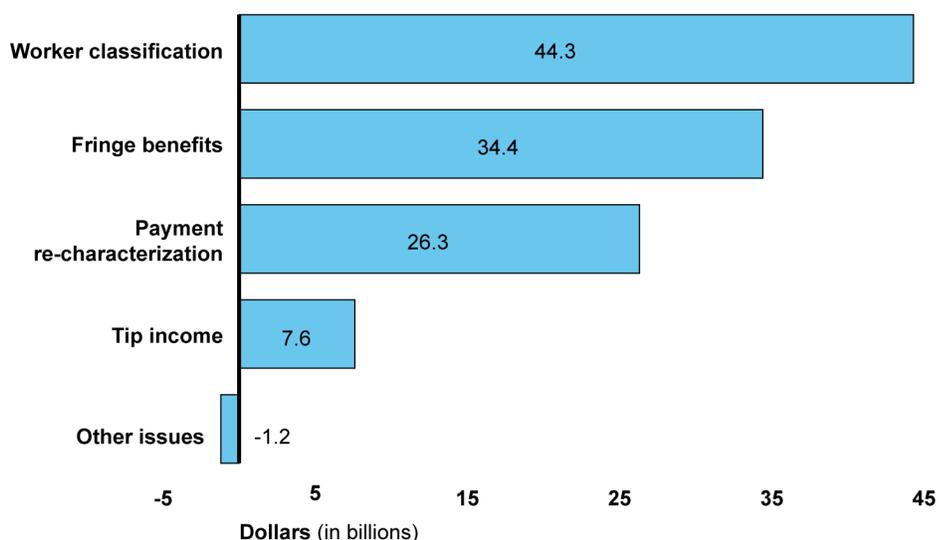
The NRP examination adjustments to taxable wages for employment tax obligations represent billions of dollars. For our review, we focused on the wage adjustments because the NRP tax adjustments include various tax relief provisions available to employers and, therefore, underestimate the level of employment tax noncompliance. For example, the safe harbor provision through Section 530 of the Revenue Act of 1978 prevents IRS from examining protected employers for worker classification issues.²³

²³About 1.5 million workers for 80,500 employers qualified for Section 530 safe harbor protection on \$26.6 billion in payments, and about 10.1 million workers for 2.1 million employers did not qualify for Section 530 protection on \$141 billion in payments. Revenue Act of 1978, as amended, Pub. L. No. 95-600, 92 Stat. 2763 (Nov. 6, 1978).

The NRP data only provides compliance information on worker classification issues when Section 530 safe harbor protection does not apply. Two other examples of employment tax relief include the worker classification settlement program (CSP) and income tax withholding relief.²⁴

Our review of wage adjustments by issue is shown in figure 3. The highest wage adjustment amounts involved worker classification, fringe benefit, and payment recharacterization issues (see table 11).

Figure 3: Wage Adjustments by Tax Examination Issue for Tax Years 2008 through 2010



Source: GAO analysis of Internal Revenue Service National Research Program data. | GAO-17-371

Note: Other issues in the figure include some National Research Program employment tax examination issues such as for alien employment, U.S. citizens and residents living abroad, and excess benefit transactions.

²⁴For NRP examinations of employers eligible to use CSP to reduce their employment tax liability if they prospectively treat certain workers as employees, an estimated \$11 billion of the wage adjustments from worker classification issues per tax year qualified for either a partial or total reduction in tax adjustment due to the CSP agreement. For employers examined for income tax withholding relief eligibility, NRP examinations resulted in an estimated \$54 billion in wage credits for qualified employers.

The estimated average wage adjustment for all adjusted issues (see table 12) is \$32,747. The two issues with the highest average wage adjustments were worker classification and tip income. Worker classification issues included reclassifications involving corporate officers, statutory employees such as drivers who distributed certain food items and the factors that may be used to determine whether the worker was an independent contractor or employee based on, among other things, whether the employer controlled how the worker was to provide the service, such as through written contracts and training.²⁵ The tip income issue included employers in industries that reported tip income, such as restaurants and gaming activities.

NRP Study Results for SB/SE Employers Suggest Noncompliance May Be Higher for Smaller Employers than for Larger Employers

Our review of these study results suggests that smaller SB/SE employers are more noncompliant than larger ones using a couple of different size measures.²⁶ We focused on results of NRP examinations involving SB/SE employers because, as we have previously reported, small businesses tend to have more compliance problems than other taxpayers.²⁷ In addition, tax compliance burdens can be greater for small businesses due to economies of scale.²⁸ To the extent that these burdens affect tax compliance of taxpayers, smaller businesses likely would be more noncompliant than larger ones.

We estimate using the NRP data that 2.9 million of the 6.4 million examined issues (46 percent) for SB/SE employers with three or less employees resulted in adjustments, compared to 3.3 million of the 7.9 million examined issues (42 percent) for employers with four or more

²⁵Other statutory employees include life insurance sales agents; individuals who work at home on goods that are supplied by and must be returned to an employer; and sales persons with service contracts under which the seller provides the service on a continuing basis for the same payer and is not a substantial investor in the materials used to perform the service. 26 U.S.C. § 3121(d).

²⁶The NRP sample of SB/SE employers represents a majority of the employers, an estimated 5.6 million (or 91 percent) of the 6.1 million employers on average from tax years 2008 through 2010. See appendix II for information about and the data used for this section, including estimates for the total and average wage adjustments by size measures.

²⁷GAO, *Small Business: Taxpayers Face Many Layers of Requirements*, [GAO/T-GGD-99-76](#) (Washington, D.C.: Apr. 12, 1999).

²⁸GAO, *Small Businesses: IRS Considers Taxpayer Burden in Tax Administration, but Needs a Plan to Evaluate the Use of Payment Card Information for Compliance Efforts*, [GAO-15-513](#) (Washington, D.C.: June 30, 2015).

employees.²⁹ We also estimate that SB/SE employers with three or less employees represent 44 percent of SB/SE wage adjustments, but only employ 6 percent of SB/SE employees. Conversely, larger SB/SE employers (four or more employees) account for 56 percent of the SB/SE wage adjustments and employ 94 percent of SB/SE employees. This comparison suggests greater noncompliance for smaller SB/SE employers than for larger employers on a per employee basis.

Similarly, our review indicates that smaller SB/SE employers are more noncompliant than larger employers on a basis of total compensation. For example, we estimate using the NRP data that 2.6 million of the 5.6 million examined issues (47 percent) for SB/SE employers paying total compensation of \$78,500 or less resulted in adjustments, compared to 3.6 million of the 8.7 million examined issues (41 percent) for SB/SE employers that pay more than \$78,500 in total compensation.³⁰ In addition, SB/SE employers paying total compensation of \$78,500 or less represent about 37 percent of the SB/SE wage adjustments, but only pay 4 percent of SB/SE total compensation. Conversely, larger SB/SE employers (pay more than \$78,500 in total compensation) account for 63 percent of the SB/SE wage adjustments and pay 96 percent of SB/SE total compensation. The disproportionate level of wage adjustments suggests greater noncompliance for smaller SB/SE employers than for larger employers on a basis of total compensation.

²⁹We considered SB/SE employers who employ three employees or less to represent smaller employers and SB/SE employers who employ more than three employees to represent larger employers. This threshold represents the median number of employees for SB/SE employers within the data.

³⁰As an alternative measure of employer size, we considered SB/SE employers that paid \$78,500 or less in total compensation to represent smaller employers and SB/SE employers that paid more than \$78,500 in total compensation to represent larger employers. This threshold represents the median value of total compensation for SB/SE employers within the data.

IRS Business Units Applied Aspects of NRP Examination Practices to Operational Employment Tax Examinations

NRP Examinations Led to Changes in Planning, Documenting, and Reporting of Operational Employment Tax Examinations

Certain practices that were used for NRP examinations were carried over and are now used for operational employment tax examinations by the three business units that participated in the NRP study.³¹ These practices fell into three categories: planning, documentation, and reporting.

- **Planning:** IRS carried over NRP practices that help examiners plan the issues to examine.
 - **Information Return Analysis System (IRAS):** A program that analyzes electronic versions of information returns, such as Form W-2s and Form 1099s, to test if income was treated as nontaxable, and if certain employees were incorrectly treated as exempt from employment taxes or received both a Form W-2 and Form 1099, among other tests. The results from these tests can help IRS examiners identify potential examination issues. According to IRS officials and examiners, IRAS allows examiners to analyze a substantial number of information returns quickly.
 - **Notice CP2100:** A notice taxpayers receive that provides information on improperly filed Form 1099s with an invalid Taxpayer Identification Number (TIN), no TIN, or mismatched TIN. It indicates if the employer may be subject to backup withholding, which requires income tax withholding of 28 percent from certain payments if the employee fails to furnish the correct TIN. According to IRS examiners, this tool allowed them to identify these issues early in NRP examinations.

³¹SB/SE and TE/GE were the two IRS business units who completed the NRP employment tax examinations. Within TE/GE, its Exempt Organizations group and Federal, State, and Local Governments group completed the study.

-
- Data Collection Instrument (DCI)-1: A workbook that contains data about the taxpayer, an issue summary, and issue specific lead sheets that IRS examiners used in the NRP study. The workbook is used to plan the examination steps. For operational examinations, the Employment Tax Lead Sheet (ETLS) is now used, which is based on the DCI-1.
 - Related Entity Return Information. According to IRS examiners, having the related income tax return, the Exempt Organization return, or specific lines of information from those returns help to identify issues to examine.
 - **Documentation:** The DCI-1 was also used in the NRP examinations to allow examiners to document their findings on examined issues. In our group discussions with examiners, a number of them mentioned that the DCI-1 provided a roadmap for documenting the examination steps, such as the questions posed to the taxpayer, the information requested, and the support for the examination findings. For operational examinations, ETLS is now used, which is based on the DCI-1.
 - **Reporting:** The DCI-2 is a workbook used in the NRP examinations to complete the employment tax report. The DCI-2 calculates the tax adjustments as a result of examination findings and presents them in closing reports to the taxpayer.³² In addition, IRS officials said that the DCI-2 helped examiners to automatically make complex calculations to determine additional taxes and penalties due, instead of making them by hand. For operational examinations, the workbook is known as the Employment Tax Examiner’s Report, which is based on the DCI-2.

Table 3 shows the specific practices that SB/SE, TE/GE-EO, and TE/GE-FSLG each carried over from NRP examinations to operational employment tax examinations, and whether those practices are provided upfront as part of the case file or on request.

³²The Form 4667, *Examination Changes—Federal Unemployment Tax*, the Form 4668, *Employment Tax Examination Changes Report*, and the Form 2504, *Agreement to Assessment and Collection of Additional Tax and Acceptance of Overassessment* (Excise or Employment Tax) as well as variants of those forms.

Table 3: Employment Tax National Research Program (NRP) Examination Practices Applied to Operational Examinations

IRS Business Unit	Electronic Case File	Information Return Analysis System	CP2100	Related Entity Return Information	Taxpayer's Examination History	Cash Transaction Data	Employment Tax Lead Sheets	Employment Tax Examiner's Report
Small Business/ Self-Employed		Available on request	Available on request	Available on request	Available on request	Available on request	Available on request	Available on request
Tax Exempt and Government Entities – Exempt Organizations		Available on request	Available on request	Provided upfront in case file	Available on request	Available on request	Available on request	Available on request
Tax Exempt and Government Entities – Federal, State, and Local Governments		Provided upfront in case file	Provided upfront in case file		Provided upfront in case file		Available on request	Available on request

- Practice carried over due to NRP employment tax study.
- Practice already in place prior to NRP employment tax study.
- Not Applicable to Internal Revenue Service business unit.
- Not currently used for employment tax examinations.

Source: GAO analysis of Internal Revenue Service documentation. | GAO-17-371

As seen in table 3, the only NRP practice carried over to all business units was IRAS. However, only FSLG offers IRAS data upfront in the case file, as done for NRP examinations. FSLG also offers the CP2100 upfront. In contrast, the NRP practices carried over by SB/SE and TE/GE-EO were made available to examiners on request. Other practices, such as the taxpayer's examination history, were in place in all three business units before IRS started the NRP study.

In general, the business units decided which NRP practices to carry over to operational employment tax examinations based on annual feedback sessions held with their staff involved in the study as well as informal discussions among those staff. The annual feedback sessions were organized by the RAAS division, which designed the NRP employment tax study. The feedback sessions were mainly held to improve the operations of the study. However, during the feedback sessions, examiners identified NRP practices, such as IRAS, that they found

helpful, but they did not have access to or access to in the same manner on operational examinations.

Beyond this feedback, officials in SB/SE and TE/GE said that they carried over NRP practices to operational employment tax examinations based on the resources each unit had available. They also said they considered those “best practices” that were helpful and made sense on the operational side. IRS officials said that they did not analyze the benefits of NRP practices carried over to operational examinations. IRS officials said that the purpose of the NRP employment tax study was not to improve the operational examination process, but to improve tax gap estimates and identify noncompliance areas. They also said they had no baseline data before the NRP study to compare changes made to operational examinations after the NRP study. Therefore, IRS was unable to analyze the effects of making these changes.

TE/GE-FSLG did not carry over some NRP practices because they were not applicable to its examinations. For example, TE/GE-FSLG government entities do not have a related return, which is why that practice was not carried over to operational examinations, according to officials.

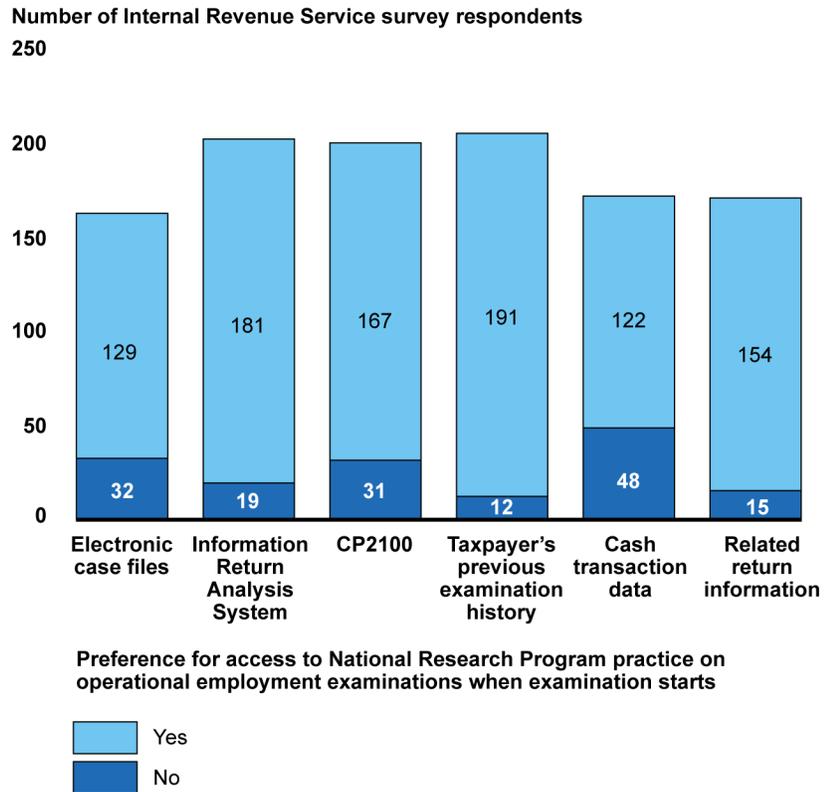
IRS Examiners See Benefits to NRP Practices for Operational Employment Tax Examinations, but Half Were Unaware They Could Request Access to Certain Practices

Examiners Would Like Access to NRP Practices at the Start of Operational Examinations but IRS Officials Raised Concerns

IRS examiners who have worked on both NRP employment tax examinations and operational employment tax examinations identified NRP practices that they would like to have access to when operational employment tax examinations start. Their responses to our survey, which asked about a number of the NRP practices, indicated that the majority of them would like to have access to all of the practices used in NRP examinations as well as electronic case files upfront when the operational examination starts.³³ See figure 4.

³³See appendix III for a summary of our survey responses.

Figure 4: Internal Revenue Service Staff Preferences for Access to Practices Used in the National Research Program (NRP)



Source: GAO survey of Internal Revenue Service staff. | GAO-17-371

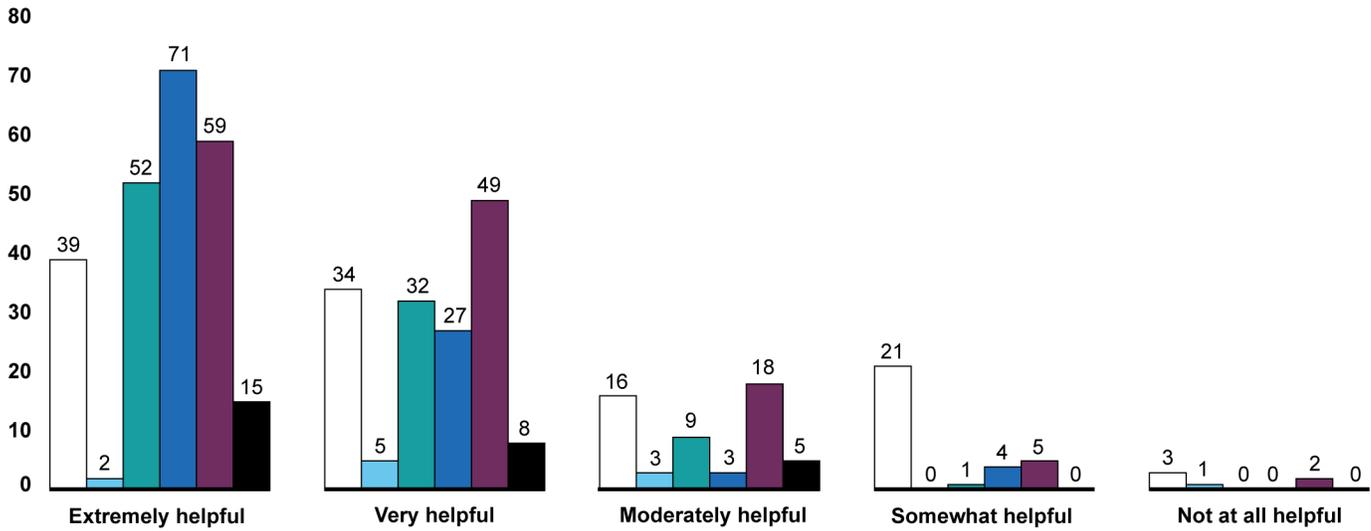
Note: The total number of respondents varies among the National Research Program (NRP) practices above because some respondents may have answered "not applicable" if a certain practice was already in place in that business unit. In addition, if survey respondents answered "don't know" or "not applicable" to a prior question asking if they have used that practice on operational examinations since the NRP examinations were completed, they were skipped to the next set of questions asking about a different practice.

The NRP practice that most IRS examiners said they wanted upfront in the case file and also found to be most helpful were the data used in IRAS and IRAS itself. Specifically, 181 of 200 (90.5 percent) respondents wanted access to IRAS and the IRAS data upfront, and 98 of 105

respondents stated that having IRAS and the IRAS data prior to starting an examination was very or extremely helpful.³⁴ See figure 5.

Figure 5: Extent to Which Internal Revenue Service Survey Respondents Believe Selected Practices Used in the National Research Program Are Helpful

Number of Internal Revenue Service survey respondents



Degree of helpfulness

- Taxpayer's previous examination history
- Cash transaction data
- Related return information
- Information Return Analysis System
- Electronic case files
- CP2100

Source: GAO survey of Internal Revenue Service staff. | GAO-17-371

³⁴A higher number of survey respondents wanted the taxpayer's previous examination history upfront (191 of 203) than IRAS data, but a smaller number found the taxpayer's previous examination history extremely or very helpful (73 of 113). Survey respondents were asked about the degree of helpfulness if they had used the practice on operational examinations since completing NRP examinations, which is why the number of respondents asked about helpfulness varies. In addition to the IRAS data on information returns, IRAS itself provides the ability to analyze these data.

As noted earlier, only TE/GE-FSLG includes the IRAS data in the case file sent to the examiner at the start of the examination. TE/GE FSLG officials noted that establishing a case on its systems and requesting the IRAS data as well as other data such as from the CP2100 and taxpayer's examination history can take their one case preparer 60 to 90 minutes, and that receiving the requested IRAS data takes 1 to 2 weeks depending on the day of the week the request is made.

As for the other two units, TE/GE-EO does not include the IRAS data in a case file since the examination focuses on the Form 990, and employment tax issues are examined only to the extent the examiners uncover potential noncompliance when checking those issues. SB/SE provides the IRAS data if requested by the examiner. In our survey, 87 of 100 SB/SE examiners said they were aware that they could request IRAS data for operational examinations. However, 91 of the 100 SB/SE examiners in our survey preferred to have IRAS data in the case file when an examination starts rather than on request. In addition, of the SB/SE examiners who have used IRAS on operational examinations since the NRP examinations, 46 of 50 survey respondents found it very or extremely helpful.

For a May 2013 report on a different NRP study, we developed a set of criteria for evaluating whether NRP practices should be applied to operational examinations.³⁵ These criteria include:

- Would the change be likely to help examiners correctly identify more noncompliance?
- Is it likely to make the examination more efficient—(i.e., reduce the cost of conducting an examination, increase benefits for the same cost, or increase benefits commensurate with justifiable or no increase in costs)?
- Is it likely to reduce taxpayer burden?
- Would the change meet any other IRS need?

For this review, we planned to apply these criteria to determine if the NRP employment tax practices that IRS examiners wanted the most and found most helpful would be applicable to operational examinations, such as providing IRAS and the data used in it upfront. However, SB/SE had

³⁵GAO, *Tax Administration: IRS Could Improve Examinations by Adopting Certain Research Program Practices*, [GAO-13-480](#) (Washington, D.C.: May 24, 2013).

limited data and information that aligned with the criteria. Therefore, we relied on our survey of examiners and interviews with IRS officials as discussed below.

In the survey, examiners said that having IRAS data upfront is helpful because it allows them to better plan the examination and identify issues sooner. IRAS does so by allowing them to electronically match and analyze a large number of W-2s and information returns. The identification of examination issues, in turn, facilitates their initial interview and contact with the taxpayer. It can also reduce taxpayer burden and make the examination more efficient, according to IRS examiners. These benefits align with IRS's strategic plan to deliver high-quality and timely service to reduce taxpayer burden and encourage voluntary compliance.³⁶

TE/GE-FSLG officials said that providing IRAS and the IRAS data upfront has improved efficiency by helping examiners plan the examination and reduce the need to ask taxpayers to provide information. They added that they do not have data to document their views. In addition, TE/GE-FSLG's examinations only focus on employment tax liabilities, which covered 2,003 returns in fiscal year 2015.

When we shared our survey results with SB/SE officials, they were concerned about providing IRAS data upfront for all operational examinations as was done for NRP examinations. Specifically, SB/SE's employment tax examination caseload is much higher as SB/SE examined 41,554 Form 941 returns in fiscal year 2015. Given this caseload, SB/SE officials raised concerns about providing the data upfront through case building. One concern they raised is that returns sent to an IRS campus for case building or assigned for examination from the campus may not be examined. As a result, having the campus pull IRAS data for all returns will risk that the data may not be used for some. Similarly, SB/SE officials added that many of their large examinations could involve many corporate subsidiaries of which only a handful are examined. Thus, requiring SB/SE to include the IRAS data for all subsidiaries would be burdensome. Beyond these large examinations, these officials noted that many SB/SE examinations involve employers with 10 or fewer information returns, which are too few to merit using

³⁶Internal Revenue Service, *Strategic Plan: FY2014-2017* (Washington, D.C.: 2014).

IRAS. IRS did not have data on examinations by the numbers of subsidiaries or information returns.

SB/SE officials also said that providing IRAS data in all case files upfront would move the cost burden from the examiner to an administrative office at IRS's Cincinnati campus, which helps prepare the cases. According to IRS officials, the support staff at the Cincinnati campus is shared between SB/SE's specialty groups for employment tax and excise tax. In fiscal year 2015, less than one full-time equivalent employee was devoted to building employment tax cases for SB/SE at the campus. The administrative staff who prepare the cases are generally on the General Schedule (GS)-7 pay scale, whereas the examiners tend to have more technical experience and a higher GS grade, and can determine whether the IRAS information would be helpful. The SB/SE examiners who participated in our survey were GS-11 or higher. IRS officials added that many support organizations in IRS are operating with smaller staffs due to budget constraints, and their desire is to maximize the use of resources for meeting face-to-face with taxpayers.

While we recognize that resource constraints can be an important consideration, none of the business units who have offered IRAS on request or upfront in case files had evaluated whether providing the IRAS data upfront made sense in line with the criteria we identified in May 2013 for making such decisions.³⁷ Nor did SB/SE have data on the type of examinations, such as just those with large numbers of information returns, in which IRAS would be more or less applicable. Without having these necessary data, IRS is limited in determining whether and when to provide IRAS data upfront in line with criteria we have identified in our prior work on evaluating the applicability of practices used in an NRP study.

IRS examiners we surveyed also found it helpful to have electronic case files and related return information upfront. For example, 108 of 133 survey respondents found electronic case files extremely or very helpful while 84 of 94 found related return information similarly helpful. They cited a number of benefits for both.

According to IRS examiners, electronic case files enhance efficiency by making it easier to do tasks, such as recording, updating, organizing, and

³⁷[GAO-13-480](#).

transmitting the examination information. However, IRS officials added that in some instances, such as if a case is appealed by the taxpayer, paper case files have to be completed in addition to electronic case files. TE/GE FSLG and TE/GE-EO already have fully electronic case files while SB/SE uses partially electronic case files. SB/SE officials noted that they are considering moving to fully electronic case files by the middle of 2017 or later. SB/SE officials noted that it would take that long given the complexity of aligning various IRS information systems and limited IRS resources for information technology.

Similarly, for related return information, examiners noted that having the information upfront helps plan the work and identify issues. SB/SE does not provide the related return when the examination starts, but SB/SE examiners are able to access an electronically filed related entity return shortly after an employment examination starts.

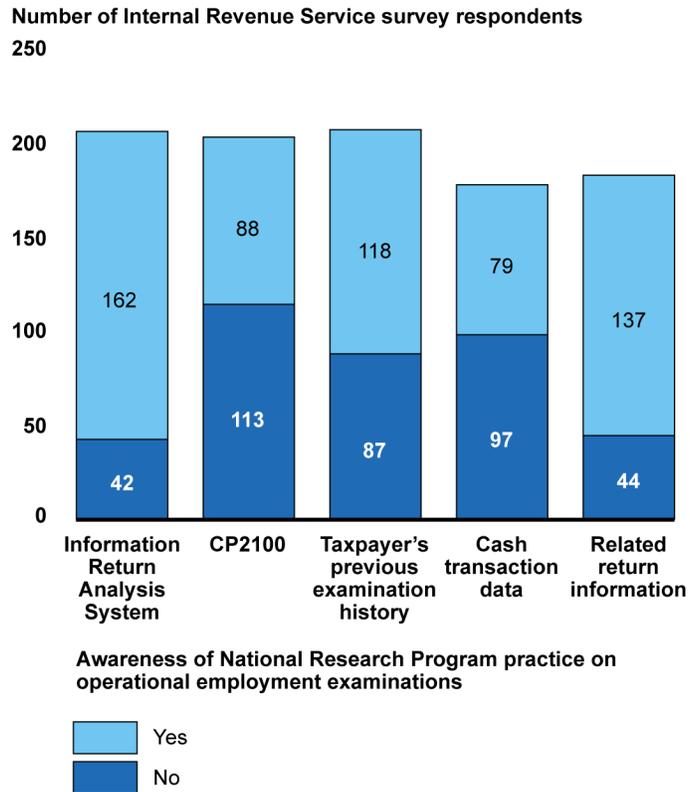
In contrast, for the CP2100 and cash transaction data, a much smaller number of IRS examiners used them on operational employment tax examinations since completing the NRP employment tax study. According to IRS officials, the low use could be due to examinations where the CP2100 or cash transaction data were not necessary. For example, 28 of 209 survey respondents had used the CP2100 and 11 of 181 survey respondents had used the cash transaction data on operational examinations since completing examinations for NRP employment tax study. This may be because the data on the CP2100 and cash transactions infrequently apply to related employment tax issues.

When the CP2100 and cash transaction data did apply, survey respondents who used both types of data on operational employment tax examinations since completing the NRP study generally found them helpful. According to IRS examiners, the CP2100 can help narrow the scope and better plan the examination, and the cash transaction data can help understand the operations of the business under examination.

Half of IRS Examiners Were Unaware They Could Request Certain NRP Practices For Operational Employment Tax Examinations

Over half of IRS examiners in our survey asked if they were aware how to request two NRP practices for operational examinations—the CP2100 and cash transaction data—answered no. See figure 6.

Figure 6: Extent to Which Examiners Were Aware of Ability to Request National Research Program Practices for Operational Employment Tax Examinations



Source: GAO survey of Internal Revenue Service staff. | GAO-17-371

All NRP practices in our survey are available for request (SB/SE and TE/GE-EO) or provided upfront (TE/GE-FSLG).³⁸ However, examiners are not always aware of how to access each NRP practice. This is inconsistent with IRS's strategic plan to empower employees with the tools and training to further develop skill proficiency and improve business performance.³⁹

³⁸TE/GE-EO provides the related return upfront for its examinations.

³⁹Internal Revenue Service, *Strategic Plan: FY2014-2017* (Washington, D.C.: 2014).

IRS officials said examiners may be unaware of how to request CP2100 and cash transaction data because the related employment tax issues are infrequently examined. Our survey results showed that a small portion of our survey respondents had used either NRP practice on operational employment tax examinations since completing the NRP examinations. Even so, examiners found these two types of data to be helpful when they did apply to the examination.

Instructions to examiners for requesting CP2100 and cash transaction data are in the IRM, which can be accessed at the examiner's discretion. However, IRS does not uniformly remind all examiners how to access them. For example, TE/GE-FSLG made examiners aware of how to access the CP2100 in a quarterly newsletter, which may explain why 22 of 26 survey respondents from FSLG were aware of how to access it, compared to 19 of 79 for TE/GE-EO and 47 of 96 for SB/SE. Prior to the survey, TE/GE-EO had not provided examiners any reminders about how to access the CP2100, but did so afterwards through an informal training, which is also available to examiners through a shared computer drive along with instructions for using CP2100. SB/SE has training on backup withholding that instructs examiners how to request a CP2100.

Without examiners being aware of these practices and able to utilize them when needed, they may be limited in their ability to effectively examine employment tax returns. While survey respondents said CP2100 and cash transaction data were not used frequently, these practices can be helpful when needed. IRS examiners said CP2100 can help an examiner narrow the scope and better plan the examination. Cash transaction data can help the examiner understand the operations of the business under examination.

Conclusions

IRS's first NRP study on employment tax returns since 1984 provides a valuable opportunity to identify what noncompliance areas are contributing to the \$16 billion annual employment tax gap, and better align IRS resources with the most prevalent areas of noncompliance. As our analysis shows, the NRP results present a rich overview of examination issues—like worker classification and fringe benefits—and their estimated prevalence. The study results also provide the opportunity to analyze those issues by various descriptive statistics such as employer size and compensation. However, IRS has no specific plans to study the results and assess issues of noncompliance, or update the current estimate of the employment tax gap, and has not completed any analysis of the results.

In addition, the NRP study provides IRS with an opportunity to improve the operational examination process. Ensuring that examiners are given the opportunity to access certain NRP practices—and are aware of how to do that—once they move from NRP examinations to operational examinations could reduce the burden placed on taxpayers and help examiners identify examination issues. As practices such as the CP2100 and cash transaction data are less frequently used, examiners may need reminders or easily accessible information about how to access them. In some instances, using certain NRP practices when the operational examination starts may help examiners to identify examination issues sooner. If IRS does not pursue these opportunities to maximize its NRP investment, IRS is missing a chance to improve operational examinations.

Recommendations for Executive Action

To help ensure that IRS leverages lessons learned from the NRP examinations and effectively completes operational employment tax examinations, we recommend that the Commissioner of Internal Revenue take the following five actions:

1. Develop and document plans to analyze the results in 2017 of the NRP employment tax study to identify the major issues of noncompliance.
2. Develop and document plans for addressing the noncompliance identified in IRS's analysis of the NRP employment tax results.
3. Develop and document plans for assessing the results of the NRP employment tax study to estimate the current state of the employment tax gap.
4. Determine whether and when to provide IRAS upfront for SB/SE operational examinations based on criteria such as whether it would help identify more noncompliance, reduce taxpayer burden, and improve audit efficiency by reducing overall IRS costs (examiner versus campus costs).
5. Regularly remind employment tax examiners how they can access and request the CP2100 and cash transaction data for operational employment tax examinations.

Agency Comments

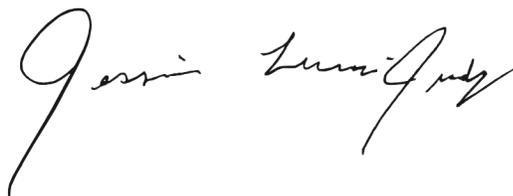
We provided a draft of this report to the Commissioner of Internal Revenue. In its comments, reproduced in appendix IV, IRS generally agreed with all five of our recommendations. We also received technical comments from IRS, which we incorporated where appropriate. IRS also provided additional documentation during its review of our draft report that

led us to modify the first recommendation to reflect that IRS has begun preliminary analysis of NRP study results.

We appreciate IRS's response to our report, which highlighted that addressing the data issues we identified in the NRP data should make the analysis of it more accurate and that IRS is considering additional changes to its examination procedures. We look forward to additional details on the actions and timelines that IRS plans to take in response to our recommendations.

As agreed with your offices, unless you publicly announce the contents of this report earlier, we plan no further distribution until 30 days from the report date. At that time, we will send copies to the Chairmen and Ranking Members of other Senate and House committees and subcommittees that have appropriation, authorization, and oversight responsibilities for IRS. We will also send copies of the report to the Commissioner of Internal Revenue and other interested parties. In addition, this report will be available at no charge on the GAO website at <http://www.gao.gov>.

If you or your staff have any questions about this report please contact me at (202) 512-9110 or lucasjudyj@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made key contributions to this report are listed in appendix V.



Jessica Lucas-Judy
Acting Director, Tax Issues
Strategic Issues

Appendix I: Objectives, Scope, and Methodology

Our objectives were to (1) evaluate how the Internal Revenue Service (IRS) plans to analyze the National Research Program (NRP) data, (2) review NRP data available on areas of noncompliance, (3) describe NRP examination practices that IRS applied to operational employment tax examinations, and (4) assess additional NRP examination practices that could be applied to operational employment tax examinations.

To evaluate IRS's plans to analyze the NRP data and use the NRP results on noncompliance areas, we interviewed IRS research and examination officials about their research and analysis plans and gathered documentation where available. These research and examination officials represented Research, Applied Analytics, and Statistics (RAAS) and Tax-Exempt/Government Entities (TE/GE) and Small Business/Self-Employed (SB/SE). We gathered and reviewed documentation, if available, to confirm any IRS plans to analyze and use the data. We compared this testimonial and documentary evidence to IRS's strategic plan and the Internal Revenue Manual (IRM).¹

To review NRP data available on noncompliance areas for employment taxes, we obtained the NRP data set on completed examinations of the employer's Form 941 - *Employer's Quarterly Federal Tax Return* as of July 18, 2016. Each return selected and examined in the study consisted of any of the four quarters filed or required for a tax year. IRS's final sample sizes for the study were 2,507, 2,387 and 2,318 for tax years 2008, 2009 and 2010, respectively. The sample stratification included 14 strata across the four participating business units (TE/GE-Exempt Organization (EO), TE/GE-Federal, State, and Local Governments (FSLG), SB/SE, and Large Business and International (LB&I)) that served as the primary stratifying variable; other stratifying variables included the employer's total wages and the mean number of employees.² RAAS initially estimated that the NRP employment tax study size should be approximately 20,000 returns. However, according to IRS, this would not be possible based on resources available for the study. The limitations of the sample size were pointed out by the Treasury Inspector General for Tax Administration, which noted that the examination results for the

¹The IRM is an official compendium of internal guidelines for IRS personnel. It is available at: <https://www.irs.gov/irm/> (last visited April 10, 2017). Also see Internal Revenue Service, *Strategic Plan: FY2014-2017* (Washington, D.C.: 2014).

²The sample included a single stratum for government entities during 2008, which was split into two strata based on the level of total wages during 2009 and 2010—resulted in the sample having 15 total strata during 2009 and 2010.

sampled taxpayers may not enable IRS to fully estimate compliance levels for business taxpayers, among other findings.³

Unlike other IRS examinations, NRP examinations can be used to estimate taxpayer reporting compliance, such as for reporting employment tax liabilities. The NRP employment tax study represents employers that filed at least one quarterly Form 941 return for the study year. However, certain types of employers were excluded from the study sample. For example, any nonfilers and other employment tax reporting businesses such as agricultural businesses (Form 943), household employers (Schedule H), or businesses with less than \$1,000 in annual employment taxes due (Form 944) were excluded from the sample. Additional exclusions from the sample included federal governments, large corporations with assets of \$250 million or more, foreign subsidiaries, Indian Tribal Governments, and maritime employers. Furthermore, the TE/GE-EO division excluded all church cases from the 2008 study year due to an unresolved legal issue; churches were included in the study for tax years 2009 and 2010. Since the study excluded some government entities and large businesses, the NRP results may not reflect the full and accurate level of compliance for government and large business employers.

We analyzed and estimated the issues examined as well as the wage adjustments made as a result of the examination, if any. We were not able to estimate the tax adjustments associated with certain issues being examined because the workpapers used for the NRP examinations spread across two data collection instruments (DCIs). The DCI-1 included the issues (lead sheets) examiners had to examine as part of the NRP employment tax study as well as the wage adjustments to be documented from examining those issues. All wage adjustments were required to be recorded for the study. The DCI-2 included the employment tax reports that were shared with taxpayers as a result of the examination. The DCI-2 calculated the tax adjustments to a taxpayer's tax liability (based on the wage adjustments in the DCI-1), but did not break out the tax adjustment by issues, similar to the DCI-1. We also analyzed and estimated the SB/SE employers' wage adjustments by the number of employees and the total compensation.

³Treasury Inspector General for Tax Administration, *Limitations in the Sample Size for the Internal Revenue Service's Employment Tax Study May Impact the Ability to Determine Compliance Levels*, 2011-10-034 (Washington, D.C.: May 17, 2010).

Our analysis also combined similar issues into higher level groups. For example, we combined examination results on fringe benefits for executives and nonexecutives, meaning that the same employer could be examined for both of these fringe benefit issues. See table 4 for how the employment tax examination issues were combined. IRS reviewed our combining of issues and provided suggestions, which we incorporated.

Table 4: Crosswalk of Combined and Individual National Research Program Employment Tax Examination Issues

Combined Issues	Individual Issues
Fringe benefits	<ul style="list-style-type: none"> • Fringe benefits for executives • Fringe benefits for non-executives
Payment re-characterization	<ul style="list-style-type: none"> • Re-characterization of payments to corporate officers when W-2 was issued • Payment recharacterization (e.g., 1099 payment re-characterization to W-2)
Worker classification	<ul style="list-style-type: none"> • Corporate officer reclassification when W-2 was not issued • Statutory employee • Common law factors
Backup withholding	<ul style="list-style-type: none"> • Backup withholding
Tip income	<ul style="list-style-type: none"> • Restaurants • Nonrestaurants • Gambling activity
Other issues	<ul style="list-style-type: none"> • Alien employment • Citizens or residents of the United States living abroad • Other payment re-characterization (payments to partners, math errors, etc.) • Section 4958 – Excess benefit transaction

Source: GAO analysis of Internal Revenue Service data. | GAO-17-371

Note: Other issues were not included due to temporary or infrequent occurrences or because the issues are for information purposes only. See appendix II for more information on the combined issues used for this analysis.

IRS officials described the quality review and data reliability process they used for data collected from the NRP examinations. In terms of data validations, IRS officials said that they used various consistency and validation checks when the examination was complete to determine if certain fields were blank or not blank, to ensure certain questions were answered based on the response to a prior element, and to check all entries in the DCI-1 against rules they created. This process took place at the end of examination before data were transmitted to the database.

During our analysis of the NRP data, we conducted several reliability tests to ensure the data excerpts were sufficiently complete. For example, we electronically tested the data for obvious errors. Additionally, we

shared our results with IRS officials to ensure that the data excerpts we used were complete and accurate for our purposes. We identified a number of inconsistencies that needed to be corrected before we could do our analysis. These included the identification of a number of questionable results for both the total number of employees and the amount of compensation. The inconsistencies included the numbers of employees showing “999999” for some cases, or very large numbers that were the same as the total compensation. Other inconsistencies might show similar numbers of employees for three of the quarters and a substantially different number of employees for the other quarter. In certain instances a fourth quarter value for number of employees or total compensation would be missing. IRS officials said the potential missing fourth quarter data represent the difference in time when the return was filed and when it was selected for the study. In these instances, we replaced the missing values for the number of employees and total compensation with the average value for the three quarters that were not missing.

We shared these inconsistencies and our corrections with IRS officials, who agreed with our changes and said they were working on correcting these inconsistencies as of February 2017. IRS officials said that the NRP employment tax study presented unique challenges in ensuring data reliability, which took significantly longer than previous NRP studies because they were dealing with three business units (SB/SE, TE/GE, and LB&I) that use different systems to track examinations issues.

We reviewed documentation on the NRP data, interviewed IRS officials about the data, and conducted several reliability tests discussed above. We report average annual estimates for 2008 through 2010 where data were available. For example, the variables we used to indicate whether issues were examined during each NRP audit are missing for 2008. However, other examination information, including wage adjustment information, is available by examination issue for all three years of the study. Therefore, we report NRP estimates using data for only 2009–2010 when addressing which issues were examined, while NRP estimates using data for 2008–2010 are used to report wage adjustments amounts by issue and information used to reflect the compliance of SB/SE employers of different sizes. Generally, the precision of estimates increases with more observations. Because a probability procedure based on random selections was used, the sample was only one of a large number of samples that might have been drawn. Since each sample could have provided different estimates, we express our confidence in the precision of our particular sample’s results as a 95 percent confidence

interval (e.g., +/- 7 percentage points). This is the interval that would contain the actual population value for 95 percent of the samples that could have been drawn. See appendix II for the specific estimates of this analysis and information about their sampling errors. Based on the steps we undertook, we concluded that the data were sufficiently reliable for the purposes of this report.

To describe NRP examination practices that IRS has applied to operational employment tax examinations, we interviewed RAAS staff who administered the NRP employment tax study on the key differences between NRP and operational examinations. We also interviewed examination staff from the SB/SE division and the TEGE division—who were responsible for NRP examinations during the employment tax study. Within TE/GE, these included examination staff from EO and FSLG groups. Based on those discussions, we gathered documentation, to the extent it was available, to confirm the NRP examination practices carried over to operational employment tax examinations. We also discussed and gathered documentation, if available, on the costs and benefits of carrying over NRP practices to operational employment tax examinations, and discussed the benefits with the SB/SE and TE/GE staffs.

To assess the extent that additional improvements could be made to operational employment tax examinations based on IRS's NRP experience, we used a three-step process. First, we interviewed IRS officials and examiners who completed NRP and operational examinations to identify potential improvements to operational examinations from using NRP practices. Second, we sent a survey to all IRS examiners who worked on NRP and operational examinations to get their views on additional potential improvements. Third, we discussed the practices that IRS examiners favored with IRS examination staff. We compared those ideas against a set of criteria to the extent data were available to determine whether the ideas warranted further action. We discuss these three steps in more detail below.

We held discussions with RAAS staff as well as SB/SE and TE/GE examination staff who participated in the NRP study to get their views on additional NRP practices that could improve operational employment tax examinations. To get similar views, we held four group discussions (one with FSLG, one with EO, and two with SB/SE) with IRS examiners who had worked both operational examinations and NRP examinations. These examiners were identified by IRS. The practices identified included (1) NRP practices that examiners would like to have, but were not carried over to the operational examinations; or (2) NRP practices that examiners

were not aware they had access to on operational examinations, but would like to have that access.

Based on these discussions, we identified a set of NRP practices that (1) could be applied to operational examinations, but have not yet been applied across IRS business units involved in the study; or (2) IRS examiners were not aware they could access. We developed a set of specific, close-ended, and open-ended questions that addressed those topics and had multiple pretests to ensure that the questions were understandable and answerable. We then administered the web-based survey to all IRS examiners in SB/SE and TE/GE who had experience completing operational and NRP employment tax examinations. The survey asked the same set of questions for six NRP practices we identified as well as demographic information about the examiners. These questions included if they would like to have access to these NRP practices on operational examinations, if and why they found them helpful, and if they are aware they had access to those NRP practices on operational employment tax examinations. The survey was sent to the complete list of 269 examiners identified by IRS officials as of July 2016 that were thought to meet the criteria of examiners with NRP and operational examination experience. Of those examiners, 23 were determined to not meet this criteria according to their responses to two screening questions to ensure IRS examiners had applicable experience to fill out the survey. These included:

1. According to IRS records, you have completed both NRP employment tax examinations and non-NRP employment tax examinations. Is this correct? (yes/no)
2. Have you completed a non-NRP employment tax examination since completing an NRP employment tax examination? (yes/no).

If the survey respondents answered no to either question, they were sent to the conclusion section of the survey, and did not provide responses to the remaining demographics questions and questions about the six NRP practices. We received a response rate of 85 percent, with 209 of the 246 examiners who met our criteria completing the survey. We also reviewed the raw data of the survey and made changes to ensure the skip patterns in the survey were adhered to by the respondents. We analyzed the survey data by the IRS business unit, current position, and key case year of NRP returns on which the respondent worked.

For each of the six NRP practices, we also asked an open-ended question about why they thought the NRP practice was helpful. We also

asked an open-ended question on whether the respondents had any other views to share at the end of the survey. To analyze the responses to these questions, one of our analysts reviewed the responses and coded them to identify themes for the seven open-ended responses with a second analyst reviewing those themes and the coded responses; we reconciled any disagreements through discussion.

After analyzing the closed-ended and open-ended data from the survey, we discussed the IRS examiners' summary responses with IRS examination staff in SB/SE and TE/GE. Specifically, we discussed applying the six NRP examination practices to operational employment tax examinations. To help lead those discussions with IRS examination staff, we used the following criteria, which were used for our prior work evaluating the NRP individual study.⁴

- Would the change be likely to help examiners correctly identify more noncompliance?
- Is it likely to make the examination more efficient—(i.e., reduce the cost of conducting an examination, increase benefits for the same cost, or increase benefits commensurate with justifiable or no increase in costs)?
- Is it likely to reduce taxpayer burden?
- Would the change meet any other IRS need?

Where available, we asked for documentation on the criteria above to assess whether to apply those NRP practices to operational examinations. These criteria generally are based on our 2005 report, *Understanding the Tax Reform Debate* ([GAO-05-1009SP](#)),⁵ Office of Management and Budget Circular A-94, and the Internal Revenue Manual.⁶ IRS officials agreed that these criteria were valid. As noted in our 2005 report, the criteria may conflict with each other, and as a result, trade-offs are to be considered among the criteria when evaluating a particular proposal. In those cases, we used our professional judgment in

⁴GAO, *Tax Administration: IRS Could Improve Examinations by Adopting Certain Research Program Practices*, [GAO-13-480](#) (Washington, D.C.: May 24, 2013).

⁵GAO, *Understanding the Tax Reform Debate: Background, Criteria, and Questions*, [GAO-05-1009SP](#) (Washington, D.C.: Sept. 1, 2005).

⁶Office of Management and Budget, *Circular A-94 Guidelines and Discount Rates for Benefit-Cost Analysis of Federal Programs* (Washington, D.C.: September 2005). Also, the IRM can be accessed at: <https://www.irs.gov/irm/>.

weighing the relative importance of these criteria in making our recommendations. We discussed these criteria with IRS to get its feedback. To the extent data were available on additional NRP practices that could be used in operational employment tax examinations, we used that data and information to evaluate those NRP practices using the criteria above as well as relevant sections from the IRS strategic plan.⁷

We conducted this performance audit from April 2016 to April 2017 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 objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

⁷Internal Revenue Service, *Strategic Plan: FY2014-2017* (Washington, D.C.: 2014).

Appendix II: Data on Results of National Research Program Employment Tax Examinations

Table 5: Overview of Frequently Examined National Research Program Employment Tax Issues

Issue	Description
Fringe benefits	A fringe benefit is any property, service or cash received from the employer in addition to regular compensation, such as an employer paying for an employee's moving expenses. Whether a fringe benefit is taxable depends on whether a statutory exclusion applies to the benefit. The fair market value of taxable fringe benefits must be included in the pay of employees in the Form W-2 as well as reported for independent contractors on Form 1099-MISC and for partners on Schedule K-1 (Form 1065).
Payment re-characterization	Certain payments made from employers to employees should have been reported on the Form W-2. These payments may have been reported using Form 1099. Once payments are recharacterized as wages, the employer also becomes liable for the taxes they previously failed to withhold and their own portion that are assessed during the examination. Future wages would be subject to withholding. An example of payment recharacterization is when employers pay employees for overtime using Form 1099, instead of on the employees' W-2.
Worker classification	Worker classification issues arise when employers misclassify employees as independent contractors or other nonemployees such as shareholders and corporate officers. When employees are misclassified, the employer's obligation to withhold and pay employment taxes is not established and therefore, goes unpaid.
Backup withholding	Generally, any payor must withhold a tax of 28 percent on reportable payments of interest, dividends, and other compensation if the payee fails to furnish his or her correct taxpayer identification number to the payor, as required, at the time the reportable threshold is met.
Tip income	Tips are considered wages for purposes of the Federal Insurance Contributions Act (FICA) and federal income tax withholding for cash tips of \$20 or more received in a calendar month. Once an employee reports tips received to the employer, they are considered wages for purposes of FICA and federal income tax withholding. The employer is to withhold the employee's share of FICA and federal income tax withholding, and deposit those shares with the employer's share of FICA.

Source: Internal Revenue Service information. | GAO-17-371

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Table 6: Annual Internal Revenue Service National Research Program Examination Issues from 2009 through 2010

	Number of Examined Issues	Estimate as a Percentage of Total Issues^a	95 Percent Lower Confidence Limit	95 Percent Upper Confidence Limit	Margin of Error as a Percentage of Estimate
Fringe Benefits	5,986,191	38	5,782,534	6,189,848	3
Payment Recharacterization	3,701,977	24	3,548,779	3,855,176	4
Worker Classification	3,080,484	20	2,910,656	3,250,313	6
Backup Withholding	1,933,931	12	1,817,045	2,050,818	6
Tip Income	455,659	3	389,837	521,480	14
Other Issues	510,185	3	433,923	586,447	15
Total Issues	15,668,427	100	15,187,585	16,149,269	3

Source: GAO analysis of Internal Revenue Service National Research Program data. | GAO-17-371.

^aThe margin of error for the estimate as a percentage of the total issues is within +/- 1 percentage point.

Table 7: Annual Internal Revenue Service National Research Program Examination Issues for Small Business/Self-Employed (SB/SE) Observations from 2009 through 2010

	Number of Total Issues Examined	95 Percent Lower Confidence Limit	95 Percent Upper Confidence Limit	Margin of Error as a Percentage of Estimate
Total Issues—SB/SE Observations Only	14,281,275	13,809,531	14,753,018	3
SB/SE—3 or less employees	6,389,696	6,014,120	6,765,272	6
SB/SE—4 or more employees	7,891,578	7,529,451	8,253,706	5
SB/SE—total compensation of \$78,500 or less	5,622,931	5,258,690	5,987,172	6
SB/SE—total compensation greater than \$78,500	8,658,344	8,317,928	8,998,760	4

Source: GAO analysis of Internal Revenue Service National Research Program data. | GAO-17-371.

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Table 8: Annual Internal Revenue Service National Research Program Examination Issues with Wage Adjustments from 2009 through 2010

	Number of Examined Issues with Adjustments	Estimate as a Percentage of Total Issues ^a	95 Percent Lower Confidence Limit	95 Percent Upper Confidence Limit	Margin of Error as a Percentage of Estimate
Fringe Benefits	2,213,720	33	2,081,144	2,346,296	6
Payment Recharacterization	1,323,248	20	1,213,079	1,433,417	8
Worker Classification	1,275,165	19	1,159,920	1,390,410	9
Backup Withholding	1,431,902	21	1,326,249	1,537,556	7
Tip Income	242,651	4	195,907	289,395	19
Other Issues	238,078	4	191,179	284,978	20
Total Issues	6,724,763	100	6,424,342	7,025,183	4

Source: GAO analysis of Internal Revenue Service National Research Program data. | GAO-17-371.

^aThe margin of error for the estimate as a percentage of the total issues with wage adjustments is within +/- 2 percentage points.

Table 9: Annual Internal Revenue Service National Research Program Examination Issues with Wage Adjustments for Small Business/Self-Employed (SB/SE) Observations from 2009 through 2010

	Number of Examined Issues with Adjustments	95 Percent Lower Confidence Limit	95 Percent Upper Confidence Limit	Margin of Error as a Percentage of Estimate
Total Issues—SB/SE Observations Only	6,207,620	5,911,621	6,503,618	5
SB/SE—3 or less employees	2,919,465	2,684,934	3,153,996	8
SB/SE—4 or more employees	3,288,155	3,083,993	3,492,318	6
SB/SE—total compensation of \$78,500 or less	2,624,806	2,401,324	2,848,288	9
SB/SE—total compensation greater than \$78,500	3,582,814	3,377,339	3,788,289	6

Source: GAO analysis of Internal Revenue Service National Research Program data. | GAO-17-371.

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Table 10: Annual Internal Revenue Service National Research Program Percent of Examination Issues Resulting in Wage Adjustments from 2009 through 2010

	Percentage of Examined Issues with Adjustments	95 Percent Lower Confidence Limit	95 Percent Upper Confidence Limit	Margin of Error as a Percentage Point
Fringe Benefits	37	35	39	2
Payment Recharacterization	36	33	38	3
Worker Classification	41	39	44	3
Backup Withholding	74	71	77	3
Tip Income	53	46	61	8
Other Issues	47	39	54	8
Total Issues	43	42	44	1
Small Business/Self-Employed (SB/SE) Observations Only				
Total Issues—SB/SE Observations Only	43	42	45	2
SB/SE—3 or less employees	46	43	48	3
SB/SE—4 or more employees	42	40	43	2
SB/SE—total compensation of \$78,500 or less	47	44	49	3
SB/SE—total compensation greater than \$78,500	41	40	43	2

Source: GAO analysis of Internal Revenue Service National Research Program data. | GAO-17-371.

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Table 11: Annual Internal Revenue Service National Research Program (NRP) Wage Adjustments from 2008 through 2010 (dollars)

	Amount of Wage Adjustments	95 Percent Lower Confidence Limit	95 Percent Upper Confidence Limit	Margin of Error as a Percentage of Estimate
Fringe Benefits	34,411,535,192	25,767,376,821	43,055,693,564	25
Payment Recharacterization	26,316,953,736	20,170,218,901	32,463,688,570	23
Worker Classification	44,264,158,719	37,671,312,321	50,857,005,116	15
Tip Income	7,576,750,613	5,897,460,267	9,256,040,960	22
Other Issues^a	-1,196,930,079	-6,622,528,539	4,228,668,381	453 ^a
Other Issues (Increases Only)	6,291,187,760	4,074,193,270	8,508,182,251	35
Other Issues (Decreases Only)	-7,488,117,839	-12,432,204,167	-2,544,031,511	66
Total Wage Adjustments	111,372,468,181	97,171,008,981	125,573,927,380	13
Small Business/Self-Employed (SB/SE) Observations Only				
Total Issues—SB/SE Observations Only	97,908,053,717	85,937,673,817	109,878,433,617	12
SB/SE—3 or less employees	42,959,995,130	35,159,310,032	50,760,680,229	18
SB/SE—4 or more employees	54,948,058,586	45,745,097,773	64,151,019,399	17
SB/SE—total compensation of \$78,500 or less	35,842,230,264	29,415,555,423	42,268,905,106	18
SB/SE—total compensation greater than \$78,500	62,065,823,452	51,898,449,156	72,233,197,749	16

Source: GAO analysis of Internal Revenue Service National Research Program data. | GAO-17-371.

^aOther issues include some NRP employment tax examination issues such as for alien employment, U.S. citizens and residents living abroad, and excess benefit transactions, which can be positive or negative. When computing the margin of error as a percentage of estimates for positive or negative total wage adjustments only, the margin of error as a percentage of the estimate is within +/- 35–65 percentage points.

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Table 12: Annual Internal Revenue Service National Research Program (NRP) Average Wage Adjustment Amount For Issues Adjusted from 2008 through 2010 (dollars)

	Average Wage Adjustment Amount for Adjusted Issues	95 Percent Lower Confidence Limit	95 Percent Upper Confidence Limit	Margin of Error as a Percentage of Estimate
Fringe Benefits	18,362	13,783	22,941	25
Payment Recharacterization	23,553	18,282	28,824	22
Worker Classification	38,690	33,431	43,949	14
Tip Income	33,683	27,085	40,280	20
Other Issues^a	-2,785	-15,416	9,845	453 ^a
Other Issues (Increases Only)	18,455	12,225	24,685	34
Other Issues (Decreases Only)	-84,312	-138,557	-30,066	64
Total Issues	32,747	28,652	36,842	13
Small Business/Self-Employed (SB/SE) Observations Only				
Total Issues—SB/SE Observations Only	30,944	27,256	34,631	12
SB/SE—3 or less employees	27,518	22,753	32,282	17
SB/SE—4 or more employees	34,280	28,672	39,888	16
SB/SE—total compensation of \$78,500 or less	24,606	20,420	28,792	17
SB/SE—total compensation greater than \$78,500	36,351	30,540	42,161	16

Source: GAO analysis of Internal Revenue Service data. | GAO-17-371.

^aOther issues include some NRP employment tax examination issues such as for alien employment, U.S. citizens and residents living abroad, and excess benefit transactions, which can be positive or negative. When computing the margin of error as a percentage of estimates for positive or negative total wage adjustments only, the margin of error as a percentage of the estimate is within +/- 35–65 percentage points.

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Table 13: Annual Employers Represented by Internal Revenue Service National Research Program (NRP) 2008 through 2010

	Number of Employers	Estimate as a Percentage of SB/SE Employers^a	95 Percent Lower Confidence Limit	95 Percent Upper Confidence Limit	Margin of Error as a Percentage of Estimate
All NRP	6,127,281	N/A	6,110,456	6,144,107	< 1
Small Business/Self- Employed (SB/SE)	5,558,975	100	5,543,543	5,574,407	< 1
SB/SE—3 or less employees	2,963,433	53	2,897,847	3,029,020	2
SB/SE—4 or more employees	2,595,542	47	2,530,502	2,660,582	3
SB/SE—total compensation of \$78,500 or less	2,780,137	50	2,733,311	2,826,964	2
SB/SE—total compensation greater than \$78,500	2,778,838	50	2,732,890	2,824,785	2

Source: GAO analysis of Internal Revenue Service National Research Program data. | GAO-17-371.

^aThe margin of error for the estimate as a percentage of SB/SE employers is within +/- 1 percentage point.

Table 14: Annual Number of Employees Represented by Internal Revenue Service National Research Program (NRP) 2008 through 2010

	Number of Employees	Estimate as a Percentage of SB/SE Employees^a	95 Percent Lower Confidence Limit	95 Percent Upper Confidence Limit	Margin of Error as a Percentage of Estimate
All NRP	143,120,427	N/A	104,431,919	181,808,935	27
Small Business/Self- Employed (SB/SE)	60,427,220	100	38,824,775	82,029,664	36
SB/SE—3 or less employees	3,521,080	6	3,353,007	3,689,153	5
SB/SE—4 or more employees	56,906,139	94	35,302,333	78,509,946	38

Source: GAO analysis of Internal Revenue Service National Research Program data. | GAO-17-371.

^aThe margin of error for the estimate as a percentage of SB/SE employees is within +/- 2 percentage points.

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Table 15: Annual Total Compensation Represented by Internal Revenue Service National Research Program (NRP) 2008 through 2010

	Total Compensation	Estimate as a Percentage of SB/SE Total Compensation^a	95 Percent Lower Confidence Limit	95 Percent Upper Confidence Limit	Margin of Error as a Percentage of Estimate
All NRP	5,300,037,782,831	N/A	3,965,327,556,574	6,634,748,009,087	25
Small Business/Self-Employed (SB/SE)	1,915,371,480,176	100	1,584,480,962,106	2,246,261,998,246	17
SB/SE—total compensation of \$78,500 or less	83,766,453,387	4	80,536,334,425	86,996,572,349	4
SB/SE—total compensation greater than \$78,500	1,831,605,026,789	96	1,500,693,956,017	2,162,516,097,560	18

Source: GAO analysis of Internal Revenue Service National Research Program data. | GAO-17-371.

^aThe margin of error for the estimate as a percentage of SB/SE total compensation is within +/- 1 percentage point.

Table 16: Annual Wage Adjustments Represented by Internal Revenue Service National Research Program (NRP) 2008 through 2010

	Wage Adjustments	Estimate as a Percentage of SB/SE Wage Adjustments^a	95 Percent Lower Confidence Limit	95 Percent Upper Confidence Limit	Margin of Error as a Percentage of Estimate
All NRP	111,372,468,181	N/A	97,171,008,981	125,573,927,380	13
Small Business/Self-Employed (SB/SE)	97,908,053,717	100	85,937,673,817	109,878,433,617	12
SB/SE—3 or less employees	42,959,995,130	44	35,159,310,032	50,760,680,229	18
SB/SE—4 or more employees	54,948,058,586	56	45,745,097,773	64,151,019,399	17
SB/SE—total compensation of \$78,500 or less	35,842,230,264	37	29,415,555,423	42,268,905,106	18
SB/SE—total compensation greater than \$78,500	62,065,823,452	63	51,898,449,156	72,233,197,749	16

Source: GAO analysis of Internal Revenue Service National Research Program data. | GAO-17-371.

**Appendix II: Data on Results of National
Research Program Employment Tax
Examinations**

^aThe margin of error for the estimate as a percentage of SB/SE wage adjustments is within +/- 6 percentage points.

Table 17: Miscellaneous Annual Estimates from Internal Revenue Service National Research Program 2008 through 2010

	Estimate	95 Percent Lower Confidence Limit	95 Percent Upper Confidence Limit	Margin of Error as a Percentage of Estimate
Number of Employers Where Section 530 was Relevant Issue	2,415,437	2,318,914	2,511,959	4
Number of Employers Determined to Have Section 530 Protection	80,531	59,488	101,574	26
Number of Employees Determined to be Protected Under Section 530	1,504,822	354,244	2,655,400	76
Amount of Payments (in \$) Determined to be Protected Under Section 530	26,582,738,321	-7,880,027,002	61,045,503,645	130
Number of Employers Determined Not to Have Section 530 Protection	2,066,558	1,973,407	2,159,709	5
Number of Employees Determined Not Protected Under Section 530	10,061,772	8,093,113	12,030,432	20
Amount of Payments (in \$) Determined Not Protected Under Section 530	141,333,212,528	118,049,799,787	164,616,625,270	16
Number of Employers Where Determination of Reasonable Cause was Relevant Issue	4,605,621	4,520,005	4,691,236	2
The Number of Employers that Qualified for a 25% Classification Settlement Program (CSP) Offer	34,454	21,328	47,580	38
Amount of Wage Adjustments that Qualified for a 25% CSP Offer	1,996,751,116	522,851,284	3,470,650,949	74
Amount of Wage Adjustments that Qualified for a no adjustment CSP Offer	9,027,580,636	2,517,076,965	15,538,084,307	72
Amount of Wage Adjustments that Qualified for a 25% or no adjustment Classification Settlement Program (CSP) Offer	11,024,331,753	4,350,684,743	17,697,978,762	61

**Appendix II: Data on Results of National
Research Program Employment Tax
Examinations**

	Estimate	95 Percent Lower Confidence Limit	95 Percent Upper Confidence Limit	Margin of Error as a Percentage of Estimate
Number of Employers Considered for Section 3402(d) Relief from Income Tax Withholding	1,102,994	1,029,360	1,176,628	7
Number of Employers that Received Section 3402(d) Relief	851,060	785,818	916,302	8
Amount of Wage Credit Received on Form 941 (in \$) Due to Section 3402(d) Relief	5,949,630,815	4,316,398,731	7,582,862,900	27
Amount of Wage Credit Received on Form 945 (in \$) Due to Section 3402(d) Relief	48,000,877,263	13,095,613,271	82,906,141,255	73
Amount of Wage Credit Received (in \$) Due to Section 3402(d) Relief	53,950,508,078	19,011,249,603	88,889,766,554	65
Number of SB/SE employers as a percent of all employers	91	91	91	< 1 ^a

Source: GAO analysis of Internal Revenue Service National Research Program data. | GAO-17-371.

^aFor this estimate, the margin of error and the margin of error as a percentage of the estimate are both within +/- 1 percentage point.

Appendix III: Results from GAO Survey of Internal Revenue Service Examiners

Table 18: Internal Revenue Service (IRS) Examiners Who Used National Research Program (NRP) Practices on Operational Examinations since Completing NRP Employment Tax Study By IRS Business Unit

	Small Business/Self Employed	Federal, State, and Local Governments	Exempt Organizations	Total
Electronic Case Files	60 of 100	23 of 27	50 of 82	133 of 209
Information Return Analysis System	50 of 100	27 of 27	28 of 82	105 of 209
CP2100	11 of 100	13 of 27	4 of 82	28 of 209
Taxpayer's Examination History	46 of 100	19 of 27	49 of 82	114 of 209
Cash Transaction Data	11 of 100	N/A	0 of 81	11 of 181
Related Return Information	51 of 98	N/A	45 of 81	96 of 179

Source: GAO analysis of survey data of Internal Revenue Service examiners. | GAO-17-371.

Notes: Survey respondents were given the option of answering "Yes," "No," "Don't know," or "Not Applicable" to this question. If respondents answered "No" they skipped the question in table 19 on helpfulness and were sent to the question covered in table 20. If they answered "Don't know" or "Not applicable" they were skipped to these same set of questions asking about the next NRP practice.

Table 19: Internal Revenue Service Examiners Views on Helpfulness of National Research Program (NRP) Practices on Operational Examinations (very to extremely helpful)

	Small Business/Self Employed	Federal, State, and Local Governments	Exempt Organizations	Total
Electronic Case Files	45 of 60	21 of 23	42 of 50	108 of 133
Information Return Analysis System	46 of 50	26 of 27	26 of 28	98 of 105
CP2100	8 of 11	11 of 13	4 of 4	23 of 28
Taxpayer's Examination History	28 of 46	16 of 18	29 of 49	73 of 113
Cash Transaction Data	7 of 11	N/A	0 of 0	7 of 11
Related Return Information	47 of 51	N/A	37 of 43	84 of 94

Source: GAO analysis of survey data of Internal Revenue Service examiners. | GAO-17-371.

Note: Respondents were only asked if they question if they answered "Yes" to the question in table 18 above. Respondent could also answer if they found the NRP practice "moderately helpful," "somewhat helpful," or "not at all helpful."

**Appendix III: Results from GAO Survey of
Internal Revenue Service Examiners**

Table 20: Internal Revenue Service Examiners Views on Having National Research Program Practices on Operational Examinations

	Small Business/Self Employed	Federal, State, and Local Governments	Exempt Organizations	Total
Electronic Case Files	60 of 99	17 of 27	52 of 78	129 of 204
Information Return Analysis System	91 of 100	25 of 26	65 of 78	181 of 204
CP2100	85 of 96	24 of 26	58 of 79	167 of 201
Taxpayer's Examination History	88 of 96	26 of 26	77 of 81	191 of 203
Cash Transaction Data	66 of 98	N/A	56 of 77	122 of 175
Related Return Information	90 of 100	N/A	64 of 78	154 of 178

Source: GAO analysis of survey data of Internal Revenue Service examiners. | GAO-17-371.

Note: IRS Federal, State, and Local Governments business unit notified us that the cash transaction data and related return information is not applicable to government entities.

Table 21: Internal Revenue Service (IRS) Examiners Awareness of Requesting and Regularly Having National Research Program Practices on Operational Examinations

	Small Business/Self Employment	Federal, State, and Local Governments	Exempt Organizations	Total
Information Return Analysis System	87 of 100	27 of 27	48 of 77	162 of 204
CP2100	47 of 96	22 of 26	19 of 79	88 of 201
Taxpayer's Examination History	55 of 98	18 of 26	45 of 81	118 of 205
Cash Transaction Data	49 of 98	N/A	30 of 78	79 of 176
Related Return Information	80 of 100	N/A	57 of 81	137 of 181

Source: GAO analysis of survey data of Internal Revenue Service examiners. | GAO-17-371.

Note: IRS Federal, State, and Local Governments business unit notified us that the cash transaction data and related return information is not applicable to government entities. Electronic case files were not asked about for this question because their use cannot be requested. IRS business units either use or do not use electronic case files.

Appendix IV: Comments from the Internal Revenue Service



COMMISSIONER

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

April 4, 2017

Jessica K. Lucas-Judy
Acting Director, Tax Issues, Strategic Issues Team
United States Government Accountability Office
Washington, DC 20548

Dear Ms. Lucas-Judy:

Thank you for the opportunity to review your draft report entitled, *Employment Taxes: Timely Use of National Research Program Results Would Help IRS Improve Compliance and Tax Gap Estimates* (GAO-17-371).

The Internal Revenue Service (IRS) promotes compliance with the employment tax laws through educational and other efforts designed to encourage and facilitate voluntary compliance, and through enforcement activities when voluntary compliance is not forthcoming. As your report notes, the IRS uses the examination-based National Research Program (NRP) to study compliance issues. The NRP collects valuable data that we analyze to better understand taxpayer compliance behavior to effectively promote voluntary compliance and improve the ability to detect noncompliance.

Your report reviewed aspects of the NRP study that covered Form 941, Employer's Quarterly Tax Return. This return is used by employers to report—and reconcile with tax deposits—federal income tax withheld from wages and other compensation, the employer share of FICA tax, and the employee share of FICA tax withheld from wages. Employment taxes related to FICA and federal unemployment insurance are a significant portion of total federal revenues (\$952 billion gross collections in FY 2015) and underreporting on these taxes contributed an estimated \$16 billion to the gross tax gap for TY 2008-2010. As the report notes, these estimates were based on compliance rate data from the last IRS study which was conducted in the 1980s. Information from the current NRP study will be used for the next update of the tax gap estimates planned for 2019.

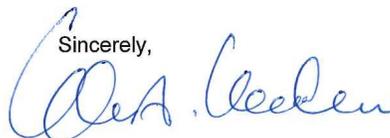
We appreciate your acknowledgement of the work the IRS has already done to help improve current examination processes by implementing NRP practices and your analysis of the initial NRP study results. While we agree with your recommendations, we are considering incorporating additional changes to examination procedures. Through your analysis, we were able to identify additional data issues that will result in more accurate analysis once addressed.

2

The IRS recognizes the need for timely analysis of the data from the NRP Employment Tax Reporting Compliance Study and is currently taking steps to deliver and analyze the data as expeditiously as possible. These efforts in estimating compliance and identifying specific areas of noncompliance will provide additional information for exploring options for enhancing tax administration in this area. Although the effect of IRS budget cuts on both customer service and enforcement staffing are most well-known, staff reductions among research and analytical staff have affected our work in this area. We are committed to completing a comprehensive and thorough analysis of the NRP data, although the timeframe for completing this analysis will be longer than originally expected.

Thank you again for the valuable feedback you have provided. We provided technical comments on the draft separately. If you have questions, please contact me, or a member of your staff may contact Ben Herndon, Director, Research, Applied Analytics & Statistics at 202-317-4276.

Sincerely,

A handwritten signature in blue ink, appearing to read "John A. Koskinen".

John A. Koskinen

Enclosure

Enclosure

**GAO Recommendations and IRS Responses to GAO Draft Report
Employment Taxes: Timely Use of National Research Program Results Would
Help IRS Improve Compliance and Tax Gap Estimates (GAO-17-371)**

Recommendation:

1. Develop and document plans to start analyzing in 2017 the results of the NRP employment tax study to identify the major issues of noncompliance.

Comment:

We agree with this recommendation. The IRS recognizes the need for timely analysis of the NRP Employment Tax Study data to maximize the effectiveness of the research effort. Currently both RAAS and the participating Business Operating Divisions are reviewing the data and compiling the study results which include issues of noncompliance.

Recommendation:

2. Develop and document plans for addressing the noncompliance identified in IRS's analysis of the NRP employment tax results.

Comment:

We agree with this recommendation. Currently both RAAS and the participating Business Operating Divisions are reviewing the data and compiling the study results which include issues of noncompliance. Once this process is complete, the IRS will revisit the study results and assess whether additional plans to improve taxpayer compliance are necessary and feasible.

Recommendation:

3. Develop and document plans for assessing the results of the NRP employment tax study to estimate the current state of the employment tax gap.

Comment:

We agree with this recommendation. Competing priorities and diminishing resources have resulted in prolonged delivery of the final study data and subsequent analysis. However, the IRS is committed to ensuring the successful completion of the study and using the results of the study to inform the next release of tax gap estimates.

Recommendation:

4. Determine whether and when to provide IRAS upfront for SB/SE operational examinations based on criteria such as whether it would help identify more noncompliance, reduce taxpayer burden, and improve audit efficiency by reducing overall IRS costs (examiner versus campus costs).

2

Comment:

We agree with this recommendation. The IRS agrees with the need to continuously strive to better identify noncompliance, reduce taxpayer burden and improve audit efficiency. The IRS recognizes the importance of valuable case building tools, but also the need to balance the relative costs of the tools with the respective benefit. The IRS further recognizes the need to review whether and when IRAS data should be included in a case file built for SB/SE operational field employment-tax examinations.

Recommendation:

5. Regularly remind employment tax examiners how they can access and request the CP2100 and cash transaction data for operational employment tax examinations.

Comment:

We agree with this recommendation. The IRS recognizes the need to take steps to ensure examiners are aware of and provided the tools needed to effectively and efficiently perform their jobs. The IRS will consider the most effective and efficient method to provide this information for their examination groups.

Appendix V: GAO Contact and Staff Acknowledgments

GAO Contact

Jessica Lucas-Judy, (202) 512-9110 or lucasjudyj@gao.gov

Staff Acknowledgments

In addition to the contact named above, Tom Short (Assistant Director), Jehan Chase, Karen O'Connor, Steven Flint, Robert Gebhart, Donna Miller, Robert MacKay, Cynthia Saunders, Albert Sim, Sonya Vartivarian, and Jason Vassilicos made significant contributions to this report.

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