



*Plans for Evaluating the Use
of Soft Notices in Addressing
Underreporting Can Be Enhanced*

August 27, 2010

Reference Number: 2010-30-089

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



HIGHLIGHTS

PLANS FOR EVALUATING THE USE OF SOFT NOTICES IN ADDRESSING UNDERREPORTING CAN BE ENHANCED

Highlights

Final Report issued on August 27, 2010

Highlights of Reference Number: 2010-30-089 to the Internal Revenue Service Commissioners for the Small Business/Self-Employed Division and the Wage and Investment Division.

IMPACT ON TAXPAYERS

Improving service to taxpayers is one of the highest priorities for the Internal Revenue Service (IRS). Guided by its strategic plan, the IRS' vision is to make it easier for taxpayers to fulfill their civic responsibility to pay taxes by providing them with world-class service, taking proactive steps to better understand issues from the taxpayer's perspective, and reducing taxpayer burden. Consequently, it will be important for the IRS to understand and minimize the time and resources taxpayers spend dealing with soft notices to increase the likelihood of achieving its vision for improving service to taxpayers.

WHY TIGTA DID THE AUDIT

This audit was initiated because the IRS is involved in a multi-year initiative (the Initiative) to determine if soft notices can address underreporting discrepancies. Briefly stated, the notices ask the taxpayer to review their return and if they underreported their income to file an amended return.

If determined to be successful, the Initiative could result in permanently using soft notices in the IRS Automated Underreporter (AUR) Program to address a large number of taxpayers each year that would not ordinarily be contacted by the IRS due to resource constraints. Given the fact that the notices do not require any taxpayer action, questions can be raised about why the IRS would incur costs to send the notices and risk unnecessarily burdening taxpayers, especially those that result in little or no tax change.

WHAT TIGTA FOUND

This report focused on the IRS' planning activities for the Initiative. In the next phase of the review, TIGTA will assess how well the plan was implemented and managed and if reliable results were produced for deciding to expand, modify, or terminate the use of soft notices in the AUR Program.

To their credit, the IRS team responsible for conducting the Initiative addressed many key issues during their planning activities. However, TIGTA does have observations in two areas that the team may find useful. The areas involve enhancing the credibility of results and the support information for deciding whether to incorporate soft notices into the AUR Program on a permanent basis.

WHAT TIGTA RECOMMENDED

TIGTA recommended that the IRS establish criteria for determining what will constitute success for the Initiative and ensure all costs are quantified for determining the net benefit of implementing the soft notice process in the AUR Program.

IRS management agreed with the recommendations and plans to develop the metrics in the coming year to measure and report soft notice results. As for determining the net benefit of the soft notice process, IRS management responded that the large-scale rollout will be fully costed and that no corrective action is necessary. TIGTA is pleased that IRS management agreed with this recommendation. However, the absence of specific commitment on when the full-scale rollout will take place could diminish the effectiveness of an important control for assuring that key issues were considered before using soft notices in the AUR Program on a permanent basis.



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

August 27, 2010

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED
DIVISION

COMMISSIONER, WAGE AND INVESTMENT DIVISION

Michael R. Phillips

FROM:

Michael R. Phillips

Deputy Inspector General for Audit

SUBJECT:

Final Audit Report – Plans for Evaluating the Use of Soft Notices in
Addressing Underreporting Can Be Enhanced (Audit # 200930038)

This report presents the results of our review to determine whether the Automated Underreporter Program Soft Notice Initiative was effectively designed and managed to provide Internal Revenue Service (IRS) officials with reliable information for deciding whether the Initiative should be expanded, modified, or terminated. While our Fiscal Year 2010 Annual Audit Plan originally envisioned reporting and evaluating the IRS' experience under this Initiative during Fiscal Year 2010, the late start of pilot testing provided limited time for a full assessment. Accordingly, we are providing an interim report that is focused on the IRS' planning activities for the Initiative. In the next phase of the review, we will assess how well the plan was implemented and managed and if reliable results were produced for deciding to expand, modify, or terminate the use of soft notices in the Automated Underreporter Program. This review addresses the major management challenge of Tax Compliance Initiatives.

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

Copies of this report are also being sent to the IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Margaret E. Begg, Assistant Inspector General for Audit (Compliance and Enforcement Operations), at (202) 622-8510.



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Abbreviations

AUR	Automated Underreporter Program
CP	Computer Paragraph
FY	Fiscal Year
GAO	Government Accountability Office
IRS	Internal Revenue Service
TY	Tax Year



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Background

One purpose of the Automated Underreporter Program (hereafter referred to as the AUR or the AUR Program) is to resolve income discrepancies between the information taxpayers report to the Internal Revenue Service (IRS) on tax returns and related information employers and financial institutions provide the IRS on information returns. Once discrepancy cases are identified, the IRS decides how many cases it believes it has sufficient resources to investigate out of the total number identified.

Once selected, AUR cases are distributed to six IRS campuses¹ where tax examiners manually review each case. After analyzing the tax returns, tax examiners are sometimes able to immediately resolve the discrepancies, in which case no further actions are taken. For the remaining AUR cases, tax examiners may request additional information from taxpayers by sending a Computer Paragraph (CP) 2000 notice.²

If the taxpayer provides supporting documentation and the tax examiner determines the information resolves the discrepancy, the case is closed with no changes to the taxpayer's account. However, if the examiner determines the information does not resolve the discrepancy and the taxpayer agrees with the examiner's determination, the IRS will assess additional tax based on the CP 2000 notice and close the case as agreed. When a taxpayer does not agree or does not respond to the CP 2000 notice within the required time period, a Statutory Notice of Deficiency³ will be issued to assess additional tax.

Because IRS resources cannot investigate all areas of noncompliance, including AUR discrepancies, the IRS is increasingly using alternative approaches to resolve compliance issues outside its traditional processes. In the AUR Program, where millions of discrepancy cases were not investigated for Tax Year (TY) 2007, officials selected approximately 31,000 cases for mailing AUR soft notices to taxpayers.

The soft notices are called a CP 2057⁴ and do not require that the taxpayer pay more tax, provide documentation, or file an amended return. Instead, they are designed to serve as an educational tool, encourage self-correction, and improve voluntary compliance. Although the notice requests the taxpayer to file an amended return if appropriate, it is not required. By comparison, the

¹ Campuses are the data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.

² The CP 2000 notice is an IRS letter sent to a taxpayer to resolve discrepancies between income, credits, and/or deductions claimed on a tax return and those reported by a third party, as well as to propose an additional tax assessment.

³ An IRS letter sent to taxpayers notifying them of an increase in the amount of taxes they owe.

⁴ See Appendix V for an example of the CP 2057 notice.



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CP 2000 is primarily focused on compliance and indicates that the IRS has made, or is proposing, a tax change and that the taxpayer owes additional tax.

The review was performed at the IRS Wage and Investment Division Headquarters Office in Atlanta, Georgia, during the period September 2009 through April 2010. Except for not auditing the IRS Individual Master File⁵ that was used to validate the accuracy and reliability of the data, we conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. Detailed information on our audit objectives, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

⁵ The IRS database that maintains transactions or records of individual tax accounts.



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Results of Review

In the AUR Program, where millions of cases with a potentially significant amount of unreported taxes are not investigated each year, an IRS team is involved in the AUR Program Soft Notice Initiative (the Initiative). It is a multi-year initiative to determine if soft notices can address compliance issues among taxpayers that would not otherwise be subject to an AUR contact due to resource constraints. To their credit, the team responsible for carrying out the Initiative addressed many key issues recommended by the Government Accountability Office (GAO) for establishing new business processes or improving existing ones.

However, in two areas of the team's evaluation plan, we have observations that they may find useful. The first area involves the team defining what would constitute success for the Initiative. The second area involves ensuring all costs the IRS has or will incur are quantified and considered in the plan for determining the net benefit of implementing soft notices into the AUR process. By taking such actions, the team can enhance the creditability of the Initiative's results and assure senior IRS executives that important issues were considered before deciding whether to incorporate soft notices into the AUR Program on a permanent basis.

Soft Notices May Further Enhance Automated Underreporter Program Results

In Fiscal Years (FY) 2004 through 2009, IRS statistics showed the AUR Program assessed \$29.4 billion in taxes from closing 18.5 million cases involving discrepancies between the information taxpayers reported on tax returns and the related information reported by third parties. This condition indicates that, in FYs 2004 through 2009, each AUR case averaged about \$1,589 in additional assessments. Despite the seemingly high return from AUR cases, resource constraints have historically limited the AUR Program's ability to working a relatively small portion (about one-third) of the discrepancies identified each year. However, recent IRS tests have shown that it has successfully leveraged its limited resources to address noncompliance in various areas by sending soft notices that ask taxpayers to voluntarily fix their misreporting by filing an amended return or not repeating the action in the next year.



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The IRS Wage and Investment Division successfully demonstrated it can use soft notices to help address issues involving duplicate Taxpayer Identification Numbers⁶

Researchers in the IRS Wage and Investment Division assessed the impact of using soft notices as early as TY 2002 in a project that involved 820,111 taxpayers of an estimated 2.4 million taxpayers who claimed a duplicate Social Security Number for a dependent to obtain an exemption, Earned Income Tax Credit, or child tax credits. According to the researchers' Calendar Year 2005 report,⁷ the IRS received amended returns from 11.4 percent of the population that received soft notices. In addition, researchers reported that 84.9 percent of the taxpayers did not repeat the same mistake in the 2 subsequent tax years (2003 and 2004).

Because the soft notices appeared to have altered noncompliant behavior, researchers estimated that approximately \$218 million in tax revenue may have been saved after fewer Earned Income Tax Credit and/or dependency exemptions were claimed in TY 2003 by taxpayers who received soft notices. In addition, the IRS moved beyond testing soft notices on this segment of filers and now sends millions of soft notices as part of its regular business processes that address issues with duplicate Social Security Numbers.

The IRS Small Business/Self-Employed Division reported that soft notices in the AUR Program can have a beneficial impact on taxpayer behavior

In the AUR Program, researchers in the Small Business/Self-Employed Division reported positive results in November 2008 from a project called the AUR Self-Correct Letter Test. The project followed up on an earlier AUR soft notice test but incorporated statistical sampling techniques in assessing whether soft notices affect the compliance behavior of taxpayers identified as underreporting income and who are served by the Small Business/Self-Employed Division. In March 2008, the soft notices were sent to 500 randomly selected taxpayers who underreported income on their TY 2006 returns. In addition, a randomly selected control group of 500 taxpayers, who underreported income, were similarly selected but were not sent a soft notice.

According to their Calendar Year 2008 report,⁸ researchers identified four factors supporting their conclusion that soft notices can have a beneficial impact on the reporting behavior of Small Business/Self-Employed Division taxpayers. First, the soft notices generated amended returns from 46 (9 percent) of the 500 taxpayers, of which 26 owed additional taxes ranging from \$7 to \$7,560. Second, only 2 of the 500 taxpayers in the control group filed an amended return.

⁶ A nine-digit number assigned to taxpayers for identification purposes. Depending upon the nature of the taxpayer, the Taxpayer Identification Number is either an Employer Identification Number, a Social Security Number, or an Individual Tax Identification Number.

⁷ *Soft Notice for Duplicate TINs for Tax Years 2002, 2003 and 2004 Level 2 Report* (Wage and Investment Division Research Project Number 6-05-12-2-030E, dated November 29, 2005).

⁸ *AUR Self-Correct Letter Test* (Project Identification Number: DEN0081, dated November 2008).



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Third, after receiving a soft notice, 147 (29 percent) of the 500 taxpayers called the IRS seeking assistance with completing and filing an amended return. Fourth, all but one of the amended returns filed addressed the discrepancy noted in the soft notice.

Besides concluding that soft notices can have a beneficial impact on taxpayer behavior, the researchers made several recommendations to IRS executives based on lessons learned from their work. Specifically, the recommendations were aimed at strengthening support data for using soft notices in the AUR Program and included 1) partnering with the Wage and Investment Division in conducting a new project involving more taxpayers served by the Divisions, 2) using control groups and statistical sampling techniques to cover all categories of income discrepancies, 3) modifying the soft notice so it informs taxpayers of the potential consequences of not filing an amended return, 4) staggering the issuance of the soft notices to reduce the volume of calls from taxpayers seeking assistance, and 5) ensuring IRS personnel are better prepared to respond to taxpayer inquiries. In response to the recommendations, the IRS formed a team to conduct a multi-year initiative to assess if soft notices can address compliance issues among taxpayers that would not otherwise be subject to an AUR contact because of resource constraints.

Most Key Issues Were Addressed in Planning the Soft Notice Initiative

One of the best practices for developing and implementing new business processes, or for improving existing ones, is to establish an overall approach that contains detailed steps for carrying out the various phases of an initiative. For example, the GAO developed and used a 20-step approach to evaluate⁹ earlier improvement initiatives in the IRS Small Business/Self-Employed Division. The approach is based on its *Business Process Reengineering Assessment Guide*¹⁰ and discussions with managers in private industry as well as in other Federal agencies. According to the GAO, the 20 steps included in its approach help ensure potential obstacles are considered in planning, problems are pinpointed and addressed through pilot testing, and results are evaluated accurately.

We used GAO's 20-step approach as criteria to assess how closely the team considered each of the recommended steps during their planning activities for the Initiative. In making our assessment, it is important to recognize that the first six steps in the approach deal, in large part, with understanding the problem and using empirical data as the basis for deciding to implement a new process or improve an existing one. Since the team was convened after the decision was made to expand soft notice testing in the AUR Program, we used IRS statistics, the Internal Revenue Manual,¹¹ strategic planning documents, and research results to make our judgment

⁹ *Tax Administration: Planning for IRS's Enforcement Process Changes Included Many Key Steps but Can Be Improved* (GAO-04-287, dated January 2004).

¹⁰ GAO/AIMD-10.1.15, dated May 1997.

¹¹ A manual containing IRS internal guidelines.



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about these items. We believe it is equally important to recognize that, according to the GAO, a degree of discretion is involved in making judgments about each of the steps and some steps will not be appropriate for every project. As shown in Figure 1, except for the two areas indicated with an empty bubble, the team did a good job overall of planning the Initiative. Appendix IV provides additional details for each of the items in the GAO approach.

**Figure 1: Assessment of the AUR Program Soft Notice Initiative
Using Key Best Practices**

<i>Steps</i>	<i>Included</i>	<i>Comments</i>
<i>Map current process</i>	●	
<i>Identify productivity baselines</i>	●	
<i>Identify causes of poor performance</i>	●	
<i>Include complexity and quality in productivity measures</i>	●	
<i>Measure gap between current and desired productivity</i>	●	
<i>Compare current productivity to internal and external benchmarks</i>	◐	Internal but not external benchmarks considered.
<i>Use best practices</i>	◐	Used best practices from within, but not outside the IRS.
<i>Design process to close productivity gap</i>	○	Intended outcomes for success not quantified.
<i>Analyze alternatives</i>	●	
<i>Obtain executive support</i>	●	
<i>Assess barriers to implementing changes</i>	●	
<i>Assess resource needs and availability</i>	●	
<i>Conduct pilot tests</i>	●	
<i>Adjust process based on pilot</i>	●	
<i>Define roles and responsibilities</i>	●	



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<i>Steps</i>	<i>Included</i>	<i>Comments</i>
<i>Establish employee expectations</i>	<i>N/A</i>	Employee roles and responsibilities not anticipated to change.
<i>Monitor and evaluate the new process</i>	0	Intended outcomes for success not quantified.
<i>Establish a change management strategy</i>	●	
<i>Establish a transition team</i>	●	
<i>Develop workforce training plans</i>	●	
● Full ● Partial 0 No		

Source: Our analysis of GAO's 20-step approach to evaluate process improvement and data provided by the IRS.

By addressing most of the steps in planning, the team is better positioned to produce the data needed for making a more informed decision about whether the use of soft notices in the AUR Program should be expanded, modified, or terminated. For example, in the planning phase of the Initiative, we found evidence of IRS officials participating in and supporting expanded testing of soft notices in the AUR Program. As reflected in the IRS 2008 Tax Forums,¹² efforts were also made to build support and momentum for the Initiative. During the Forums, IRS officials provided an overview of the Initiative to thousands of tax return preparers and others who attended the presentations offered in major cities throughout the country.

Potential barriers were also assessed as well as resource needs, availability, and costs. For example, the Initiative originally called for coordinating with the IRS Modernization and Information Technology Services organization in automating the issuance of some 250,000 soft notices. When the computer programming resources were not available, the team decided instead to reduce the number of soft notices and issue them manually to help keep the project on track.

Notably, the team also incorporated some best practices recommended from, but not consistently used in, previous soft notice pilot tests. For example, the Initiative's first pilot test, called the TY 07 Soft Notice Test, involves significantly more taxpayers and includes representative samples from each of the major categories of discrepancies covered by the AUR Program. The samples for both the soft notices and the control group were randomly drawn from the population of TY 2007 discrepancies that were not included in the AUR Program's inventory

¹² The IRS Tax Forums are annual seminars given by the IRS at various locations around the country. They are used to communicate current information from IRS leadership and experts in the fields of tax law, compliance, and ethics to tax preparers and other interested individuals.



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due to resource constraints. Statisticians for both the IRS and the Treasury Inspector General for Tax Administration confirmed the validity of the sampling methodology so the results should be able to be projected to the population as a whole. Figure 2 provides details on the number sampled from each discrepancy type.

Figure 2: TY 2007 AUR Program Inventory for the Initiative

Discrepancy Categories	Population	Soft Notice Sample	Control Sample	Percentage of the Population	Percentage of the Sample Total
Advanced Earned Income Credit	15,043	684	684	4.5%	2.2%
Pension and retirement income	705,438	2,748	2,748	.4%	8.9%
Payments from States	326,249	766	766	.2%	2.5%
Investment income	3,031,656	8,622	8,622	.3%	28.0%
Withholding differences	260,478	767	767	.3%	2.5%
Income from rent and royalties	273,310	1,528	1,528	.6%	5.0%
Mortgage interest	1,698,767	2,113	2,113	.1%	6.9%
Agricultural subsidies	8,587	649	649	7.6%	2.1%
Gambling winnings	219,276	767	767	.3%	2.5%
Wages	1,793,576	2,194	2,194	.1%	7.1%
Nonemployee compensation	700,426	1,135	1,135	.2%	3.7%
Self-Employed	142,839	766	766	.5%	2.5%
Other	3,465,087	8,081	8,081	.2%	26.2%
Total	12,640,732	30,820	30,820		*100.0%

Source: Our analysis of IRS-provided data on AUR Program Soft Notice Initiative population for sampling and selected samples. * = Column does not add precisely due to rounding.

To their credit, the team developed an evaluation plan that includes a combination of performance measures for assessing the Initiative’s outcomes. According to the GAO, good performance measures are needed for weighing the costs of the process against expected benefits, determining whether a process is achieving desired results, and assessing if further improvements are needed.



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Plans for Evaluating the Initiative's Results Could Be Improved

The team's evaluation plan calls for collecting and measuring data on the impact soft notices have on the IRS' revenue, staff, and compliance coverage. Importantly, data will also be collected and assessed on the time and resources (burden) taxpayers spend dealing with the soft notices. Careful collection and assessment of taxpayer burden issues are vital because AUR soft notices may ultimately be sent to millions of taxpayers. In this regard, the team plans to collect and evaluate various aspects of the issue through three measures.

The first measurable item, called the screen-out rate, involves manually reviewing discrepancies identified by IRS computers before issuing a soft notice that may not be warranted. A discrepancy, for example, can be identified by IRS computers but a manual review may identify something the computer could not, such as an income item mistakenly reported on the incorrect line of a tax return. The practice of screening notices is routinely used for regular AUR notices (CP 2000) and annually results in eliminating hundreds of thousands of unnecessary notices that would have otherwise been sent to taxpayers.

The second measureable item, called the no-change rate, measures the percentage of notices that are issued to taxpayers but closed without making additional tax changes. Contacts that end with no change to taxes owed could have adjustments (e.g., reduced a reported loss but not enough to produce a tax liability). From the IRS' perspective, a closure with adjustments is viewed as a productive contact, while one without any changes is viewed as unproductive and burdensome to the taxpayer. The third item the team intends to measure is the percentage of taxpayers that sought the assistance of a paid tax preparer in dealing with the soft notice and, therefore, incurred the additional related expense.

Enhancements can be made by defining what would constitute success for the Initiative and including information about the total costs the IRS will incur

Although the team's evaluation plan includes a combination of performance measures, it could be enhanced in two areas that are typically part of a sound assessment methodology. The first area involves the team defining what it would consider a success within each of the measureable items and/or how much weight the various factors being measured will have in determining the overall success of the Initiative. Making such determinations can enhance the credibility of the Initiative's results while helping avoid any perception of bias.

The second area involves ensuring all costs the IRS has or will incur are quantified and considered in the plan for determining the net benefit of implementing soft notices into the AUR process. During our early discussions with IRS officials about this Initiative, we learned a contractor was heavily involved in designing the management information system that is being used to capture, track, and analyze taxpayer responses to the soft notices. Consequently, it will be important to ensure contractor expenses are considered as well as the costs associated with preparing and issuing the notices.



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While the preparation and issuance of the notices is expected to be largely automated, these costs could rise substantially if the IRS needs to process payments and amended returns because of the additional processing involved with mail sorting, computer data input, data verification, and deposit. In addition, costs will be incurred when the receipt of the notice by the taxpayer generates further correspondence between taxpayers and the IRS. In these instances, there will be costs associated with IRS personnel responding directly to the taxpayer regarding the correspondence or the information provided.

By specifying all costs in their plan, as well as benefits, the team can establish an important control for assuring IRS senior executives that important issues were considered before deciding to incorporate soft notices into the AUR Program on a permanent basis. Moreover, reliable cost-benefit information may help alleviate concerns that could be raised about why the IRS incurs the costs associated with sending the notices, particularly when those notices result in no or small tax changes, because they do not require any taxpayer action.

Recommendations

The Director, Compliance, Wage and Investment Division, and the Director, Campus Compliance Services, Small Business/Self-Employed Division, should coordinate actions to:

Recommendation 1: Establish criteria for determining what will constitute a success for the Initiative, including the relative weight, if any, that will be given to the various performance measures and whether there are specific thresholds that must be achieved to be considered successful.

Management's Response: IRS management agreed that criteria for measuring success are important. They will continue to refine case selection criteria each year to identify the best candidates for soft notices. In the coming year, the IRS will develop the metrics and establish the criteria necessary to measure and report soft notice results.

Recommendation 2: Ensure all costs the IRS has or will incur are quantified and considered in the plan for determining the net benefit of implementing soft notices into the AUR process.

Management's Response: IRS management agreed with this recommendation but responded that no corrective action is necessary. According to IRS management, the large-scale rollout will be fully costed as a budget initiative for the Wage and Investment Division Submission Processing and Accounts Management functions. According to the response, all costs will be captured for measuring success and reporting the cost-benefit of soft notices to the AUR Program.

Office of Audit Comment: We are pleased that IRS management agreed with the recommendation and recognized the need for measuring success and reporting the cost-benefit of soft notices to the AUR Program. However, the absence of specific commitment on when the full-scale rollout will take place could diminish the



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effectiveness of an important control for assuring that key issues were considered before deciding to incorporate soft notices into the AUR Program on a permanent basis.



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Appendix I

Detailed Objectives, Scope, and Methodology

The overall objectives of this review were to determine whether the AUR Program Soft Notice Initiative (the Initiative) was effectively designed and managed to provide IRS officials with reliable information for deciding whether the Initiative should be expanded, modified, or terminated. As part of the review, we relied on databases provided to us by the IRS and did not audit the source systems. Unless otherwise noted, our limited tests of the reliability of data obtained from the IRS did not identify any errors. We tested the reliability of the data by scanning the data received for blank, incomplete, illogical, or improper data. In addition, we traced a judgmental sample of the data to the source information on the IRS Individual Master File¹ to ensure accuracy. To accomplish our objectives, we:

- I. Determined if the IRS developed a business case or its elements for the AUR Program Soft Notice Initiative, took steps to identify obstacles, and implemented the Initiative with good management practices in place.
 - A. Obtained and analyzed prior IRS research studies related to soft notices.
 - B. Interviewed AUR Program management to identify the purpose and goals of the AUR Program Soft Notice Initiative. We secured and evaluated the elements of the business case that were developed for the AUR Program Soft Notice Initiative to determine whether agency priorities and direction were addressed.
 - C. Interviewed AUR Program management and obtained documentation for review to evaluate whether steps were taken to ensure potential implementation obstacles were considered in planning the AUR Program Soft Notice Initiative and whether results were monitored and evaluated.
 - D. Determined if the IRS addressed key design issues in the Initiative using the GAO process reengineering approach as criteria (see Appendix IV).
 - E. Determined if the AUR Program Soft Notice Initiative was implemented with good management practices. We analyzed the methodology used to measure the results of the Initiative.
 - F. Obtained AUR Program business result statistics related to inventory and case closures for background purposes.

¹ The IRS database that maintains transactions or records of individual tax accounts.



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- II. Assessed the statistical validity of the IRS' sampling methodology and analyzed the population and sampled taxpayers by discrepancy type.
 - A. Obtained from the IRS the sampling model developed by the Statistics of Income Division.
 - B. Obtained confirmation on the validity of the sampling methodology from statisticians working for the IRS and the Treasury Inspector General for Tax Administration.
 - C. Analyzed the overall population of cases identified by the AUR Program as having an income discrepancy for TY 2007 from which the soft notice and AUR control samples were selected.
 - D. Analyzed the soft notice and AUR control samples' composition by discrepancy type and percentage of the population.

Internal controls methodology

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We did not review internal controls in this review because our scope was limited to evaluating the planning of the AUR Program Soft Notice Initiative.



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Appendix II

Major Contributors to This Report

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Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Deputy Commissioner for Services and Enforcement SE
Deputy Commissioner, Small Business/Self-Employed Division SE:S
Deputy Commissioner, Wage and Investment Division SE:W
Director, Campus Compliance Services, Small Business/Self Employed Division SE:S:CCS
Director, Compliance, Wage and Investment Division SE:W:CP
Director, Strategy and Finance, Wage and Investment Division SE:W:S
Director, Reporting Compliance, Wage and Investment Division SE:W:CP:RC
Chief, Performance Improvement, Wage and Investment Division SE:W:S:PRA:PEI
Chief Counsel CC
National Taxpayer Advocate TA
Director, Office of Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis RAS:O
Office of Internal Control OS:CFO:CPIC:IC
Audit Liaisons:
 GAO/TIGTA Liaison, Small Business/Self-Employed Division SE:S
 Senior Operations Advisor, Wage and Investment Division SE:W:S



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Appendix IV

*Recommended Approach for Business
Process Changes*

The three figures in this appendix present summary information on the criteria the GAO developed for use when considering, planning, and implementing new or improving existing business processes. The GAO developed the approach based on its *Business Process Reengineering Assessment Guide* and discussions with top-level managers in private industry as well as in other Federal agencies.

Figure 1: Recommended Steps in Considering a Potential Process Change

<i>Steps</i>	<i>Description</i>
<i>Map current process</i>	Similar to flowcharting, process mapping is a graphical representation of the various activities, procedures, roles, and responsibilities within one or more business processes. Its purpose is to help present a clear picture of the current processes to help identify the root causes for under performance and achieve the desired level of improvement.
<i>Identify productivity baselines</i>	Baseline data are needed to provide measures from the current processes to use in comparing the level of improvement achieved by the new process.
<i>Identify causes of poor performance</i>	This step involves identifying the factors or combination of factors that are causing the poor performance in the current process. Examples could include a lack of resources and/or regulatory requirements.
<i>Include complexity and quality in productivity measures</i>	Productivity measures the efficiency with which a process uses resources to produce a product or service, such as the number of audits an IRS examiner completes in a month. To be accurate, a combination of measures is generally needed and consideration needed to be given to the level of difficulty involved.
<i>Measure gap between current and desired productivity</i>	Ideally, the level of performance improvement desired should be achievable and based on empirical data that define where a particular performance level is and where the level of improvement is sought.
<i>Compare current productivity to internal and external benchmarks</i>	Benchmarks are measures from which performance improvement can be quantified. They provide reference points that can be used to help identify and close performance gaps between processes used in other organizations and/or in different functions within the same organization.

Source: The GAO and our analysis of the GAO Business Process Reengineering Assessment Guide (May 1997).



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Figure 2: Recommended Steps for Planning a Process

<i>Steps</i>	<i>Description</i>
<i>Use best practices</i>	Identifying and using best practices is a form of benchmarking that involves adapting practices of others to reach new improvement levels. It is especially recommended that government agencies use business organizations in private industry for this purpose.
<i>Design process to close productivity gap</i>	Quantitative data are needed to support changing to a new process that shows the change will narrow the gap between current performance and the desired level of performance level. To add credibility and avoid any perception of bias in making the change, the desired level of performance sought should be specified.
<i>Analyze alternatives</i>	Alternative process changes that may produce the same level of improvement should be explored in terms of their relative costs and benefits. Such exploration can be done through limited testing and may identify a more cost-effective approach to achieving the same or similar results.
<i>Obtain executive support</i>	Executive support and oversight throughout a process change is important for a number of reasons that include ensuring resources are available, securing support from internal and external stakeholders, and approving proposed recommendations for implementation.
<i>Assess barriers to implementing changes</i>	Identifying and assessing the costs of overcoming potential barriers to implementing a change is important because it may ultimately prove to be too great a burden. Examples of barriers could include laws, regulations, employee union agreements, lack of resources, current political environment, and/or lack of executive support.
<i>Assess resource needs and availability</i>	Before initiating a process improvement project, it is important to ensure the resources are available to design, plan, and implement the change. Otherwise, there is a risk the new change will only be partially implemented.

Source: The GAO and our analysis of the GAO Business Process Reengineering Assessment Guide (May 1997).



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Figure 3: Recommended Steps for Implementing a Process Change

Steps	Description
Conduct pilot tests	In short, pilot testing is designed to show intended benefits from a change can in fact be realized. It involves evaluating how well the process change works in practice, pinpointing and correcting problems, and refining performance measures. Importantly, it can also strengthen executive and other stakeholder support for moving from testing to full-scale operation.
Adjust process based on pilot	This step is designed to incorporate and test needed changes to the new process based upon lessons learned in earlier pilot testing.
Define roles and responsibilities	To ensure accountability, it is vital to designate the specific personnel who will be responsible for making the process improvement.
Establish employee expectations	Developing and issuing new performance expectations needs to be considered and developed if the new process causes traditional roles, responsibilities, and expectations to change for employees.
Monitor and evaluate the new process	An evaluation plan is one of the first steps needed for evaluating the success of process change and needs to include a combination of performance measures for weighing the costs of the new process against expected benefits, determining whether the process is achieving desired results, and assessing if further improvements are needed. To enhance credibility and avoid potential bias, the criteria about what would constitute a success needs to be defined.
Establish a change management strategy	Change management is a structured approach for how best to address the transitional issues associated with moving to a new process. These issues, among others, include addressing resistance that may be encountered within an organization or work unit to a new way of conducting business. The approach should be designed to build support and positive attitudes for the change.
Establish a transition team	Typically, a transition team is responsible for managing the implementation of a new process. As such, the team should develop a plan that communicates the various aspects of the new process, its goals, and how it will be implemented.
Develop workforce training plans	In general, employee training plans need to be considered and developed if the change is going to significantly alter traditional roles and responsibilities. For example, employees may need training to learn new technical or communication skill sets if they are going to successfully take on new responsibilities or be expected to work more independently under the new process.

Source: The GAO and our analysis of the GAO Business Process Reengineering Assessment Guide (May 1997).



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Appendix V

Example of a Computer Paragraph 2057 Notice¹

Department of the Treasury
Internal Revenue Service
 PO Box XXXXX
 City, ST XXXXX-XXXX

Social Security Number: XXX-XX-XXXX

Tax Year: 2007

Taxpayer Name(s)
 PO BOX – Street Address
 City, State, Zip Code

To call for assistance:
 1-800-829-XXXX Toll Free
 between 7:00 AM and 8:00 PM

Check Your Records to Confirm the Income You Received

Why We're Sending You This Notice

The amount of income/deduction reported on your 2007 tax return is different from the amount reported to us by third party payers such as employers, financial institutions, etc. We've listed the issue(s) in question, as reported by third parties, on page three of this letter.

What You Need To Do Now

Please compare the amount reported to us on page three of this letter with the amount reported on your 2007 return. If you need a copy of your return, complete Form 4506, *Request for Copy of Tax Return*, and send it to the IRS office where you filed your tax return. You can request forms at www.irs.gov or by calling 1-800-829-3676.

If the amount reported on your return is . . .	Then . . .
Correct	<ul style="list-style-type: none"> •Do not call or respond to the IRS in reference to this letter. •Contact the payer if you believe the amount was incorrectly reported to the IRS and request that the payer verify and correct his records if necessary. <p>If the amount is not corrected before filing future returns, you may continue to have similar reporting problems.</p>

¹ All dates, monetary, and taxpayer identifying information contained in this example are hypothetical.



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If the amount reported on your return is . . .	Then:
Not Correct	<ul style="list-style-type: none">• Correct your return by completing the enclosed Form 1040X, <i>Amended U.S. Individual Income Tax Return</i>.• Securely attach the completed Form 1040X to a copy of this notice and send to IRS, PO Box XXXXX, City, ST, XXXXX-XXXX. An envelope is enclosed for your convenience. <p>Failure to file an amended return may result in further action by the IRS to verify the correct amount is reported on your return.</p>

What To Do If You Need Assistance

If you have questions or need help, please call our toll-free number 1-800-829-XXXX.

Sincerely yours,



XXXX XXXXXXXX
Operations Manager

Enclosures:
Form 1040X, *Amended U.S. Individual Income Tax Return*
Instructions for Form 1040X
Envelope
Copy of this Notice



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Gross Pensions - Payer Information	Amount Reported to the IRS:
#001 SSN: XXX-XX-0009 Form 1099-R Account: 00000099205959493056 EIN: XX-XXXXXXX LIFE INSURANCE COMPANY XXXXXX AMERIPRISE FINANCIAL MINNEAPOLIS, MN XXXXX-XXXX	Gross Pensions \$
#002 SSN: XXX-XX-0009 Form 1099-R Account: 94652040240009000001 EIN: XX-XXXXXXX BANK OF N.A. DEPOSIT PRODUCT OPERATION CITY – STATE – ZIP CODE	Gross Pensions \$
#003 SSN: XXX-XX-0009 Form 1099-R Account: 94652053240821000001 EIN: XX-XXXXXXX BANK OF N.A. DEPOSIT PRODUCT OPERATION CITY – STATE – ZIP CODE	Gross Pensions \$
#004 SSN: XXX-XX-0009 Form 1099-R Account: PBGC1 187965 EIN: XX-XXXXXXX PENSION PAYMENTS RETIREMENT CITY – STATE – ZIP CODE	Gross Pensions \$
Total Amount of Gross Pensions	\$



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Taxable Social Security Benefits - Payer Information	Amount Reported to the IRS:
#001 SSN: XXX-XX-0009 Form SSA-1099 Taxable Social Security Benefits Account: EIN: XX-XXXXXXX SOCIAL SECURITY ADMINISTRATION	\$
#002 SSN: XXX-XX-0009 Form SSA-1099 Taxable Social Security Benefits Account: EIN: XX-XXXXXXX SOCIAL SECURITY ADMINISTRATION	\$
Total Amount of Taxable Social Security Benefits	\$



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Appendix VI

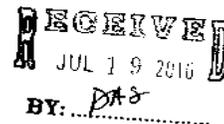
Management's Response to the Draft Report



COMMISSIONER
WAGE AND INVESTMENT DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

July 19, 2010



MEMORANDUM FOR MICHAEL R. PHILLIPS
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Richard Byrd, Jr. *Richard Byrd*
Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report – Plans for Evaluating the Use of Soft Notices
in Addressing Underreporting Can Be Enhanced
(Audit # 200930038)

We have reviewed the subject draft report and appreciate the acknowledgement that the IRS team conducting the initiative did a good job overall. We also agree that our planning addressed most key issues, recommended by the Government Accountability Office, for establishing new business processes or improving existing ones. We share your view that recent IRS tests have shown we can effectively leverage our scarce Automated Underreporter Program (AUR) resources by sending soft notices to taxpayers so they can voluntarily self-correct any misreported or unreported income. This will also assist in avoiding repeat errors in subsequent years. As noted in your report, these tests also clearly indicate soft notices have a beneficial impact on taxpayer reporting behavior, and produce savings in tax revenue without the need for direct IRS enforcement action.

We also appreciate your recommendations for enhancing our plans for evaluating the soft notice initiative results. With regard to establishing criteria for measuring success, it is important to note that starting with our first comprehensive soft notice pilot for Tax Year (TY) 2007, IRS has had a set of six objectives, and one or more accompanying measures for each objective, for a total of 17 measures. We will use these measures for TY 2008 and TY 2009 as we continue to refine case selection to identify the best candidates for soft notices. In addition, beginning with TY 2009, taxpayer responses to AUR soft notices will be processed by the Wage and Investment Division (W&I) Submission Processing and Accounts Management staffs. There are currently no readily available means to capture data, from these Functions, on the revenue generated from amended returns or from changes in subsequent year behavior, specifically attributable to soft notices. As a result, in the coming year, we will develop the metrics and establish the criteria necessary to measure and report soft notice results.



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Regarding the recommendation to ensure all costs are quantified, we had measurements in place to track costs for the TY 2007 pilot, and are also using them for the small scale soft notice issuances for TY 2008 and TY 2009. The large scale rollout will be fully costed as a budget initiative for Submission Processing and Accounts Management. Therefore, this corrective action is unnecessary.

If you have any questions, please contact me, or a member of your staff may contact R. Ray Johnson, Acting Director, Reporting Compliance, Wage and Investment Division, at (404) 338-8983.

Attachment



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Attachment

The Director, Compliance, Wage and Investment Division, and the Director, Campus Compliance Services, Small Business/Self-Employed Division, should coordinate actions to:

RECOMMENDATION 1

Establish criteria for determining what will constitute a success for the Initiative, including the relative weight, if any, that will be given to the various performance measures and whether there are specific thresholds that must be achieved to be considered successful.

CORRECTIVE ACTION

We agree that criteria for measuring success is important. We have developed, and are using, measurements to refine case selection for the small scale soft notice issuances. We will use these measures for Tax Year (TY) 2008 and TY 2009 as we continue to refine case selection to identify the best candidates for soft notices. In addition, beginning with TY 2009, taxpayer responses to Automated Underreporter Program (AUR) soft notices will be processed by the Wage and Investment Division (W&I) Submission Processing and Accounts Management staffs. There are currently no readily available means to capture data, from these Functions, on the revenue generated from amended returns or from changes in subsequent year behavior, specifically attributable to soft notices. As a result, in the coming year, we will develop the metrics and establish the criteria necessary to measure and report soft notice results.

IMPLEMENTATION DATE

January 15, 2012

RESPONSIBLE OFFICIALS

Director, Reporting Compliance, Wage and Investment Division
Director, Reporting Compliance, Small Business/Self Employed Division

CORRECTIVE ACTION MONITORING PLAN

We will monitor this corrective action as part of our internal management control system.

RECOMMENDATION 2

Ensure all costs the IRS has or will incur are quantified and considered in the plan for determining the net benefit of implementing soft notices into the Automated Underreporter process.



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CORRECTIVE ACTION

We agree with the recommendation, but no corrective action is necessary. The large scale rollout will be fully costed as a budget initiative for W&I Division Submission Processing and Accounts Management functions. All costs, including contractor expenses, if any, will be captured and included in the above mentioned plan for measuring success and reporting the cost-benefit of soft notices to the AUR.

IMPLEMENTATION DATE

Completed.

RESPONSIBLE OFFICIALS

Director, Reporting Compliance, Wage and Investment Division
Director, Submission Processing, Wage and Investment Division
Director, Accounts Management, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

N/A