



Treasury Inspector General for Tax Administration Office of Audit

SIGNIFICANT TAX ISSUES ARE OFTEN NOT ADDRESSED DURING CORRESPONDENCE AUDITS OF SOLE PROPRIETORS

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Highlights

Highlights of Report Number: 2010-30-024 to the Internal Revenue Service Commissioner for the Small Business/Self-Employed Division.

IMPACT ON TAXPAYERS

Estimates by the Internal Revenue Service (IRS) show that \$68 billion of the \$345 billion tax gap in 2001 was due to sole proprietors who underreported their income. TIGTA evaluated closed correspondence audits of individual returns reporting sole proprietor operations and found significant tax issues were not addressed during these audits. Sole proprietors who underreport their income can create unfair burden on honest taxpayers and diminish the public's respect for the tax system.

WHY TIGTA DID THE AUDIT

This audit was initiated to determine whether IRS correspondence audits effectively address the compliance risks of sole proprietors. This review was conducted as part of our Fiscal Year 2009 Annual Audit Plan under the major management challenge of Tax Compliance Initiatives.

WHAT TIGTA FOUND

The IRS has successfully expanded audit coverage using the correspondence process as one of several ways to help remedy the noncompliance that contributes to the annual tax gap. However, the absence of required minimum checks for unreported income and unfiled returns in correspondence audits involving sole proprietors may be undermining the effectiveness of a process designed to verify that the correct amount of tax is reported. TIGTA found 129 audits where sole proprietors may have avoided tax and interest assessments totaling more than \$1.7 million after significant potential income misstatements were not addressed during the audits. These audits were identified from a statistically valid sample of 298 closed correspondence audits of individual returns with sole proprietorships that were closed by tax examiners in the IRS Campus Compliance Services operations during Fiscal Year 2007. Unlike procedures for audits

conducted in the field, procedures for correspondence audits of sole proprietors do not require examiners to complete minimum checks for unfiled returns (employment tax and information returns) and to probe for unreported income.

WHAT TIGTA RECOMMENDED

TIGTA recommended that the Director, Campus Compliance Services, require examiners to conduct and document, in audit case files, checks to identify unfiled employment tax and information returns and the results of automated preliminary cash transactions analyses, including consideration given to transferring the audit to the field if issues are identified. In addition, TIGTA recommended that controls be expanded to ensure that examiners are properly performing checks for unfiled employment tax and information returns and conducting preliminary cash transaction analyses so that corrective actions can be identified and taken, if needed.

In their response to this report, IRS management partially agreed with our three recommendations by responding with alternative corrective actions. IRS management stated that they plan to develop inventory selection filters to identify and exclude sole proprietors who had unfiled employment tax or information returns and/or had indicators of unreported income from correspondence examination inventory and make them available for field examination; provide additional guidance to correspondence examiners on documenting case files and transferring them to field examination; and ensure that appropriate actions were taken during quality reviews to provide feedback that can be used to update inventory selection filters.

TIGTA agrees that the IRS' alternative corrective actions may help reduce the number of significant tax issues that are not addressed during correspondence audits of sole proprietors. However, the absence of a specific commitment from the IRS requiring that examiners conduct a preliminary cash transaction analysis during sole proprietor audits is surprising given the high number of correspondence audits closed in recent years, including those involving a sole proprietor. A preliminary cash transaction analysis can identify considerable differences between expenditures and income. This difference raises very serious questions about whether expenses may be overstated on the return and/or whether there may be additional sources of income that should have been reported. Moreover, the IRS readily admitted in its response that sole proprietor underreporting is a serious compliance issue and that this type of analysis is necessary for an effective audit of the issue.

READ THE FULL REPORT

To view the report, including the scope, methodology, and full IRS response, go to:

<http://www.treas.gov/tigta/auditreports/2010reports/201030024fr.pdf>.

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