

IMPROVING THE EFFICIENCY AND EFFECTIVENESS OF THE AUR PROGRAM

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SYNOPSIS

Tax authorities need comprehensive and accurate financial information to ensure income is accurately reported. This paper discusses how the United States Internal Revenue Service (IRS) uses the over two billion third party information reports it receives each year in the automated underreporter program (AUR). The result is that IRS collects billions of dollars of additional revenue at low cost.

This paper can provide useful lessons for any tax authority receiving third party information reports. In addition, tax administrators may develop creative ways to utilize new sources of information to increase revenue in the short-term and voluntary compliance in the longer term.

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After the audit, the automated under reporter (AUR) program is the most productive IRS compliance program from a revenue standpoint. AUR is comprised of two separate modules, AUR and Information Returns Document Matching - Case Inventory Selection and Analytics (IRDMCISA). An initial data match between individual Form 1040 tax returns and Information Returns is performed in Information Return Processing (IRP). After this match, potential AUR cases are loaded onto the system and tax examiners then compare the Form 1040 (annual tax return filing by individuals) with the third party (i.e. payers, employers) data to determine if the income in question has been reported by the taxpayer (on another line/form of the return,) or if the absence is otherwise explained. For Fiscal Year (FY) 2015, the IRS received approximately 2.6 billion information documents reporting taxpayer income, deductions, and other information reported by third parties. Using about 1,740 staff years, the IRS closed about 3.7 million cases and assessed over \$6.3 billion

in additional taxes. Therefore, the program assessed over \$3.6 million for each staff year.

While these results are impressive at first glance, to increase the revenue yield with the same staff resources, the IRS needs to consider modernizing the AUR process. This paper will discuss two approaches the IRS could use to increase the efficiency of AUR without additional resources. Specifically, in the short-term, rather than working just one year at a time, the IRS could combine multiple years identified mismatches with one contact letter. In addition, the IRS should consider annually sending out a limited number of warning or so-called soft notices for certain mismatches that IRS may not have the resources to work during one year but would work in the subsequent year. Put another way, these process changes would allow IRS to work more efficiently to increase the revenue yield with substantially the same amount of staff resources.

For the longer-term, the IRS needs a new AUR strategy because each year IRS receives more information returns and the number of identified mismatches continues to rise. This increase is due to additional information reporting requirements and the need to administer a tax system that continues to become more complex. Whether by omission or commission, the likelihood of identifying reporting errors will continue to rise. Therefore, the IRS needs to improve the matching algorithms to reduce the staff resources required to screen the AUR mismatches.

1. BACKGROUND

In the early 1960s, the IRS began matching information returns to self-reported items on a taxpayer's filed return. However, matching had limited utility in the early years because both the information and tax returns were submitted in a paper format. In the early years, IRS would pick one letter of the alphabet at random, and match those information documents with filed

returns. However, for the most part, IRS did not perform extensive returns matching until an automated Information Returns Program (IRP) was implemented in 1974. As computer technology matured, more information returns were filed in computer readable formats and the IRS was better able to use the data in the AUR program.

For CY 2015, the IRS received over 2.2 billion information documents.¹ These documents record payments received by taxpayers, e.g., bank interest and dividends, and in some cases payments made by the taxpayer that can be deducted or can produce a credit that may reduce a filer's tax liability, e.g., mortgage interest paid. The two most common forms are the Form W-2 wage and tax statement and the Form 1099 interest income statement.

After receiving information returns, IRS perfects them and matches them against filed tax returns. Perfection is the process to assure that the taxpayer identification number, usually the social security number (SSN), and the payee's name match. For example, in some cases the information document was filed with an employer identification number, and an SSN must be substituted. Where there is no filed tax return, this provides potential leads for nonfiler investigations. This is known as the automated substitute for return program (ASFR). In 2015,

for example, IRS worked over 600,000 individual nonfiler cases and assessed \$2.7 billion using 93 staff years.²

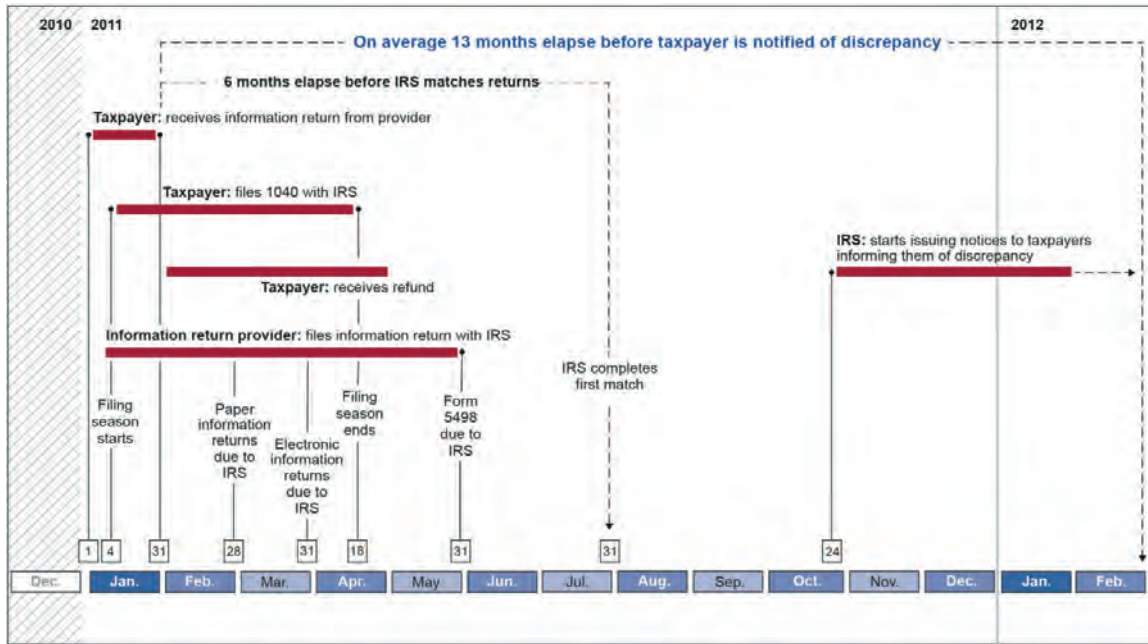
IRS makes three computer matches each year to identify discrepancies between entries on the filed tax return and the information documents. The first match is for returns filed by April 15, the second are for those with an extension, and the third for late filed returns. The IRS ignores a difference between the tax return and information document if it is below an undisclosed tax threshold. For example, if the taxpayer underreports the interest income earned by \$100, it is likely below the tax threshold and will not be pursued. The reason is that it would not be cost beneficial to pursue the tax de minimus tax owed.

Graphic 1 provides an illustrative timeline for submitting information and tax returns for Tax Year (TY) 2010 to IRS and the subsequent matching process.

1. See, *Publication 6961 Calendar Year Projections of Information and Withholding Documents for the U.S. and IRS Campuses (2015) Table 2.*
2. *IRS 2015 Data Book, Table 14*

Graphic 1

Timelines for Submission, Matching and Taxpayer Notification of Discrepancies for Information Returns and Timely Filed Individual Income Tax Returns, 2011 Filing Season (Tax Year 2010) ³



Source: GAO analysis of IRS documents.

IRS works AUR mismatches one year at a time, and sends notices for one tax year. After taking the de minimus tax threshold into account, the IRS identified 23.8 million mismatches for 2010. The mismatches may be for more than one category. For example, IRS may find that the taxpayer may have underreported both wage and dividend income for that year. For AUR purposes, this amount is aggregated to determine if future action is warranted. Subsequently, if the cutoff for sending an AUR notice is \$500 and the

taxpayer underreported \$400 each of wages and dividends, AUR may work the case because the total is \$800.

We say “may” for two reasons. First, since IRS has limited resources, there may be too many cases at or above \$500 to work all of them. Second, IRS works cases across all income types, even below threshold so taxpayers are not able to be noncompliant in any income reporting without the chance of detection.

3. See, GAO-13-515 *Tax Refunds: IRS is Exploring Verification Improvements, But Needs to Better Manage Risks* June 4, 2013 P 13

2. THE AUR CONTACT PROCESS

When the IRS identifies a mismatch, further manual analysis is generally required. An IRS tax examiner (TE) retrieves the tax return and analyzes it to determine whether the discrepancy was reported on another line or category on the return. If the TE is unable to resolve the discrepancy and it exceeds a certain dollar threshold, the taxpayer is contacted for an explanation.

The AUR contact is made with a computer generated notice, known as the Computer Paragraph 2000 (Notice of Proposed Adjustment for Underpayment or Overpayment)⁴, or CP-2000 for short. Typically, the CP-2000 includes a transcript of everything the IRS has associated with a Social Security Number. The notice explains the apparent discrepancy and proposes an adjustment to the tax liability. The CP-2000 is not a demand for payment. However, if the taxpayer does not respond or the matter is not satisfactorily resolved, the IRS may issue a notice of deficiency, assess the tax, and attempt to collect tax on that basis.

On the other hand, if the taxpayer responds with an acceptable explanation, an AUR examiner will consider the reasonableness of the response and may close the case. Tax examiners generally do not assess the accuracy of the information in the response because they do not have examination authority. If there is a question regarding the response, the case may be referred for a correspondence examination.

Another possibility is an inquiry letter, such as a CP-2501 Notice—an initial contact letter: This typically does not have a proposed balance due, rather it requests clarification on differences

between what is reported on the tax return and information from other sources. With the additional information, AUR can compute if there is any additional tax owed. One such example is the sale of stock. Without knowing what the taxpayer paid for the shares (i.e., the basis), it is not possible to determine the taxable gain, if any.

The taxpayer can agree to the adjustment by signing the notice and sending a payment. If the taxpayer disagrees and decides to contest the CP-2000 notice, the taxpayer can submit an explanation and any supporting evidence. If the evidence is sufficient, the matter is resolved and the case is closed. If not, the taxpayer can contest the matter with the IRS Appeals Office. If still unresolved, the IRS will issue a formal deficiency notice. If the taxpayer ignores the AUR notice, the IRS computers will usually issue a notice of deficiency after a certain amount of time has elapsed, and has the option of beginning collection action.

2.1. How Productive is AUR?

Table one provides a breakdown of dollars assessed per AUR notice, and staff year. IRS has defined an AUR contact as a case closed. If the AUR notice claims that the recipient owes additional tax due to underreporting and taxpayer proves otherwise, this is a case closed without additional dollars assessed. IRS does not publish data on the number of AUR contacts that are closed without additional dollars assessed.⁵ Although anecdotal, some tax practitioners claim that about one in five AUR notices are incorrect. This does not mean no additional tax is owed, just that the dollars claimed are incorrect. Also, for smaller amounts

4. See, Appendix V of the TIGTA report 2008-40-180 for a copy of the CP-2000 notice that IRS used in FY 2007. <http://www.treas.gov/tigta/auditreports/2008reports/200840180fr.pdf>

5. According to IRS, for FY 2009 18.4 percent of the computer identified discrepancy cases were closed without contacting the taxpayer. TIGTA report

practitioners advise clients to just pay because the cost of contesting an incorrect notice can exceed the tax claimed to be owed.⁶

Using IRS published data, IRS assessed over \$3.6 million per staff year and \$1,700

per AUR contact in 2015. The actual dollars owed are somewhat higher since a successful assessment also includes interest from the time the tax return was due, and often a small negligence penalty as a percentage of the tax owed.⁷

Table 1
AUR Contacts and Dollars Assessed⁸

Year (FY)	AUR contacts (millions) ⁹	Tax assessed (millions) ¹⁰	Staff Years ¹¹	Dollars Assessed per notice	Dollars Assessed per staff year (thousands)
2000	1.354	\$1,930		\$1,425	
2001	1.162	\$1,937		\$1,667	
2002	1.491	\$2,521		\$1,691	
2003	1.561	\$2,863		\$1,834	
2004	1.948	\$3,576		\$1,836	
2005	2.837	\$3,994		\$1,408	
2006	3.209	\$4,075	1,752	\$1,270	\$2,339
2007	3.403	\$5,079	1,742	\$1,493	\$2,915
2008	3.530	\$6,396	1,782	\$1,812	\$3,518
2009	3.621	\$6,280	1,900	\$1,734	\$3,305
2010	4.336	\$7,238	2,255	\$1,669	\$3,210
2011	4.703	\$6,437	2,343	\$1,369	\$2,747
2012	4.525	\$7,113	2,217	\$1,572	\$3,208
2013	4.116	\$7,732	2,035	\$1,879	\$3,800
2014	3.777	\$5,906	1,952	\$1,564	\$3,026
2015	3.720	\$6,341	1,739	\$1,705	\$3,646

Source: IRS Data Book 2000-2015

6. Based on a statistically valid random sample, a 2008 TIGTA report indicates that approximately five percent of the AUR notices sent in FY 2007 by W & I were inaccurate. This could have resulted in an over or under assessment of tax. It should be noted that this report did not look at SB/SE notices, which currently comprise about half of the AUR notices sent. See, <http://www.treas.gov/tigta/auditreports/2008reports/200840180fr.pdf>
7. Although the table shows significant dollars assessed, one reason is that AUR picks the cases it believes have the highest dollar assessment potential. Should IRS put more resources into AUR? See, *infra*.
8. IRS Data Books for 2000-2015
9. IRS has defined contacts as cases closed. If AUR claims that the recipient owes additional tax due to underreporting and taxpayer proves otherwise, this is a case closed without additional dollars assessed. IRS does not publish data on the number of AUR contacts that are closed without additional dollars assessed.
10. Due to a change in how IRS reports data, amount assessed includes interest and penalties for 2000-04 but excludes them for subsequent years.
11. One staff year is the total staff hours expended, converted to the number of full-time equivalent (FTE) positions. In other words one staff year is equal to 2080 hours.

While the AUR program generates millions of leads that could produce revenue for the Treasury, there are costs that make it uneconomical to work all the cases identified above the secret tolerance. While the cost of generating letters and postage may be small, there are other downstream costs to consider.

First, some recipients or their return preparer will telephone IRS asking for clarification or contest the amount claimed. It costs the IRS about \$25 for each telephone call. IRS received over 100 million calls in 2010 on all matters. This is one reason that IRS tries to stagger when and how many AUR notices are sent at a given time. Including AUR, IRS sends over 200 million notices a year.¹²

Secondly, a recurrent problem with AUR (and other notices sent by the IRS) is complexity. Often times, a recipient either does not have the tax background or reading comprehension level to understand what exactly the IRS wants. This can lead to contacting the IRS—with mixed results, or just ignoring the letter that leads to subsequent compliance actions. (In turn, the IRS must train tax examiners and update procedure manuals.) Complexity increases the costs for both the taxpayer and the IRS.

Third, if the taxpayer responds, enforcement resources must be used to evaluate the documentation or explanation. For example, a parent may claim that the amount of unreported interest in a bank account with her social security number was actually that of a minor child or nephew. Should the IRS accept the explanation and close the case, or should it go further and check if the interest was actually reported?

Fourth, for the minority of taxpayers who do not respond to the notice or don't pay, how should IRS respond? Usually, a nonresponse leads to an assessment and is turned over to

the collection function. If the dollars involved are small, it is unlikely that collection staff will spend much time on the case—increasing the inventory of accounts receivable and the dollars uncollected. In other words, dollars assessed do not necessarily mean dollars collected.

Just as cost drives how AUR selects and works cases, this can also affect taxpayer responses. For small dollar amounts, the IRS often wins by default. The majority of taxpayers use a paid preparer. Since the cost of sending the notice to the preparer to research or contest it may exceed the tax owed, the preparer's advice is often to just pay what IRS says is owed.

Although Table One shows impressive dollar assessments, one reason is that AUR picks the cases with the highest dollar potential. Should IRS put more resources into AUR? See, below for a discussion of this.

2.2. How can AUR do better?

2.2.1. Multiyear contact notices

The AUR system handles cases on a one-year basis. This means that IRS has 36 months from the time a tax return is filed to contact the taxpayer and resolve the matter or issue a notice of assessment. On average, IRS begins to send out the first group of CP-2000 notices about thirteen months after the tax return is filed. Put another way AUR has almost two years to resolve the case. With this time frame, why not include any amounts owing from the prior year in the contact. Let us give an example.

For a TY 2010 tax return which was filed on April 15, 2011, IRS plans to send a CP-2000 notice to John Smith claiming that he may have underreported income that will produce an extra \$1,000 in tax liability. It takes IRS 15 months after the return is filed to do the necessary prep work

12. <http://www.americanprogress.org/issues/open-government/news/2011/05/16/9588/irs-aims-for-letter-perfect-language/>

and send the notice—in other words IRS has 21 months left for this matter. For the prior year (here TY 2009), AUR files indicate that Smith also had unreported income that would result in an extra tax of \$400. The case was not worked because it was either below the tolerance or there were insufficient resources. Before sending the 2010 notice, AUR could do a quick check to its TY 2009 discrepancy file to determine if there is an amount in question.

By combining the amounts in a CP-2000, few additional resources will be needed and the potential revenue yield will increase. In light of the 36 month assessment window, for this example, the IRS has 9 months left to resolve the 2009 matter and 21 to resolve the 2010 matter. While there are obvious complexities and procedural issues, that affect merging mismatches across multiple tax years, it seems worth doing a pilot of a sample of cases to see what the costs and benefits of this approach are. If the results are satisfactory, it can be expanded.

2.2.2. Using soft notices

IRS has periodically experimented with a concept commonly known as a soft notice. A soft notice informs the taxpayer that there may be an error on the return, and asks the filer to review the return and take appropriate action. The IRS uses soft notices for various purposes, including for earned income tax credit eligibility inquiries.

For its TY 2007 pilot, AUR sent out approximately 29,000 CP-2057 notices to taxpayers specifying that certain payments were not reported.¹³ It asked the taxpayer to file an amended return if the amount was not properly reported, or contact the payer if there was an error, and

have the payer file an amended information return. Although the notice requested that the taxpayer file an amended return, if appropriate, or contact the payer, there was no requirement that the recipient pay additional tax, provide documentation, or even respond to the IRS.

The primary goal of the TY 2007 soft notice initiative was to correct taxpayer behavior on future filed tax returns, with a secondary goal to collect any additional tax due. Approximately 30 percent of those receiving the notice filed amended returns. For a control group that received the standard CP-2000 notice, the response rate was more than double. The soft notice group generated over \$1 million in additional revenue, substantially less revenue than the control group.¹⁴

2.2.3. Focus on AUR repeaters

With additional AUR staff, the IRS would presumably be able to follow up on more discrepancies. Is this a good idea? Answering this raises both practical and philosophical questions. For the mismatches, the AUR program creates inventory categories of potential tax changes. Category A is the highest potential tax change, presumably involving many thousands of dollars of tax and G is the lowest, presumably involving a few hundred dollars in tax. The further into the inventory of cases AUR is able to work, the less potential additional tax there is likely to be assessed, i.e., diminishing returns. For the smaller dollar amounts, the cost may exceed the revenue collected.

However, the primary goal of AUR is not revenue realization but to increase voluntary compliance. Therefore, working selective lower priority cases

13. 13,330 notices went to W & I taxpayers and 15,331 to SB/SE taxpayers.

14. See, TIGTA report 2011-30-091 (Sept. 9, 2011) *Using Soft Notices to Address Reporting Discrepancies Has Merit, but Cost and Benefit Questions Remain*.

may help achieve this goal. The process would be as follows. When a taxpayer has amended the previous return based on the AUR notice, if there is a smaller, under tolerance mismatch in the current year, the taxpayer would also receive a notice. This process would inform whether the IRS can achieve taxpayer behavioral changes by tracking mismatches in future years.

By pursuing a small amount, the IRS sends the taxpayer a message that small amounts are also important. Hence, the taxpayer is more likely to be compliant in the future, and repeat this message to friends and family. To the extent that a taxpayer's friends and relatives are more compliant because of the AUR contact, the indirect effect is multiplied.

3. CONCLUSION

The audit is among the most expensive and time consuming compliance tools available to a tax administration. With its AUR program, the IRS has been able to establish a less costly and efficient way to increase compliance. Using third party information returns, the IRS provides

tax filers with information to show where there has been an "inadvertent" failure to report or underreport certain income. In most cases, this is a graceful way for a taxpayer to pay the tax owed while allowing the more efficient use of limited compliance resources.

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