



Management Has Emphasized the Fraud Program, but Opportunities Exist to Further Improve It

September 18, 2007

Reference Number: 2007-30-179

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TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

September 18, 2007

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED
DIVISION

Margaret E. Bezz

FROM: (for) Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Management Has Emphasized the Fraud Program,
but Opportunities Exist to Further Improve It (Audit #200630009)

This report presents the results of our review of the Internal Revenue Service (IRS) National Fraud Program. The overall objectives of this review were to determine whether Examination function employees are identifying potential fraud cases and referring cases to the Criminal Investigation (CI) function when appropriate and to evaluate the effectiveness of the fraud technical advisor (advisor) position.¹ This audit was conducted as part of the annual audit plan.

Impact on the Taxpayer

IRS procedures require that identification and development of potential criminal fraud and civil fraud penalty cases be considered during all examinations conducted by the Examination function. When initial indicators of fraud² are identified, the examiner should consult with his or her group manager and then contact an advisor as soon as possible for technical guidance and advice. Although examiners are generally identifying cases with potential indicators of fraud, the case documentation indicated they did not fully develop fraud issues or did not contact an advisor, when appropriate, in some cases. Criminal prosecution and civil fraud penalty assessment serve as deterrents to noncompliance and enhance voluntary tax compliance.

¹ Advisors have various responsibilities, such as providing technical and procedural fraud advice in the identification and development of potential criminal fraud referrals and civil fraud penalty cases.

² Fraud indicators consist of one or more acts of intentional wrongdoing on the part of the taxpayer with the specific purpose of evading tax.



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Synopsis

National Fraud Program office and Examination function management have continuously emphasized the importance of identifying fraud indicators through various efforts, including training. Examiners are documenting when they consider fraud during an examination and generally are identifying fraud indicators. However, in 11 (14 percent) of the 77 cases reviewed, examiners did not adequately identify fraud indicators, fully develop fraud issues, or contact an advisor when appropriate. In addition, in 15 (26 percent) of 58 cases, the examiners did not timely discuss the substantial understatement of income with their group managers, as required.

As a result of not properly identifying or fully developing potential fraud issues on six cases, the IRS may not deter noncompliance and could fail to collect revenue because penalties were not assessed. In addition, if the IRS does not address tax fraud among those who generally do not comply, voluntary tax compliance may decrease among those taxpayers who generally do comply.

Our review of 30 Examination function cases being developed for fraud issues and referred to advisors showed advisors were sufficiently involved but maintained inconsistent documentation for the cases. Fraud referral and civil fraud penalty statistics indicate that, overall, the Fraud Referral Program has helped to increase the number of referrals and civil fraud penalties assessed since Fiscal Year 2001, when the advisor groups were established. In the Examination function, the acceptance rate has increased. However, the number of Examination function referrals sent to and accepted by the CI function has increased only somewhat since Fiscal Year 2001 and had some upward and downward trends during that time. We believe that, with continued emphasis by IRS top management and by implementing our recommendations, the IRS could improve the quality of fraud development and increase the number of Examination function fraud referrals sent to and accepted by the CI function.

Recommendations

We recommended the Director, Examination, and Director, Fraud/Bank Secrecy Act, reinforce the requirements to timely contact an advisor when *initial* indicators of fraud exist, properly complete the Fraud Development Status (Form 11661) as required and whenever the advisor participates in a significant discussion during the examination, require examiners to update Form 11661 by contacting the advisor prior to closing the case, and emphasize the requirement for examiners to timely discuss with the group manager those cases with substantial amounts of unreported income. In addition, the Director, Fraud/Bank Secrecy Act, should establish a formal documentation process that tracks advisor involvement in cases, including requirements to maintain adequate and consistent records.



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Response

The Commissioner, Small Business/Self-Employed Division, agreed with the recommendations and is taking corrective actions. The Small Business/Self-Employed Division Examination function emphasized the appropriate coordination with advisors and proper use of Form 11661 in a joint memorandum issued in June 2006. The Small Business/Self-Employed Division Examination function and the Director, Fraud/Bank Secrecy Act, will continue to emphasize this guidance and will issue an additional memorandum to examiners reinforcing managerial involvement and recordation of discussions. In addition, Small Business/Self-Employed Division management is in the process of implementing program changes that will enable tracking of advisor involvement in cases and that will establish minimum recordkeeping requirements for advisors. On June 1, 2007, the National Fraud Program implemented an advisor planning tool that enables advisors to maintain adequate and consistent records. Testing is complete, and training will be conducted to ensure advisors have sufficient skills to fully use the planning tool. Management's complete response to the draft report is included as Appendix V.

Copies of this report are also being sent to IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Daniel R. Devlin, Assistant Inspector General for Audit (Small Business and Corporate Programs), at 202-622-5894.



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Abbreviations

CI	Criminal Investigation
FY	Fiscal Year
IRS	Internal Revenue Service



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Background

Tax fraud is a deliberate, conscious, purposeful violation of internal revenue laws by taxpayers who do not file and properly report their income and expenses. It requires both an underpayment and fraudulent intent. The Internal Revenue Service (IRS) states tax fraud is one of the most egregious forms of taxpayer noncompliance. The primary purpose of the IRS National Fraud Program is to foster voluntary compliance through the recommendation of criminal prosecutions and/or civil fraud penalties against taxpayers who evade the payment of taxes known to be due and owed.

The primary objective of the National Fraud Program is to foster voluntary tax compliance through the recommendation of criminal prosecutions and/or civil fraud penalties.

The identification of potential criminal fraud and civil fraud penalty cases by examiners within the IRS Examination function is an important part of this process. The Fiscal Years (FY) 2006 and 2007 Examination program letters require that the identification and development of fraud be considered in all examinations and list potential fraud as one of the Program priorities.

In supporting this priority, the IRS National Fraud Program office is responsible for coordinating the establishment of fraud strategies, policies, and procedures. This includes coordinating a Fraud Referral Program with the Examination function to assist examiners in identifying fraud and developing fraud cases. In FY 2001, the Small Business/Self-Employed Division established five fraud technical advisor¹ (advisor) groups to assist examiners with their criminal fraud referrals and civil fraud penalty assessments. The advisors play a vital role in the development of potential fraud cases by providing to the examiners technical and procedural fraud advice in the identification and development of potential criminal fraud and civil fraud penalty cases. When indicators of fraud² exist, the advisor has the opportunity to assist early in the development of the fraud case to ensure proper evidence and documentation is obtained before (1) a civil fraud penalty is assessed or (2) a criminal fraud case is referred to the Criminal Investigation (CI) function.

A civil fraud penalty case may be developed based on facts and circumstances of a civil examination or for civil settlement of a criminal prosecution case. Civil fraud penalty cases no longer require a referral to the CI function; the penalty determination is now the shared

¹ In 2004, the IRS changed the title of the fraud referral specialist to fraud technical advisor.

² Fraud indicators consist of one or more acts of intentional wrongdoing on the part of the taxpayer with the specific purpose of evading tax.



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responsibility of the Examination function and the advisors, with the final decision made by Examination function management.

The CI function has the authority to investigate criminal tax violations. When firm indications of fraud exist and criminal criteria are met, the examiner should refer the case to the CI function. Fraud referrals are an important source of cases for the CI function.

In an effort to maintain or increase focus on the number of quality fraud referrals made and in response to our prior recommendations,³ the IRS has been continuously involved in improving the Fraud Referral Program. The Examination function, National Fraud Program office, and CI function are committed to working together to deploy a successful Fraud Referral Program.

This review was performed in the Small Business/Self-Employed Division Examination function, the Small Business/Self-Employed Division Fraud Policy and Operation office, and the CI function offices in ^{(b)(4)} and in the Small Business/Self-Employed Division National Headquarters in New Carrollton, Maryland, during the period July 2006 through May 2007. The audit was conducted in accordance with *Government Auditing Standards*. Detailed information on our audit objectives, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

³ *More Consideration Is Needed During Examinations to Identify Potential Fraud Issues and Refer Cases to Criminal Investigation* (Reference Number 2001-30-063, dated March 2001).



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Results of Review

Management Has Emphasized the National Fraud Program

Small Business/Self-Employed Division management continues to emphasize the National Fraud Program. For example, in FY 2006, National Fraud Program office management added two more advisor groups to increase the assistance being provided to the IRS operating divisions, including the Examination function. In addition, National Fraud Program office management considers outreach and education a part of the advisors' duties.

Examination function management continues to emphasize the Fraud Referral Program to improve the identification and development of potential fraud cases. There has been an ongoing effort, with assistance from the National Fraud Program office and the CI function, to refine the Examination function's fraud process by revising several parts of the fraud training provided to Examination function field office employees. For example, in FY 2006, the Examination function revised the fraud training module by adding more participation from the advisors and the CI function, included fraud case scenarios in the continuous professional education training, and added a new training module covering the identification of unreported income. In addition, the Examination function clarified instructions and provided training reinforcing the fraud referral process. There is also a Fraud Digest, which is provided to all Small Business/Self-Employed Division employees to highlight the tools and techniques used to combat fraud.

Examiners Generally Identified Fraud Indicators, but More Could Have Been Done to Develop the Fraud Issues in Some Cases

IRS procedures require that identification and development of fraud be considered during all examinations. Once examiners identify fraud indicators, they should take actions to fully develop the potential fraud issues and involve an advisor in the process. Fraud indicators include substantial understatement of income; substantial overstatement of deductions with no explanation; and certain taxpayer conduct such as being deceptive, not providing information, and providing false documentation. When initial indicators of fraud are identified, the examiner should consult with his or her group manager and then contact an advisor as soon as possible for technical guidance and advice. This gives the advisor the opportunity to assist early in the development of the case and work with the examiner and manager to develop an action plan. When the examiner, the group manager, and the advisor agree the potential for fraud exists, they



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update the case to fraud development status⁴ by completing the Fraud Development Status (Form 11661), which is used to document the decision made to develop the case for fraud. Later, if the examiner determines the potential for fraud does not exist, he or she should contact the advisor before returning the case to regular examination status.

Examiners made proper decisions regarding fraud indicators on most cases

Review of our judgmental sample of 77 closed Examination function cases showed examiners are properly documenting the case files when they consider fraud and generally are identifying fraud indicators.

- In 51 cases (66 percent), examiners documented that they considered fraud and properly identified there were no fraud indicators.
- In 9 cases (12 percent), examiners properly identified fraud indicators and developed the issues, but the facts of the cases did not result in fraud determinations.
- In 6 cases (8 percent), there did not appear to be fraud present; however, we could not make a determination because there was not enough documentation in the case file.
- In 11 cases, we identified the following:
 - ▶ Examiners either did not adequately identify indicators of fraud or fully develop the fraud issues in six cases.
 - ▶ Examiners did not contact an advisor or prepare a Form 11661 when appropriate in nine cases.⁵

Examiners did not fully develop fraud issues in six cases

In the six cases, case file documentation indicated examiners either did not adequately identify fraud indicators or fully develop fraud issues.

- In two cases, examiners did not identify fraud indicators and the cases could have resulted in potential fraud referrals to the CI function. Reasons for potential fraud on these two cases included taxpayers failed to keep adequate records, refused to make certain records available, and substantially understated income on their tax returns.
- In four cases, examiners properly identified fraud indicators but did not document why the issues were not pursued. Potential fraud issues not pursued included substantial amounts of personal expenditures deducted, concealment of bank accounts, substantial overstatement of business expenses, amounts on the tax return not in agreement with amounts in books and records, and alterations made on the books and records. Our

⁴ A computer database is used to control Examination function cases by various statuses.

⁵ The nine cases include four of the six cases mentioned above and five additional cases.



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review indicated one case had the potential to be a referral to the CI function and three cases could have had the civil fraud penalty assessed.

We believe these six cases occurred because of the increase in new staffing and the loss of experienced examiners. Since January 2005, the IRS has hired approximately 500 new revenue agents⁶ and 140 new tax compliance officers⁷ and has lost many experienced agents. Examination function management informed us that fraud cases are more complex and, with the hiring of new examiners and loss of experienced agents, it is a challenge to work the cases. Also, in most cases, examiners did not clearly document why the fraud investigation was dropped.

As a result of not adequately identifying or fully developing potential fraud issues on the six cases, the IRS may not deter noncompliance and could fail to collect revenue because penalties were not assessed. These six cases either met the criteria to be referred as potential criminal cases and could have had the civil fraud penalty assessed at the civil settlement or could have had only the civil fraud penalty assessed. The aggregate underpayment of taxes for these 6 cases was approximately \$576,000; the estimated civil fraud penalties would be approximately \$432,000 based on the 75 percent civil fraud penalty rate.⁸

In addition, the IRS states that criminal prosecution and civil fraud penalty assessments serve as significant deterrents to noncompliance and enhance voluntary tax compliance. Therefore, if the IRS does not address tax fraud among those who generally do not comply, voluntary tax compliance may decrease among those taxpayers who generally do comply.

Examiners did not contact an advisor or prepare a Form 11661 when appropriate in nine cases

In the nine cases, the examiners and group managers did not adequately involve an advisor when indicators of fraud were present.

- In four cases, examiners contacted an advisor and completed Form 11661, as required; however, they removed the cases from fraud development status without notifying the advisors so the advisors could update the National Fraud Program database of cases.
- In two cases, examiners identified strong indicators of fraud and discussed them with an advisor; however, they did not complete the required Form 11661, so these cases with fraud potential did not show advisor involvement.

⁶ Employees in the Examination function that conduct face-to-face examinations of more complex tax returns such as businesses, partnerships, corporations, and specialty taxes (e.g., excise tax returns).

⁷ Employees in the Examination function that primarily conduct examinations of individual taxpayers through interviews at IRS field offices. The position title was changed in 2002 from tax auditor to tax compliance officer.

⁸ See Appendix IV for details.



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- In three cases, examiners did not contact an advisor for guidance although indicators of fraud were present or identified.

By not contacting an advisor, who is a subject-matter expert, when applicable, examiners may not properly develop a case, thus affecting the outcome of the fraud investigation. For example, our case review indicated the fraud development was terminated on these nine cases, yet there was not enough evidence documented in the case files to support the resolutions.

Examination function management informed us one reason an advisor is not contacted early in the process is because some group managers are very experienced and have enough knowledge to develop a potential fraud case without involving an advisor. In addition, group managers may want the examiner to do more work to develop the intent or to determine there are not enough fraud indicators before they contact the advisor. However, this decreases the effectiveness of the advisor program, which was established to involve advisors early in the process and to improve fraud referrals. Also, the information obtained from Form 11661 is input to a National Fraud Program database, which identifies the cases advisors were involved with and how those cases were resolved. If Form 11661 is not used properly, the National Fraud Program database will not provide complete and accurate data.

Examiners did not always discuss cases with managers when there was a substantial understatement of income

In addition to identifying and developing fraud cases, IRS procedures require the examiner to discuss the case with the group manager when the examination of reported income on a tax return reveals an understatement of income meeting a certain dollar criteria in a given year. The purpose of this discussion is to ensure the group manager can provide advice on the audit techniques to use and the depth of the examination. In addition, understatement of income is an indicator of potential fraud.

Our review of 77 cases showed 58 cases met the prescribed dollar criteria. In 15 (26 percent) of these 58 cases, examiners did not timely discuss the understatement of income with the group managers.

Reasons for this include examiners did not follow procedures and group managers may not have been involved early enough in the cases. We did not identify documented managerial involvement in the cases early in the examination process when advice would be most needed, although in most of these cases, group managers were involved prior to closing the cases.

If cases with substantial understatement of income are not discussed with the group manager, the examiner may not consider the expansion of the examination depth or specific audit techniques that can be used. Understatement of income is one of the most prevalent ways to hide income



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and could be an indicator of potential fraud by the taxpayer. In addition, a recent study⁹ showed the estimated gross tax gap¹⁰ was \$345 billion and 80 percent is caused by the underreporting of income or overstating of deductions and credits.

Recommendation

Recommendation 1: The Director, Examination, and Director, Fraud/Bank Secrecy Act, should reinforce the requirements to timely contact an advisor when *initial* indicators of fraud exist, properly complete Form 11661 as required and whenever the advisor participates in a significant discussion during the examination, require examiners to update Form 11661 by contacting the advisor prior to closing the case, and emphasize the requirement for examiners to timely discuss with the group manager those cases with substantial amounts of unreported income.

Management's Response: IRS management agreed with the recommendation. The Small Business/Self-Employed Division Examination function emphasized the appropriate coordination with advisors and proper use of Form 11661 in a joint memorandum issued in June 2006. The Small Business/Self-Employed Division Examination function and the Director, Fraud/Bank Secrecy Act, will continue to emphasize this guidance and will issue an additional memorandum to examiners reinforcing managerial involvement and recordation of discussions, in accordance with the Internal Revenue Manual.

Fraud Technical Advisors Are Involved in Cases but Should Maintain Better Documentation

Advisors have various responsibilities, such as providing technical and procedural fraud advice to examiners to help identify and develop potential criminal fraud referrals and civil fraud penalty cases. In addition, advisors assist in the development and delivery of technical fraud training materials as well as procedural information. This is provided through a variety of methods such as the Fraud web site, Continuing Education Programs, classroom training, and newsletters. Also, they collaborate with the CI function to identify and classify potential fraud leads.

The examiner, group manager, and advisor should jointly develop an action plan as early as possible to document the fraud indicators identified and the next steps to follow. Our review of a judgmental sample of 30 examination case files for 2 advisors showed, based on the records kept

⁹ *A Comprehensive Strategy for Reducing the Tax Gap*, United States Department of the Treasury, Office of Tax Policy (dated September 26, 2006).

¹⁰ The "gross tax gap" is the difference between the amount of tax that taxpayers should pay under the tax law and the amount they actually pay on time.



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by the examiners, the advisors provided adequate input for the cases. However, the documentation maintained by the advisors in their own files for these 30 cases indicated they did not keep any type of documentation of an action plan or advice given in 7 cases (23 percent). In addition, the advisors kept inconsistent records on the 30 cases. For example, in some cases, we saw a plan of action attached to the Form 11661 summarizing the background of the case and a list of recommendations provided by the advisor, while in other cases we saw only a note documenting the recommendations.

National Fraud Program office management informed us that advisors may not keep enough records because there are no formal written requirements for the types or extent of records to keep. As we discussed the Program and documentation with managers, National Fraud Program office management recognized the need for better documentation. Plans for FY 2008 include developing a procedural handbook for the level and form of documentation to keep. At a minimum, the advisors should keep a copy of the recommended action plan and advice provided throughout a case's fraud development. This process could be used to measure the effectiveness of advisor involvement and will facilitate timely followup on the cases. In those cases in which the advisor kept extra records or documentation, we were able to determine that followups were thorough and timely.

Recommendation

Recommendation 2: The Director, Fraud/Bank Secrecy Act, should establish a formal documentation process that tracks advisor involvement in cases, including requirements to maintain adequate and consistent records.

Management's Response: IRS management agreed with the recommendation. The Small Business/Self-Employed Division is in the process of implementing program changes that will enable tracking of advisor involvement in cases and that will establish minimum recordkeeping requirements for advisors. On June 1, 2007, the National Fraud Program implemented an advisor planning tool that enables advisors to maintain adequate and consistent records. Testing is complete, and training will be conducted to ensure advisors have sufficient skills to fully use the planning tool.

Most Fraud Program Productivity Indicators Have Improved, but the Number of Examination Function Referrals Sent to and Accepted by the Criminal Investigation Function Has Not Significantly Increased

To improve the quality of developing fraud issues and potentially increase the number of fraud referrals and improve the National Fraud Program overall, over the past 3 years, the IRS Examination and Collection functions have partnered with the National Fraud Program. One of the actions taken was to establish five advisor groups whose primary role is to assist in developing both criminal fraud referrals and civil fraud penalty cases. At the beginning of

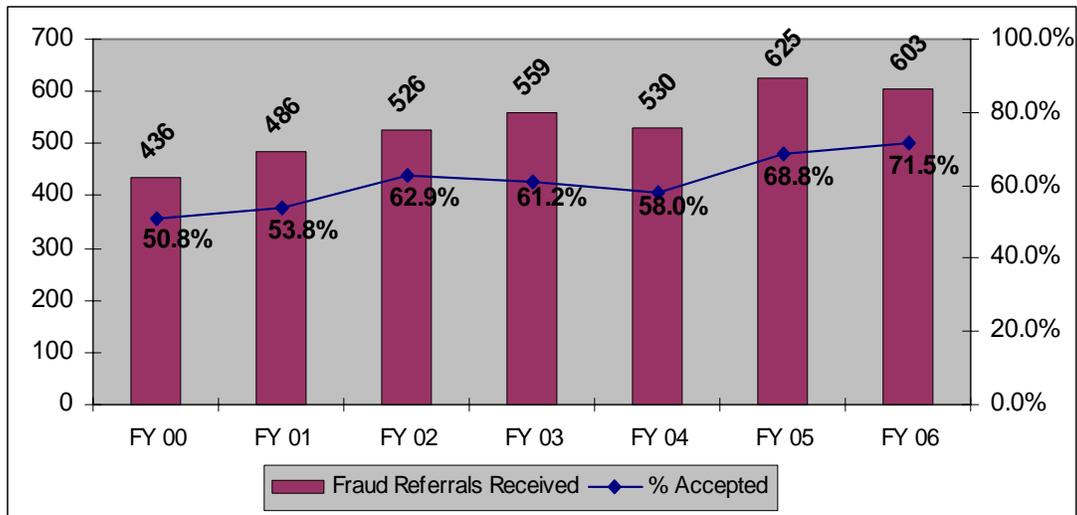


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FY 2007, there were 7 advisor groups with 41 Examination function employees and 33 Collection function employees in the advisor positions.

Figure 1 shows that, since FY 2001 when the advisor position was created, the number of fraud referrals from all IRS operating divisions has generally increased each year, with the exception of a couple of slight decreases. In addition, the percentage of referrals accepted increased from 53.8 percent in FY 2001 to 71.5 percent in FY 2006, indicating the quality of referrals has improved.

Figure 1: Fraud Referrals From the Operating Divisions



Source: Our prior audit report entitled, *Statistical Portrayal of the Criminal Investigation Function's Enforcement Activities From Fiscal Year 2000 Through Fiscal Year 2006* (Reference Number 2007-10-083, dated June 6, 2007).

Figure 2 presents the number of Examination function fraud referrals made in FYs 1996 through 2006. The acceptance rate for criminal fraud referrals generally increased since FY 2001 (with the exception of FY 2004), indicating that implementation of the advisor program has contributed to the quality of Examination function referrals. The average number of referrals accepted in FYs 1996 through 2000 was 51.4 percent; the average number of referrals accepted in FYs 2002 through 2006 (after the advisor program was established in FY 2001) was 64.5 percent, with a high of 73.2 percent in FY 2006.

However, the number of Examination function referrals sent to and accepted by the CI function increased only somewhat from FY 2001, when the advisor groups were established, and had some upward and downward trends during that time. The numbers of referrals accepted have been lower than those in several years prior to implementation of the advisor program. The average number of referrals accepted in FYs 1996 through 2000 was 397 cases, with a high of



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674 in FY 1996; the average number accepted in FYs 2002 through 2006 was 224 cases, with a high of 269 in FY 2005.

Figure 2: Examination Function Fraud Referrals

	FY 1996	FY 1997	FY 1998	FY 1999	FY 2000	FY 2001	FY 2002	FY 2003	FY 2004	FY 2005	FY 2006
Referrals Received¹¹	1,223	1,141	774	402	256	265	367	361	295	384	325
Referrals Accepted	674	556	380	212	162	150	200	222	181	269	246
Referrals Rejected	575	534	432	224	124	109	128	147	130	116	90
Acceptance Rate¹²	54.0%	51.0%	46.8%	48.6%	56.6%	57.9%	61.0%	60.2%	58.2%	69.9%	73.2%

Source: The CI function.

Emphasis by National Fraud Program office (which includes the advisor program) and Examination function executive management on developing fraud has had a positive effect on the number of cases resulting in civil fraud penalties. Civil fraud penalty cases no longer require a referral to the CI function; the penalty determination is now the shared responsibility of the Examination function and the advisors, with the final decision made by Examination function management. Statistics obtained from the National Fraud Program showed that, although the number of Examination function fraud referrals slightly decreased in FY 2006, recommendations of civil fraud penalties in FY 2006 increased 22 percent over those made in FY 2005.

During FY 2006, the National Fraud Program office implemented various strategies to improve the success of the Program and further improve the quality of the referrals, including:

- Increased staffing and improved the organization to reduce the territory the advisors must cover, which allowed them to be more responsive to the needs of their customers.
- Improved Intranet presence, which allowed employees to use the Intranet more effectively and to answer many of the questions they may have about fraud issues.
- Obtained more cooperation from other IRS operating divisions, the CI function, and the Department of Justice to improve the fraud process and to ensure the IRS does everything to help guide fraud cases to their proper resolution.

¹¹ This is the number of initial referrals (primary investigations) received from the compliance functions.

¹² The acceptance rate is calculated as follows: Referrals Accepted divided by the sum of Referrals Accepted plus Referrals Rejected.



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In summary, many actions have been taken to improve the National Fraud Program and address the quality of fraud development, and most productivity indicators have shown improvement. However, there is still a need to increase the number of referrals accepted from the Examination function. We believe that, with continued emphasis by IRS top management and by implementing our recommendations, the IRS could improve the quality of fraud development and increase the number of Examination function fraud referrals sent to and accepted by the CI function.



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Appendix I

Detailed Objectives, Scope, and Methodology

Our overall objectives were to determine whether Examination function employees were identifying potential fraud cases and referring cases to the CI function when appropriate and to evaluate the effectiveness of the advisor position.¹ To accomplish the objectives, we:

- I. Identified IRS procedures and guidelines for Examination function referrals to the CI function, assessing the civil fraud penalty, and communication between the CI and Examination functions. We also obtained current statistics related to the National Fraud Program.
- II. Evaluated the role and involvement of the advisor groups.
 - A. Interviewed National Fraud Program office management and advisors to identify procedures.
 - B. Judgmentally selected the 3(d) advisor locations, which represented two of the five advisor groups, to obtain information related to assistance on specific cases and presentations or other means of communicating with examiners. We judgmentally selected two locations because traveling to all five locations would not have been practical, and two locations were sufficient to obtain a fair representation of advisor procedures and involvement in cases. Locations were identified through discussion with IRS operations personnel.
 - C. Identified the process in place to monitor and followup on the status of the cases before and after they were referred to the CI function, including those rejected by the CI function.
 - D. Reviewed a judgmental sample of 30 cases being worked and referred by the 2 advisors working Examination function cases in the 2 locations selected in Step II.B., to identify the extent of the advisors' involvement in cases and

¹ Advisors have various responsibilities, such as providing technical and procedural fraud advice in the identification and development of potential criminal fraud referrals and civil fraud penalty cases.



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documentation maintained.² We selected the 30 cases from the lists of open advisor cases as of the dates of our site visits.³

- E. Determined how advisors are proactively involved in identifying new fraud cases.
 - F. Determined how advisors are involved in the civil fraud penalty process.
- III. Determined whether fraud issues were appropriately developed by Examination function employees by reviewing the effectiveness of case actions and determining whether cases met the criteria for a criminal fraud referral but were not developed and referred when appropriate. In addition, we determined whether the civil fraud penalty was considered if no potential criminal fraud action was identified.
- A. Obtained the nationwide population of cases that met the following criteria: closed by examination between March 31, 2005, and March 31, 2006, meeting specified dollar criteria; small business taxpayer; no indication of CI function activities; and worked by a revenue agent⁴ or a taxpayer compliance officer⁵ in an Examination function field office. This resulted in a population of 5,762 cases. We conducted tests to assess the reliability of data, including matching extracted data to original IRS databases and verifying that the data extracted met the required criteria.
 - B. Using the population of 5,762, selected a statistical sample of 105 closed cases to review, using a 90 percent confidence level, a ± 5 percent precision, and an 11 percent error rate based on prior audit findings. Although we requested from the closed case files all 105 cases, we received only 93 cases that we could review.

After reviewing the 93 cases, we determined 16 were nonfiler cases with no taxpayer contact; therefore, we could not determine whether potential indicators of fraud were present on these cases. As a result, we reported on the results from only 77 cases, which changed our sample to a judgmental sample.
 - C. Reviewed 77 Examination function cases having an aggregate tax liability totaling approximately \$10 million⁶ to determine whether it appeared fraud indicators were present and whether the indicators had been identified/considered.

² We had planned to obtain cases that were physically on location or could be obtained within a reasonable time; therefore, we planned to review open cases that were available. We selected 30 cases (15 in each location) that could be obtained. We did not plan to project results.

³ The advisors maintained manual lists of cases and the procedures were not consistent; therefore, it was difficult to obtain a population. (b)(6)

⁴ Employees in the Examination function that conduct face-to-face examinations of more complex tax returns such as businesses, partnerships, corporations, and specialty taxes (e.g., excise tax returns).

⁵ Employees in the Examination function that primarily conduct examinations of individual taxpayers through interviews at IRS field offices. The position title was changed in 2002 from tax auditor to tax compliance officer.

⁶ This was the total of the tax liabilities for the 77 cases reviewed.



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1. Reviewed cases to identify fraud indicators such as admission by the taxpayer of substantial omissions, examiner discovers understatement through fully documented deposits analysis, doubled set of books, submitting false documents for income or expenses, and/or proof of false or altered documents submitted to or made available to the examiner.
2. Determined whether the civil fraud penalty was considered if no potential criminal fraud action was identified.



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Appendix II

Major Contributors to This Report

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Parker F. Pearson, Director
Lynn Wofchuck, Audit Manager
Doris Cervantes, Lead Auditor
Phyllis Heald, Senior Auditor
Janis Zuika, Senior Auditor
Nina Julius, Auditor



*Management Has Emphasized the Fraud Program, but
Opportunities Exist to Further Improve It*

Appendix III

Report Distribution List

Acting Commissioner C
Office of the Commissioner – Attn: Acting Chief of Staff C
Deputy Commissioner for Services and Enforcement SE
Deputy Commissioner, Small Business/Self-Employed Division SE:S
Director, Communications, Liaison, and Disclosure, Small Business/Self-Employed Division
SE:S:CLD
Director, Examination, Small Business/Self-Employed Division SE:S:E
Acting Director, Fraud/Bank Secrecy Act, Small Business/Self-Employed Division SE:S:F/BSA
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 Liaison: Commissioner, Small Business/Self-Employed Division SE:S



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Appendix IV

Outcome Measure

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. This benefit will be incorporated into our Semiannual Report to Congress.

Type and Value of Outcome Measure:

- Increased Revenue – Potential; \$432,000 in civil penalties (see page 3).

Methodology Used to Measure the Reported Benefit:

We obtained the nationwide population of cases that met the following criteria: closed by examination between March 31, 2005, and March 31, 2006, meeting specified dollar criteria; small business taxpayer; no indication of CI function activities; and worked by a revenue agent¹ or a taxpayer compliance officer² in an Examination function field office. This resulted in a population of 5,762 cases, from which we chose a statistically valid sample of 105 cases using a 90 percent confidence level, a ± 5 percent precision, and an 11 percent estimated error rate based on prior audit findings. Although the sample size was 105 cases, we included only 77 in our final results due to varying factors. In effect, this changed our sample to a judgmental sample.

Of the 77 cases reviewed having an aggregate tax liability totaling approximately \$10 million,³ 6 either met the criteria to be referred as potential criminal fraud cases and could have had the civil fraud penalty assessed at the civil settlement or could have had only the civil fraud penalty assessed. The aggregate underpayment of taxes for these 6 cases was approximately \$576,000; the estimated civil fraud penalties for these 6 cases would be approximately \$432,000 based on the 75 percent civil fraud penalty rate. This is an estimate because all of it may not be collected due to each taxpayer's right to appeal and possibly have the penalty reduced.

¹ Employees in the Examination function that conduct face-to-face examinations of more complex tax returns such as businesses, partnerships, corporations, and specialty taxes (e.g., excise tax returns).

² Employees in the Examination function that primarily conduct examinations of individual taxpayers through interviews at IRS field offices. The position title was changed in 2002 from tax auditor to tax compliance officer.

³ This was the total of the tax liabilities for the 77 cases reviewed.



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Appendix V

Management's Response to the Draft Report

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COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

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

August 30, 2007

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Kathy K. Petronchak *Kathy K. Petronchak*
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – Management Has Emphasized the Fraud Program, but Opportunities Exist to Further Improve It (Audit # 200630009)

We have reviewed your draft report, "Management Has Emphasized the Fraud Program, but Opportunities Exist to Further Improve It." We appreciate your report acknowledging the importance that the Small Business/Self-Employed (SB/SE) Examination and Fraud Program management have placed on our fraud awareness and referral program.

Identification of fraud is the responsibility of every examiner in conjunction with their manager. We agree documentation of actions is important and that the examiners and managers need to record meetings and discussions on issues related to fraud. We will continue to emphasize use of the Examining Officer's Activity Record (Form 9984) and other workpapers in the case file for documentation purposes.

When a compliance employee suspects a potentially fraudulent situation, the employee is required to discuss the case at the earliest possible opportunity with his/her manager. If the group manager concurs with the employee's assessment, the employee will immediately contact a Fraud Technical Advisor (FTA). The group manager and FTA will provide joint guidance to the compliance employee on how to proceed with the investigation. SB/SE Examination and National Fraud Program (NFP) management will continue to emphasize the importance of this collaborative relationship in accordance with the Internal Revenue Manual (IRM).

We agree with your recommendation regarding the NFP establishing procedures to track FTA involvement in cases.

We have attached a detailed response outlining our planned corrective actions. If you have any questions, please call Sherri Brown, Director of Examination Policy, at 202-283-2070 or Martin Malarkey, Chief of Fraud Policy and Operations, at 202-622-9385.

Attachment



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Attachment

RECOMMENDATION 1:

The Director, Examination, and Director, Fraud/Bank Secrecy Act, should reinforce the requirements to timely contact an FTA when *initial* indicators of fraud exist, properly complete Form 11661 as required and whenever the FTA participates in a significant discussion during the examination, require examiners to update Form 11661 by contacting the FTA prior to closing the case, and emphasize the requirement for examiners to timely discuss with the group manager those cases with substantial amounts of unreported income.

CORRECTIVE ACTIONS:

SB/SE Examination emphasized the appropriate coordination with FTAs and proper use of the Form 11661 in its joint memorandum issued in June 2006. SB/SE Examination, and Director, Fraud/Bank Secrecy Act, will continue to emphasize this guidance, and will issue an additional memorandum to examiners reinforcing managerial involvement and recordation of discussions in accordance with the IRM.

IMPLEMENTATION DATE:

December 15, 2007

RESPONSIBLE OFFICIAL:

Director, Examination, Small Business/Self-Employed Division
Director, Fraud/Bank Secrecy Act, Small Business/Self-Employed Division

CORRECTIVE ACTION(S) MONITORING PLAN:

The Director, Examination, SB/SE Division, will advise the SB/SE Commissioner of any delays in implementing this corrective action.

RECOMMENDATION 2:

The Director, Fraud/Bank Secrecy Act, should establish a formal documentation process that tracks FTA involvement in cases including requirements to maintain adequate and consistent records.

CORRECTIVE ACTIONS:

We agree with this recommendation and are in the process of implementing program changes that will enable tracking of FTA involvement in cases and that will establish minimum recordkeeping requirements for FTAs. On June 1, 2007, the National Fraud Program implemented an FTA planning tool that enables the FTA to maintain adequate and consistent records. Testing is complete and training will be conducted to ensure FTAs have sufficient skills to fully utilize the planning tool.

IMPLEMENTATION DATE:

July 15, 2008

RESPONSIBLE OFFICIAL:

Director, Fraud/Bank Secrecy Act, Small Business/Self-Employed Division



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CORRECTIVE ACTION(S) MONITORING PLAN:

The Director, Fraud/Bank Secrecy Act, will advise the SB/SE Commissioner of any delays in implementing these plans.