



*Examiners Did Not Always Properly Select
the Prior and/or Subsequent Year Tax
Returns*

February 13, 2009

Reference Number: 2009-30-034

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.

Redaction Legend:

1 = Tax Return/Return Information



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

February 13, 2009

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED
DIVISION

Michael R. Phillips

FROM:

Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT:

Final Audit Report – Examiners Did Not Always Properly Select the
Prior and/or Subsequent Year Tax Returns (Audit # 200730015)

This report presents the results of our review to determine whether Examination function employees appropriately inspect and examine prior and/or subsequent year tax returns when warranted. This audit was conducted as part of our Fiscal Year 2007 Annual Audit Plan.

Impact on the Taxpayer

When a taxpayer's tax return is selected for examination, to improve efficiency and identify additional tax owed, examiners should also inspect and examine, if warranted, prior, subsequent, and related year tax returns. Our review showed 14 (21 percent) of 68 sample cases warranted examination of the prior and/or subsequent year returns but were not selected for examination. When examiners do not make the proper decision to select returns for examination, taxpayers are not provided equitable treatment, and the examination is not as effective for improving taxpayer compliance on future tax returns.

Synopsis

The Internal Revenue Service (IRS) policy is that an examination covers not only the single tax period that initiated the examination, but also any and all open tax periods that affect the taxpayer's return. Our review of a statistical sample of 68 closed cases worked by examiners in the Area Offices¹ determined that examiners did not always properly inspect prior and/or

¹ A geographic organizational level used by IRS business units and offices to help their specific types of taxpayers understand and comply with tax laws and issues.



Examiners Did Not Always Properly Select the Prior and/or Subsequent Year Tax Returns

subsequent year returns and, therefore, did not make a proper decision to select these returns for examination when warranted. In addition, examiners did not adequately document the decision to examine associated years' tax returns.

In 26 (38 percent) of 68 sample cases, there was no evidence that examiners inspected either the prior or subsequent year returns to identify similar issues to the year under examination or if large, unusual, or questionable items² existed that would warrant examination. If examiners do not properly inspect prior and/or subsequent year returns, the examination is not performed as efficiently and effectively as possible because additional cases that warrant examination might not be identified. We identified 14 (21 percent) of 68 cases that warranted the examination of a prior and/or subsequent year return, but the returns were not selected for examination. Although managers reviewed 59 (87 percent) of the 68 cases, they did not review the cases early enough. When the managers did get involved, they did not remain involved throughout the case. In 40 (68 percent) of the 59 cases, the managers reviewed the cases only one time.

Our review also showed that in 33 (49 percent) of the 68 cases, the case files did not include adequate documentation to support the decision for not selecting the prior and/or subsequent year returns for examination. Although managers reviewed most of the cases, they did not properly explain or support their decision to not select the returns. Tax compliance officers did not inspect the prior and/or subsequent year returns in a higher percentage of cases (30 percent) than revenue agents. In the majority of these cases (71 percent), they did not complete the multi-year lead sheet. Although this sheet is a resourceful tool that gives the examiners a reminder of the areas that should be considered and checked when inspecting a tax return, it is only required to be completed by the revenue agents. If examiners do not include support or a documented explanation of how a decision is reached, then managers do not have a basis to measure the examiners' judgment. Also, well-documented and supported decisions will facilitate the IRS position if the taxpayers challenge an issue, especially after the case is closed.

We also conducted an analysis of the correspondence examinations closed by campus³ Correspondence function tax examiners. Our review of 68 cases (not the same cases as previously mentioned) showed that in 31 (46 percent) cases campus Correspondence function tax examiners could have examined the subsequent year tax return because the same issues adjusted on the tax year return under examination were present on the subsequent year return. However, IRS management informed us that campus Correspondence function tax examiners do not inspect and select the related subsequent year tax returns. Instead, workload is identified on a

² Some factors to be considered when identifying large, unusual, or questionable items include: the comparative size of an expense, if the nature of the item is significant, beneficial effect of the manner in which an item is reported, and missing items on the return.

³ 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 the taxpayer accounts.



Examiners Did Not Always Properly Select the Prior and/or Subsequent Year Tax Returns

national basis through the Small Business/Self-Employed Division Compliance Services function national headquarters managers.

Because the current procedures do not permit campus Correspondence function tax examiners to assess subsequent year tax returns and select them for audit, the IRS could be missing an opportunity to conduct examinations more efficiently and consistently from year to year. Expanding examinations in the campus Correspondence function program could increase the efficiency of performing examinations, similar to how Field and Office Examination functions perform their audits.

Recommendations

We recommended that the Director, Examination, Small Business/Self-Employed Division, 1) ensure that group managers place the appropriate emphasis on the requirement to consider selection of prior and/or subsequent year tax returns for examination during documented reviews, discussions, and/or other case related activities with their examiners, 2) ensure that group managers require a clear-cut justification in the workpapers, and 3) require that tax compliance officers use the multi-year lead sheet during examinations. We also recommended that the Acting Director, Campus Compliance Services, Small Business/Self-Employed Division, determine if there is an opportunity for campus Correspondence function tax examiners to expand examinations to include subsequent year returns for limited issues.

Response

IRS management agreed with our recommendations. Management will reemphasize the requirements for consideration of prior and/or subsequent year returns by ensuring appropriate content is included in the Fiscal Year 2009 Examination All Managers' Continuing Professional Education training. They will discuss requirements with the area technical analysts during monthly conference calls and require specific actions be implemented and submit articles for inclusion in the Small Business/Self-Employed Division Group Managers' Performance Perspective and the Small Business/Self-Employed Division Technical Digest. In addition, management will issue a memorandum requiring that all office examiners use the multi-year lead sheet to document their actions regarding consideration of prior and/or subsequent year returns, revise Examination Workpapers (Form 4700) and related workpapers to correspond with the use of the administrative lead sheets, and update the Internal Revenue Manual.⁴ They will revise campus procedures to ensure that the appropriate analysis is conducted on current year correspondence deficiency case closures to determine if the same issue appears in the subsequent year return. Followup adjustment cases will receive priority in the examination workload

⁴ The manual containing the procedures for IRS employees.



*Examiners Did Not Always Properly Select the Prior
and/or Subsequent Year Tax Returns*

assignment plan. Management's complete response to the draft report is included as Appendix V.

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.



*Examiners Did Not Always Properly Select the Prior
and/or Subsequent Year Tax Returns*

Table of Contents

BackgroundPage 1

Results of ReviewPage 3

 Examination Function Management Has Emphasized the Procedures for
 Inspecting and Selecting Prior and/or Subsequent Year Tax ReturnsPage 3

 Examiners Did Not Adequately Assess Prior and/or Subsequent
 Year Tax Returns or Maintain Sufficient Documentation to Support
 Their ActionsPage 3

Recommendation 1:.....Page 6

Recommendation 2:.....Page 7

 The Correspondence Examination Function Does Not Select the
 Subsequent Year Tax Returns for Examination While Auditing the
 Originally Selected Tax Year ReturnPage 7

Recommendation 3:.....Page 8

Appendices

 Appendix I – Detailed Objective, Scope, and Methodology Page 9

 Appendix II – Major Contributors to This ReportPage 11

 Appendix III – Report Distribution ListPage 12

 Appendix IV – Outcome MeasurePage 13

 Appendix V – Management’s Response to the Draft ReportPage 14



*Examiners Did Not Always Properly Select the Prior
and/or Subsequent Year Tax Returns*

Abbreviations

IRS	Internal Revenue Service
SB/SE	Small Business/Self-Employed



*Examiners Did Not Always Properly Select the Prior
and/or Subsequent Year Tax Returns*

Background

One of the goals of the Small Business/Self Employed (SB/SE) Division Examination function is to conduct efficient and quality examinations while encouraging compliance with the tax laws. The Examination function's policy is that examinations cover not only the single tax period that initiated the examination, but also any and all open tax periods that affect the taxpayer's return.

IRS procedures state that when examining tax returns, examiners should inspect and possibly examine all related returns if warranted.

When examiners propose an adjustment to the tax year return under examination, they should inspect the taxpayer's prior and/or subsequent year (hereafter in this report, interchangeably referred to as associated years) tax returns for proper filing and to evaluate audit potential. Examining the prior and/or subsequent year returns and all related tax returns at the same time has greater tax compliance impact. Also, it takes less time than examining single tax years at various different times for the same taxpayer and contributes to a more efficient and effective examination. From July 2007 through June 2008, there were 293,959 closed examinations from Area Offices¹ of which 117,574 examinations (40 percent) were classified as closures related to selecting additional tax years or related tax returns for examination.

There are three types of examinations:

- Field examinations typically conducted in a taxpayer's place of business.
- Office examinations conducted in Internal Revenue Service (IRS) offices.
- Correspondence examinations conducted through the mail.

Revenue agents and tax compliance officers (hereafter in this report, interchangeably referred to as examiners) conduct the field and office examinations. The examiner's professional judgment is required to determine if potential compliance issues exist that warrant expanding the examination. For those cases containing proposed adjustments in the open year or the presence of large, unusual, or questionable items² on the related returns, the examiners are required to provide an explanation as to why they did not select the related or prior and/or subsequent year tax return for examination.

¹ A geographic organizational level used by IRS business units and offices to help their specific types of taxpayers understand and comply with tax laws and issues.

² Some factors to be considered when identifying large, unusual, or questionable items include: the comparative size of an expense, if the nature of the item is significant, beneficial effect of the manner in which an item is reported, and missing items on the return.



*Examiners Did Not Always Properly Select the Prior
and/or Subsequent Year Tax Returns*

Other tax examiners at various IRS campuses³ located throughout the country conduct correspondence examinations. These examinations are primarily done by mail. These cases are less complex and require a lesser degree of accounting and auditing skills to perform the examination than cases worked at the Area Offices. IRS procedures for correspondence examinations state that consideration of associated years' tax returns is a key element of one of the auditing standards to produce a quality examination. Prior and subsequent year returns containing the same issues as the tax year examined should be considered and pursued when appropriate.

This review was performed at the SB/SE Division Examination and Campus Compliance Services functions National Headquarters in New Carrollton, Maryland, during the period July 2007 through September 2008. 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 objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

³ 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 the taxpayer accounts.



*Examiners Did Not Always Properly Select the Prior
and/or Subsequent Year Tax Returns*

Results of Review

***Examination Function Management Has Emphasized the Procedures
for Inspecting and Selecting Prior and/or Subsequent Year Tax
Returns***

SB/SE Division management has been implementing various approaches to emphasize the expectation that examiners inspect and select associated years' tax returns for audit, when warranted. During Fiscal Year 2008, Examination function management took the following actions:

- Developed Field Examination function quality action plans with an emphasis placed on selecting additional tax years or related tax returns for examination.
- Highlighted in the March 2008 Keys to Success newsletter and a Technical Digest the importance of the required filing checks and selecting prior and/or subsequent year returns as part of a quality examination.
- Included in the Fiscal Year 2008 Continuing Professional Education a mandatory module that emphasized the required filing check and proper consideration of the prior and subsequent year returns.
- Included in an article in online guidance for managers the importance of selecting additional tax years or related tax returns for examination.

***Examiners Did Not Adequately Assess Prior and/or Subsequent Year
Tax Returns or Maintain Sufficient Documentation to Support Their
Actions***

Because taxpayers might have made the same kinds of errors in prior and/or subsequent years as those made in the tax year under review, inspecting those returns provides the IRS with an efficient means for identifying returns with a higher probability of adjustment. However, despite SB/SE Division management's efforts to emphasize this requirement, examiners did not always properly inspect associated years' tax returns when conducting the examination of the tax return under review. In addition, examiners did not adequately document their decision to examine associated years' tax returns. As a result, examiners did not always make the proper decision to select these returns for examination, which potentially reduced revenue, did not provide equitable treatment of taxpayers, and was not effective in improving the taxpayers' compliance on future tax returns.



Examiners Did Not Always Properly Select the Prior and/or Subsequent Year Tax Returns

Examiners did not properly inspect and examine the associated years' tax returns

An examiner must first inspect the associated years' tax returns before they can be selected for examination to identify similar issues to the year under examination or if large, unusual, or questionable items existed that would warrant examination. However, in 26 (38 percent) of 68 sample cases, there was no evidence that examiners properly inspected the prior or subsequent year tax returns as follows:

In 38 percent of our sample cases, there was no evidence that tax examiners properly inspected the prior/or subsequent tax returns.

- In 15 cases, there was no evidence that examiners inspected both the prior and subsequent year returns.
- In three cases, the examiners inspected only the prior or subsequent year return, but not both.
- In eight cases, the examiners checked a box on a form showing that they inspected returns, but there was no evidence supporting the action.

One reason that proper actions were not always taken is because managers did not always review or get involved in the cases early enough. Of the 68 reviewed cases, 9 (13 percent) had no evidence of managerial involvement, while 28 (41 percent) were not reviewed until closure. This means that more than one-half of the sample cases (54 percent) were either not reviewed, or not reviewed until closure.

In addition, the manager's first involvement occurred within the first 2 weeks after taxpayer contact in just 19 (32 percent) of the 59 cases that had managerial involvement. More than 70 days had passed before the manager became involved in 30 percent of these cases. Further, managers did not remain involved throughout the case development to ensure examiners followed proper procedures. In 40 (68 percent) of the 59 cases, managers were involved once, and there were only 4 (7 percent) where the manager was involved more than twice.

As a result, examiners did not identify all associated years' cases that warranted examination. Examiners selected prior and/or subsequent year returns for examination in only 13 (19 percent) of the 68 cases in our statistical sample. However, we identified an additional 14 cases (21 percent) that warranted an

We identified an additional 21 percent of our sample cases that warranted an examination of the prior and/or subsequent year tax returns.

examination of the prior and/or subsequent year returns. When examiners do not properly select prior and/or subsequent year returns, examinations are not being performed as efficiently and effectively as possible. Although we cannot estimate the amount of the potential tax assessments from the 14 cases that warranted examination, the additional tax assessments for the controlling



Examiners Did Not Always Properly Select the Prior and/or Subsequent Year Tax Returns

tax year originally selected for examination totaled \$50,467. In addition, we project a similar situation occurred in 16,830⁴ of the 81,745 closed cases from which we selected our sample.

Examiners did not include adequate documentation in the case files to support decisions about examining associated years' tax returns

Examiners should include all the information necessary to conduct the examination and support the result of the evaluation, especially if prior and/or subsequent year returns were not selected for examination. Examiners should document actions taken and summarize their decisions about examining associated years' returns on Examination Workpapers Forms 4318 and 4318-A for the Field Examination function and Form 4700 for the Office Audit Examination function. In addition, revenue agents in the Field Examination function use a multi-year and related returns lead sheet. Although this lead sheet is not mandatory for tax compliance officers, Examination function management encourages its use. The examiners should check the appropriate boxes on the lead sheet including the required filing check and explain what they saw when they inspected and analyzed the prior and/or subsequent year returns. They should explain if the tax year return under examination has adjustments and, if applicable, why other years did not warrant examination.

Examiners should also include in the case file any type of workpaper they obtained that documents and supports the facts used to reach the determination. These documents can be obtained from internal sources, such as the taxpayer account and filing information from the Integrated Data Retrieval System.⁵ If additional tax return information is obtained from the taxpayer, the tax examiner should keep a copy of the tax return in the file. This facilitates managers' reviews and helps support the IRS position on any tax adjustment.

Our review showed that 33 (49 percent) of the 68 case files did not include adequate documentation or an adequate explanation to support the determination for not selecting the associated years' tax returns for examination. For example, although the revenue agents checked the appropriate box on the lead sheets in most cases and included some comments, they did not include tax returns or tax account information to substantiate the determination made. In five cases, tax compliance officers did not properly prepare the Form 4700 workpaper, and in¹ [REDACTED]

Forty-nine percent of sample cases did not include adequate documentation or explanations for decisions about examining associated years' returns.

[REDACTED] In 13 other cases, the explanation on the lead sheet did not support the decision on whether to examine associated year's tax returns. For example, the written explanation was based only on items on the tax year return under examination.

⁴ See Appendix IV for details.

⁵ The IRS computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer's account records.



Examiners Did Not Always Properly Select the Prior and/or Subsequent Year Tax Returns

In addition, our review showed tax compliance officers did not inspect the associated years' returns in a higher percentage of cases (30 percent) than revenue agents and, in the majority of these cases (71 percent), they did not complete the multi-year lead sheet. Although this sheet is a resourceful tool that gives the examiners a reminder of the areas that should be considered and checked when inspecting a tax return, it is only required to be completed by the revenue agents.

As stated in the previous section, managers reviewed 59 of the 68 cases. However, during these reviews, managers did not ensure that there was supporting evidence to support the decision not to examine the associated years' returns. The examiner's professional judgment is required to determine if prior and/or subsequent year returns warrant examination. If examiners are not including supported and documented explanations of how a decision is reached, then managers do not have a basis to measure the examiners' judgment. Also, it makes it more difficult for managers to do their jobs of ensuring that tax examiners followed proper procedures. In addition, well-documented and supported decisions will facilitate the IRS position if the taxpayers challenge an issue, especially after the case is closed.

Recommendations

The Director, Examination, SB/SE Division, should:

Recommendation 1: Ensure all group managers place the appropriate emphasis on the requirement to consider selection of prior and/or subsequent year tax returns for examination during documented reviews, discussions, and/or other case related activities with their examiners. In addition, group managers should ensure that there is a clear-cut justification in the workpapers.

Management's Response: IRS management agreed with this recommendation. They will reemphasize the requirements for consideration of prior and/or subsequent year returns through the following actions:

- Ensure that appropriate content is included in the Fiscal Year 2009 Examination All Managers' Continuing Professional Education Performance Feedback to Achieve Higher Quality and Increased Productivity training module.
- Discuss requirements with the area technical analysts during monthly conference calls and require specific actions be implemented that will provide improvement for each SB/SE Division Examination function.
- Submit articles for inclusion in the SB/SE Division Group Managers' Performance Perspective and SB/SE Division Technical Digest.



*Examiners Did Not Always Properly Select the Prior
and/or Subsequent Year Tax Returns*

Recommendation 2: Require tax compliance officers to use the multi-year lead sheet during examinations.

Management's Response: IRS management agreed with this recommendation and will:

- Issue a memorandum requiring that all SB/SE Division office examiners use the multi-year lead sheet to document their actions regarding consideration of prior and/or subsequent year returns.
- Revise Form 4700 and related workpapers to correspond with the use of the administrative lead sheets.
- Update Internal Revenue Manual⁶ Section 4.10.9, *Examination of Workpapers*, to include the changes.

The Correspondence Examination Function Does Not Select the Subsequent Year Tax Returns for Examination While Auditing the Originally Selected Tax Year Return

Although IRS guidelines state that prior and/or subsequent year returns should be considered when appropriate by campus Compliance Services Correspondence function tax examiners (hereafter referred to as campus correspondence tax examiners), IRS Compliance Services function management's procedures do not permit campus correspondence tax examiners to select associated year returns when they conduct examinations. Instead of requiring the campus correspondence tax examiners to assess associated years' returns, campus Compliance Services function management controls the workload selection and delivery from a national level through its headquarters office. Periodically, analysts review reports of closed inventory to identify possible subsequent year return inventory and select returns for examination.

Our statistical sample of 68 closed correspondence cases, which was different from our other sample of cases closed within the Area Offices, showed that for 31 (46 percent) cases, the same issue adjusted on the tax year return under examination was present on the subsequent year tax return.⁷ Campus correspondence tax examiners could have examined the subsequent year tax return on these cases at the same time that they examined the originally selected return. The scope of a correspondence examination performed at a campus is limited to single tax years and issues. Although campus correspondence tax examiners might not have been trained to evaluate

⁶ The manual containing the procedures for IRS employees.

⁷ The scope for this audit test was limited to the review of subsequent year returns. Due to the high volume of correspondence cases, the fact that the campus workload deals with more recent tax returns, and the complexity involved in examining prior year returns, the campus Correspondence function cannot effectively examine prior year tax returns.



Examiners Did Not Always Properly Select the Prior and/or Subsequent Year Tax Returns

an entire tax return for every issue, they are trained to address the same routine issues and could recognize whether an issue was a concern in the subsequent year.

Because the current procedures do not permit campus correspondence tax examiners to assess subsequent year tax returns and select them for audit, the IRS could be missing an opportunity to conduct examinations more efficiently and consistently from year to year. Expanding examinations in the campus Correspondence function program could increase the efficiency of performing examinations, similar to how Field and Office Examination functions perform their audits.

Recommendation

Recommendation 3: The Acting Director, Campus Compliance Services, SB/SE Division, should determine if there is an opportunity for campus correspondence tax examiners to expand examinations to include subsequent year returns for limited issues.

Management's Response: IRS management agreed with this recommendation. They will revise campus procedures to ensure that the appropriate analysis is conducted on current year correspondence deficiency case closures to determine if the same issue appears in the subsequent year return. Followup adjustment cases will receive priority in the examination workload assignment plan.



*Examiners Did Not Always Properly Select the Prior
and/or Subsequent Year Tax Returns*

Appendix I

Detailed Objective, Scope, and Methodology

Our overall audit objective was to determine whether Examination function employees appropriately inspect and examine prior and/or subsequent year tax returns when warranted. To accomplish this objective, we:

- I. Identified the IRS procedures and guidelines for pick up of prior and/or subsequent year tax returns for the Area Offices and campuses.¹
- II. Determined whether examiners within the Area Offices followed proper procedures. We reviewed the effectiveness of case actions and determined whether prior and/or subsequent year tax returns were inspected and examined during the examination when warranted.
 - A. Extracted all examination closed cases from the Audit Information Management System,² with the following criteria: closed between July 1, 2006, and June 30, 2007; individual cases; small business taxpayers; worked by a revenue agent or a tax auditor in the Area Offices; and with specific selection reasons.
 - B. Validated the data by comparing it to the IRS Integrated Data Retrieval System files to ensure that there was examination activity during our audit period of July 1, 2006, through June 30, 2007.
 - C. From the population of 81,745 closed cases, selected a statistical sample of 68 closed cases to review, using a 95 percent confidence level, ± 10 percent precision, and a 23 percent error rate based on the results from the Examination function quality review results.
 - D. Reviewed the examination closed cases and determined whether examiners inspected and examined prior and/or subsequent year tax returns when warranted.
 1. Developed a case review questionnaire using criteria and procedures identified.

¹ Area Offices are geographic organizational levels used by IRS business units and offices to help their specific types of taxpayers understand and comply with tax laws and issues. 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 the taxpayer accounts.

² A computer system used to control returns, input assessments/adjustments to the Integrated Data Retrieval System, and provide management reports. The Integrated Data Retrieval System is the IRS computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer's account records.



*Examiners Did Not Always Properly Select the Prior
and/or Subsequent Year Tax Returns*

2. Used the case review questionnaire and captured information from each case reviewed in an Access database. We reviewed cases and identified whether proper actions were taken.
 3. Identified the degree of managerial involvement on the closed cases.
- III. Determined whether campus correspondence tax examiners in the Compliance Services function should have examined subsequent year tax returns.
- A. Obtained a download from IRS management of the Examination Operational Automation Database³ of closed correspondence cases with the following criteria: closed between July 1, 2006, and September 30, 2007; individual cases; small business taxpayers; and worked in the campus Compliance Services Correspondence function. During our review of cases, we validated through the Integrated Data Retrieval System that the cases selected for our sample were examination cases.
 - B. Conducted a data analysis from the data obtained in Step III.A. and identified the primary reason for examination and the issues adjusted by the examiner. Using the population of 85,661 cases obtained from the data analysis, we selected a statistical sample of 68 closed cases for review. We used the following criteria: 95 percent confidence level, ± 10 percent precision, and a 23 percent error rate based on the results from the Examination function quality review results.
 - C. Used internal research tools to review the 68 closed cases and identified any trends that indicated whether the subsequent year tax returns could have been examined.
- IV. Discussed conclusions on the cases reviewed with IRS management and identified any reasons for Examination function employees and managers not inspecting or selecting prior and/or subsequent year tax returns during an examination when warranted.

³ The database designed to track examination results by issue and related cause. These data are used to enhance the ability to identify specific areas of noncompliance based on examination results.



*Examiners Did Not Always Properly Select the Prior
and/or Subsequent Year Tax Returns*

Appendix II

Major Contributors to This Report

Margaret E. Begg, Assistant Inspector General for Audit (Compliance and Enforcement Operations)
Carl Aley, Director
Lynn Wofchuck, Audit Manager
Doris A Cervantes, Lead Auditor
Mike J. Della Ripa, Auditor



*Examiners Did Not Always Properly Select the Prior
and/or Subsequent Year Tax Returns*

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
Director, Examination, Small Business/Self-Employed Division SE:S:E
Acting Director, Campus Compliance Services, Small Business/Self-Employed Division
SE:S:CCS
Director, Campus Reporting Compliance, Small Business/Self-Employed Division
SE:S:CCS:CRC
Director, Examination Policy, Small Business/Self-Employed Division SE:S:E:CP
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



*Examiners Did Not Always Properly Select the Prior
and/or Subsequent Year Tax Returns*

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; 16,830 taxpayer accounts affected (see page 3).

Methodology Used to Measure the Reported Benefit:

We identified a population of 81,745 closed examination cases from the Audit Information Management System¹ database meeting the following criteria: closed between July 1, 2006, and June 30, 2007; individual cases; small business taxpayers; worked by a revenue agent or a tax auditor in the Area Offices;² and with specific selection reasons. From this population, we reviewed a statistical sample of 68 closed cases, using a 95 percent confidence level, ±10 percent precision, and a 23 percent error rate based on the results from the Examination function quality review results.

We reviewed the 68 cases to determine whether Examination function employees appropriately inspected and examined prior and/or subsequent year tax returns when warranted. In 14 of the 68 cases, the prior and/or subsequent year returns warranted examination.

Based on these 14 cases, we estimated that 16,830 cases in our population might have had the same situation. This is based on the ratio of 14 to 68 (.2058823) and applicable to the total population of 81,745 cases, which resulted in 16,830 taxpayers who could be affected.

¹ A computer system used to control returns, input assessments/adjustments to the Integrated Data Retrieval System, and provide management reports. The Integrated Data Retrieval System is the IRS computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer's account records.

² A geographic organizational level used by IRS business units and offices to help their specific types of taxpayers understand and comply with tax laws and issues.



*Examiners Did Not Always Properly Select the Prior
and/or Subsequent Year Tax Returns*

Appendix V

Management's Response to the Draft Report



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

January 23, 2009



MEMORANDUM FOR MICHAEL R. PHILLIPS
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Christopher Wagner
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – Examiners Did Not Always Properly Select
the Prior and/or Subsequent Year Tax Returns
(Audit 200730015)

Thank you for the opportunity to review the draft report entitled "Examiners Did Not Always Properly Select the Prior and/or Subsequent Year Tax Returns." We concur with your conclusions that taking the appropriate actions on prior and/or subsequent year returns in conjunction with current year examinations can improve our compliance efforts and reduce taxpayer burden.

We agree with your recommendations and are committed to ensuring all examiners are fully aware of their responsibilities regarding prior and/or subsequent year audit consideration. Continued focus will be placed on this important area through analysis of the relevant data captured by our National Quality Review System.

Attached is a detailed response outlining our corrective actions. If you have questions, please call me at (202) 622-0600 or Monica Baker, Director, Examination Policy at (202) 283-2659 or Jeffrey Basalla, Acting Director, Campus Compliance Services at (202) 283-7399.

Attachment



*Examiners Did Not Always Properly Select the Prior
and/or Subsequent Year Tax Returns*

Attachment

RECOMMENDATION 1:

The Director, Examination SB/SE Division should ensure all group managers place the appropriate emphasis on the requirement to consider selection of prior and/or subsequent tax returns for examination during documented reviews, discussions, and/or other case related activities with their examiners. Group managers should ensure that there is a clear-cut justification in the workpapers.

CORRECTIVE ACTIONS:

We concur with this recommendation. We will reemphasize the requirements for consideration of prior and/or subsequent year returns through the following actions:

1. Ensure appropriate content is included in the FY 09 Examination All Managers' Continuing Professional Education Performance Feedback to Achieve Higher Quality and Increased Productivity training module.
2. Discuss requirements with the Area Technical Analysts during monthly conference calls and require specific actions be implemented that will provide improvement for each SB/SE Examination Area.
3. Submit articles for inclusion in the SB/SE Group Managers' Performance Perspective and SB/SE Technical Digest.

IMPLEMENTATION DATE:

October 15, 2009

RESPONSIBLE OFFICIAL:

Director, Examination Policy SB/SE Division

CORRECTIVE ACTION(S) MONITORING PLAN:

The Director, Examination Policy SB/SE Division will monitor the status and advise the Director, Examination SB/SE Division of any delays in implementing.

RECOMMENDATION 2:

The Director, Examination SB/SE Division should require tax compliance officers to use the multi-year lead sheet during examinations.



*Examiners Did Not Always Properly Select the Prior
and/or Subsequent Year Tax Returns*

2

CORRECTIVE ACTIONS:

We concur with this recommendation. We will:

1. Issue a memorandum requiring that all SB/SE office examiners use the multi-year leadsheet to document their actions regarding consideration of prior and/or subsequent year returns.
2. Revise Form 4700 and related workpapers to correspond with the use of the Administrative Leadsheets.
3. Update IRM 4.10.9, *Examination of Workpapers*, to include the changes.

IMPLEMENTATION DATES:

Corrective Action #1 – March 15, 2009
Corrective Action #2 – June 15, 2009
Corrective Action #3 – January 15, 2010

RESPONSIBLE OFFICIAL:

Director, Examination Policy SB/SE Division

CORRECTIVE ACTION(S) MONITORING PLAN:

The Director, Examination Policy SB/SE will monitor the status and advise the Director, Examination SB/SE of any delays in implementing.

RECOMMENDATION 3:

The Acting Director, Campus Compliance Services SB/SE Division, should determine if there is an opportunity for campus correspondence tax examiners to expand examinations to include subsequent year returns for limited issues.

CORRECTIVE ACTIONS:

We concur with this recommendation. We will revise Campus procedures to ensure the appropriate analysis is conducted on current year correspondence deficiency case closures to determine if the same issue appears in the subsequent year return. Follow-up adjustment cases will receive priority in examination workload assignment plan.

IMPLEMENTATION DATE:

June 15, 2009



*Examiners Did Not Always Properly Select the Prior
and/or Subsequent Year Tax Returns*

3

RESPONSIBLE OFFICIAL:

Director, Campus Reporting Compliance

CORRECTIVE ACTION(S) MONITORING PLAN:

The Director, Campus Reporting Compliance SB/SE will monitor the status and advise the Director, Campus Compliance Services SB/SE of any delays in implementing.