



*Potential Opportunities Exist to Enhance
the Favorable Productivity Trends
for Audits Initiated by the
Updated Return Selection Formulas*

August 5, 2009

Reference Number: 2009-30-105

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.



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

August 5, 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 – Potential Opportunities Exist to Enhance the
Favorable Productivity Trends for Audits Initiated by the Updated
Return Selection Formulas (Audit # 200830030)

This report presents the results of our review to determine the status of using National Research Program¹ data to select individual returns for examination in the Small Business/Self-Employed (SB/SE) Division and the impact the data are having on examination results. The review was part of our risk-based audit coverage for Fiscal Year 2008 under the major management challenge of Tax Compliance Initiatives.

Impact on the Taxpayer

Fewer examinations initiated by the updated Discriminant Index Function (DIF)² formulas are being closed with no recommended tax changes, which indicates that the Internal Revenue Service (IRS) is better focusing its examination resources on returns posing the greatest compliance risk and not burdening compliant taxpayers with an examination. SB/SE Division statistics also indicate that taxpayers are agreeing with more of the additional taxes recommended in examinations initiated by the updated DIF formulas. This is important because the additional taxes owed from agreed examinations are far more likely to be collected than those that are assessed by default or disputed and appealed through the IRS administrative processes or the courts.

¹ See Appendix IV for a glossary of terms.

² In this report, the term DIF examinations includes returns related to those originally selected for examination.



Potential Opportunities Exist to Enhance the Favorable Productivity Trends for Audits Initiated by the Updated Return Selection Formulas

Synopsis

The IRS considers the National Research Program very important, and the SB/SE Division reflected this priority in the emphasis given to using the updated DIF formulas developed from National Research Program data to select returns for examination. The updated formulas were first used to score individual tax returns in Processing Year 2006, and by the end of Fiscal Year 2008 SB/SE Division statistics show the number of DIF initiated examinations is increasing, especially among Revenue Agents (RA).

When compared to earlier DIF initiated examinations, SB/SE Division statistics show that examination productivity continued favorable trends since the updated DIF formulas were introduced. The combined RA and Tax Compliance Officer results show DIF initiated examinations are yielding higher recommended additional taxes, both on an hourly and return basis, and are generating higher examination agreement rates. Statistics also show that the percentage of no-change examinations has decreased since the updated DIF formulas were introduced.

While overall examination productivity is trending favorably for DIF initiated examinations, the results are mixed for those closed by RAs. Before the updated formulas were introduced, DIF initiated examinations closed by RAs generated more recommended additional taxes and lower no-change rates for most of the five previous periods analyzed. Comparatively, Tax Compliance Officer results show higher recommended additional taxes on a return and hourly basis and a lower no-change rate after the updated DIF formulas were introduced.

The differences noted in the productivity trends between RAs and Tax Compliance Officers suggest there may be opportunities to improve how effectively returns are screened (i.e., finding questionable items that need to be audited) once delivered to RA groups in the field. Like examinations, return screening at the group level is extremely important because RAs and their managers ultimately decide which DIF selected returns are examined. Unlike controls over examinations, return screening controls are less formalized and rely heavily on the judgment and experience of individual RAs and their managers. Neither RAs nor their managers are required to document the reasons for rejecting (surveying) DIF selected returns. In addition, there is no feedback process in place to evaluate the quality or appropriateness of the survey decisions.

Since the updated DIF formulas were introduced, RAs and their managers have surveyed 15,483 DIF selected returns after they were delivered to the group. One-third of the surveys involved returns reporting \$200,000 or more of income, which is a segment of the return population (high-income individuals) where the IRS believes there is a need for more examination coverage. If controls were strengthened so that survey decisions based on low audit potential were adequately supported to allow evaluation, the advantages would likely outweigh the disadvantages.



*Potential Opportunities Exist to Enhance the
Favorable Productivity Trends for Audits Initiated
by the Updated Return Selection Formulas*

In terms of advantages, the documentation and feedback might identify potential opportunities to enhance revenue and reduce taxpayer burden by better ensuring that RAs and their managers are, in fact, only surveying returns with limited or no audit potential and not surveying returns that should be examined because they pose a high compliance risk. Using the recommended taxes generated by RAs on a return basis in Processing Year 2006 and constant dollars, we estimate that even a modest 4 percent reduction in the no-change rate for DIF initiated audits over the next 5 years would generate an additional \$18.7 million in recommended taxes. The no-change reduction would also eliminate the burden associated with an examination on an estimated 1,341 compliant taxpayers.

Recommendation

To determine the extent that decisions to survey DIF selected returns based on low examination potential may be affecting examination productivity indicators, we recommended that the Director, Examination, establish a process, at least on a test basis, to evaluate the quality and appropriateness of those decisions.

Response

IRS management agreed with our recommendation and will conduct a review of surveyed DIF returns using a modified Income Tax Survey After Assignment (Form 1900). IRS management also noted that our recommendation will strengthen the SB/SE Division's understanding of the reasons DIF returns are surveyed. 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 recommendation. 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.



*Potential Opportunities Exist to Enhance the
Favorable Productivity Trends for Audits Initiated
by the Updated Return Selection Formulas*

Table of Contents

Background	Page 1
Results of Review	Page 3
The Small Business/Self-Employed Division Is Taking Advantage of National Research Program Data to Select Returns for Examination	Page 3
The Number of Returns Identified for Examination but Subsequently Rejected Due to Low Examination Potential Warrants Closer Scrutiny	Page 6
<u>Recommendation 1</u> :	Page 9
 Appendices	
Appendix I – Detailed Objectives, Scope, and Methodology	Page 11
Appendix II – Major Contributors to This Report	Page 13
Appendix III – Report Distribution List	Page 14
Appendix IV – Glossary of Terms	Page 15
Appendix V – Management’s Response to the Draft Report	Page 16



*Potential Opportunities Exist to Enhance the
Favorable Productivity Trends for Audits Initiated
by the Updated Return Selection Formulas*

Abbreviations

AIMS	Audit Information Management System
DIF	Discriminant Index Function
FY	Fiscal Year
IRS	Internal Revenue Service
NRP	National Research Program
PY	Processing Year
RA	Revenue Agent
SB/SE	Small Business/Self-Employed Division
TCO	Tax Compliance Officer



Potential Opportunities Exist to Enhance the Favorable Productivity Trends for Audits Initiated by the Updated Return Selection Formulas

Background

The Internal Revenue Service (IRS) established the National Research Program¹ (NRP) in 2000 to resume measuring taxpayers' voluntary compliance, better approximate the tax gap, and develop updated formulas to select noncompliant returns for examination. In previous years, the IRS gathered taxpayer compliance data through Taxpayer Compliance Measurement Program examinations. However, many external stakeholders, including Congress and taxpayer representative associations, believed that the Taxpayer Compliance Measurement Program, which included a line-by-line examination of each item on a tax return, was too intensive and a significant burden on the taxpayers with returns selected for the program. The last Taxpayer Compliance Measurement Program examinations for individual taxpayers were conducted using tax returns filed in 1988.

The first NRP study produced critical data that were used to update IRS screening formulas that select likely noncompliant individual tax returns for examination.

Since its inception, the NRP has strived to minimize the burden on the taxpayers selected for its studies. To meet this objective, NRP personnel accessed the IRS' automated information systems to collect and analyze IRS and third-party information before making contact with taxpayers. This case building process enables the IRS to obtain a more complete picture of a taxpayer's financial situation and limit the information that must be requested from taxpayers once contact is initiated. According to a Government Accountability Office report,² the IRS was carrying out the initial NRP study in accordance with plans formalized in 2002. The plans included identifying and training more than 3,000 examiners and establishing quality assurance checks to help ensure consistent and accurate data collection.

The NRP completed the study of individual reporting compliance in 2006 and released an initial tax gap estimate based on reviewing about 46,000 randomly selected Tax Year 2001 individual tax returns. According to the NRP estimate, the annual tax gap was \$345 billion and the largest identified portion of the gap (\$197 billion, or 57 percent) was attributed to individuals underreporting their income. Besides the updated tax gap estimate, the NRP study also produced critical data that were used to update the Discriminant Index Function (DIF) formulas to help close the \$197 billion tax gap attributed to individual underreporting.

The DIF formulas are used to calculate and assign a DIF score for all individual returns based on their examination potential. The higher the score, the greater the chance an examination will

¹ See Appendix IV for a glossary of terms.

² *Tax Administration: IRS Is Implementing the National Research Program as Planned* (GAO-03-614, dated June 2003).



*Potential Opportunities Exist to Enhance the
Favorable Productivity Trends for Audits Initiated
by the Updated Return Selection Formulas*

result in a material tax change. After the DIF assigns a score, the returns with the highest scores are evaluated by classifiers. These classifiers, who are experienced examiners, determine which returns are most in need of examination and, through examination, will promote the highest degree of voluntary compliance. In some instances, they may also select the issues to be covered during the examination.

Once the decision is made that an examination is warranted, the returns are forwarded to either a Revenue Agent (RA) or Tax Compliance Officer (TCO) based on the type of return and issues involved. In general, RAs conduct examinations involving more complex issues related to business individuals and of individuals with higher income levels. After being received in the group, the return is screened again by the group manager and either an RA or TCO. During this final screening, an examination is initiated or the return is eliminated from the DIF selected audit stream.

This review was performed in the IRS Small Business/Self-Employed (SB/SE) Division Headquarters Office in New Carrollton, Maryland, and at the IRS Office of Research, Analysis, and Statistics in Washington, D.C., during the period April 2008 through January 2009. 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.



Potential Opportunities Exist to Enhance the Favorable Productivity Trends for Audits Initiated by the Updated Return Selection Formulas

Results of Review

Overall, statistics in the SB/SE Division show that examination productivity is improving for individual returns selected by the updated DIF formulas. However, the number of returns that the DIF is identifying for examination but are subsequently rejected due to low examination potential warrants closer scrutiny.

The Small Business/Self-Employed Division Is Taking Advantage of National Research Program Data to Select Returns for Examination

The IRS considers the NRP very important, and the SB/SE Division reflected this priority in the emphasis given to using the updated DIF formulas developed from NRP data to select returns for examination. The updated formulas were first used to score individual tax returns in Processing Year (PY) 2006, and by the end of Fiscal Year (FY) 2008 SB/SE Division statistics show the number of DIF initiated examinations³ conducted by RAs is increasing. Although the number of RAs remained about the same, Figure 1 shows there was a considerable increase (49 percent) from FY 2007 to 2008 in the number of RA examinations initiated by DIF as well as an overall increase in the number of examinations closed in FY 2008.

Figure 1: SB/SE Division's Individual Tax Return Examination Closures in FYs 2007 and 2008

<i>FY</i>	<i>RA DIF Initiated</i>	<i>RA Other*</i>	<i>TCO DIF Initiated</i>	<i>TCO Other*</i>	<i>Totals</i>
<i>2007</i>	27,945	69,784	53,889	72,088	223,706
<i>2008</i>	41,644	72,012	61,658	67,229	242,543
<i>Totals</i>	69,589	141,796	115,547	139,317	466,249

* Other: Examinations can be initiated from a variety of sources including potentially abusive transactions, studies/research projects, and third-party document matching.

Source: Our analysis of closed examination data from the IRS Audit Information Management System (AIMS) for FYs 2007 and 2008.

SB/SE Division statistics additionally indicate that taxpayers agreed with more of the additional taxes recommended in examinations initiated by the updated DIF formulas. In FY 2008, the number of agreed DIF initiated examinations increased 76 percent from a comparable period ending in FY 2005. From a revenue collection perspective, this is important because the

³ In this report, the term DIF initiated examinations includes related returns.



Potential Opportunities Exist to Enhance the Favorable Productivity Trends for Audits Initiated by the Updated Return Selection Formulas

additional taxes owed from agreed examinations are far more likely to be collected than those that are either assessed by default or disputed and appealed through the IRS administrative processes or the courts. To illustrate, we evaluated the collections from a random sample of 30 closed examinations for which the taxpayers agreed with the results (agreed assessments) and 30 examinations for which the taxes were assessed by default during FY 2004. Our evaluation, summarized in Figure 2, shows that even though more than 200 percent more taxes were owed from the defaulted assessments, the agreed assessments produced 184 percent more revenue. Figure 2 additionally shows that almost all (99.8 percent) of the additional taxes, penalties, and interest recommended in the agreed examinations have been collected, while the vast majority (75 percent) of the taxes, penalties, and interest owed from the defaulted examinations remains outstanding.

Figure 2: Comparison Between the Amount of Assessments Collected From FY 2004 Agreed and Defaulted Examinations Through March 1, 2009

<i>Type of Closure</i>	<i>Number of Examinations</i>	<i>Total Assessed</i>	<i>Total Collected</i>	<i>Percentage Collected</i>
<i>Agreed</i>	30	\$438,123.88	\$437,117.08	99.8
<i>Default</i>	30	\$949,753.06	\$237,237.34	25.0

Source: Our analyses of random pilot samples of agreed and default cases.

Besides finding the SB/SE Division is conducting more DIF initiated examinations and obtaining more agreements, our comparative analysis shows key examination productivity indicators are trending favorably since the updated DIF formulas were introduced. When compared to earlier DIF initiated examinations, RA and TCO combined results show that under the updated formulas, DIF initiated examinations are yielding higher recommended additional taxes, both on an hourly and return basis, and are resulting in fewer closures with no recommended tax changes (no-change examinations).

Overall, productivity indicators are trending favorably for DIF initiated examinations

It is important to note that the periods included in our comparative analysis are based on PYs 2001 through 2006 and the 2 succeeding fiscal years for each processing year when the examinations were completed and the results recorded in the IRS AIMS. We conducted our analysis in this manner to present a fair and meaningful comparison because at the time of our review only 2 fiscal years (2007 and 2008) of examinations had been completed after the updated formulas were implemented in PY 2006. Consequently, examinations open longer than the 2 fiscal years following the year in which the examined tax return was processed are not included in our analysis. We also believe it is important to recognize that, due to various other ongoing initiatives that the SB/SE Division has implemented to enhance the examination process, we were unable to isolate the impact on examination productivity from the updated

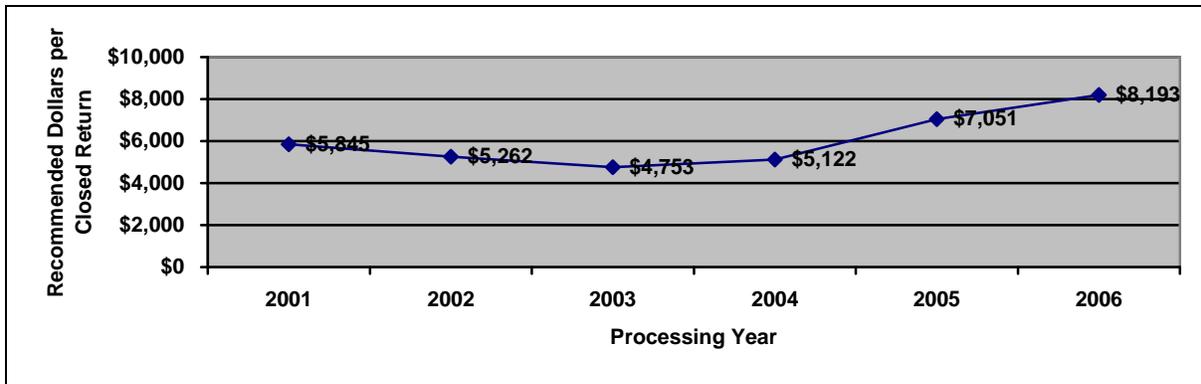


Potential Opportunities Exist to Enhance the Favorable Productivity Trends for Audits Initiated by the Updated Return Selection Formulas

formulas with any degree of preciseness. These initiatives included an increased emphasis on limiting the scope of examinations to just the issues posing the greatest compliance risk and using a fast track settlement process to resolve disputes.

One measure of examination productivity is the amount of additional taxes recommended for each return examined. Overall, we found that the recommended additional taxes on a return basis continued to increase for DIF initiated examinations after the updated formulas were introduced in PY 2006. As Figure 3 shows, the recommended additional taxes increased 72 percent from a low of \$4,753 in PY 2003 to \$8,193 in PY 2006. Our analysis also shows that RA examinations resulted in as much as two to three times more additional tax recommended per return than those conducted by TCOs. A factor likely contributing to the difference is the types of returns the examiners generally are assigned to examine. In general, RAs conduct more examinations of business individuals and of individuals with higher income levels. Typically, examinations of business individuals and those at higher income levels result in higher additional recommended taxes per return than examinations of nonbusiness individuals and those at lower income levels.

Figure 3: Additional Taxes Recommended by RAs and TCOs Per Return for PYs 2001 Through 2006



Source: Our analysis of closed examination data for PYs 2001 through 2006 returns from the IRS AIMS for FYs 2002 through 2008.

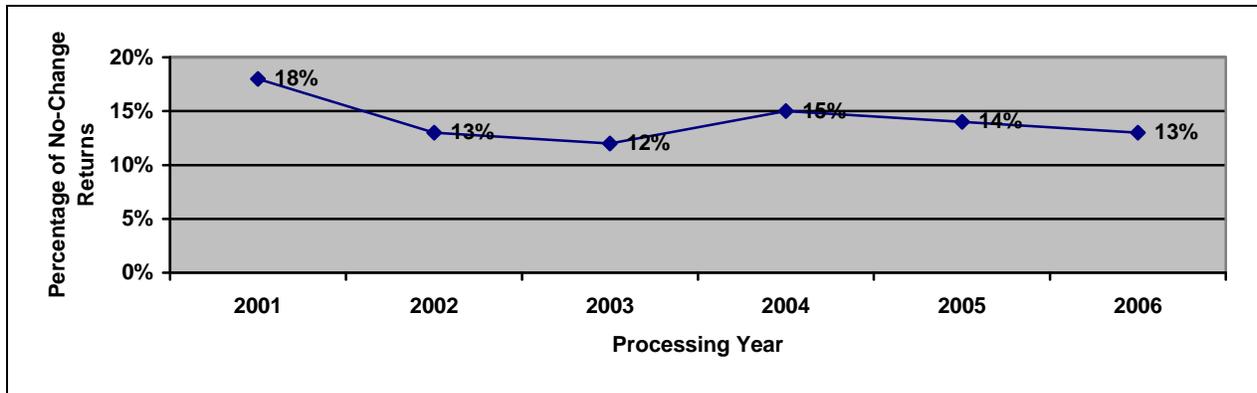
Two other examination productivity indicators are the amount of additional taxes recommended for each direct examination hour used to examine the return and the percentage of examinations closed as a no-change. Concerning the amount of additional taxes recommended for each direct examination hour used to examine the return, we found the examinations initiated under the updated DIF formulas resulted, on average, in a modest increase of about 11 percent more additional recommended taxes than the DIF examinations closed in earlier periods. Additionally, there was a decline in the percentage of no-change examinations initiated under the new formulas, as reflected in Figure 4. The reduction in the percentage of no-change examinations is notable because it indicates that the IRS is better focusing its examination resources on returns



Potential Opportunities Exist to Enhance the Favorable Productivity Trends for Audits Initiated by the Updated Return Selection Formulas

posing the greatest compliance risk and not burdening as many compliant taxpayers with an examination.

Figure 4: Combined Percentage of RA and TCO DIF Initiated No-Change Examinations in PYs 2001 Through 2006



Source: Our analysis of closed examination data for PYs 2001 through 2006 returns from the IRS AIMS for FYs 2001 through 2008.

While overall examination productivity is trending favorably for DIF initiated examinations, the results are mixed for those closed by RAs. In most of the 5 processing years before the updated formulas were introduced, DIF initiated examinations closed by RAs generated more recommended additional taxes and had lower no-change rates.

The Number of Returns Identified for Examination but Subsequently Rejected Due to Low Examination Potential Warrants Closer Scrutiny

In 4 of the 5 processing years (2001 through 2005) before the updated DIF formulas were introduced, our comparative analysis shows the DIF initiated examinations closed by RAs generated higher recommended additional taxes on an hourly and return basis than those examinations after the DIF formulas were updated. We also found the RA no-change rate was lower in 3 of the 5 processing years before the updated formulas were introduced.

Comparatively, TCO results are trending more favorably. Their recommended additional taxes on a return and hourly basis were higher and no-change rate lower after the updated DIF formulas were introduced in PY 2006. Figure 5 summarizes the RA and TCO recommended additional taxes and no-change rates in PYs 2001 through 2006.



Potential Opportunities Exist to Enhance the Favorable Productivity Trends for Audits Initiated by the Updated Return Selection Formulas

Figure 5: RA and TCO Recommended Additional Taxes and No-Change Rates From DIF Initiated Examinations in PYs 2001 Through 2006

Processing Year	Revenue Agent			Tax Compliance Officer		
	Dollars per Hour	Dollars per Return	No-Change Rate	Dollars per Hour	Dollars per Return	No-Change Rate
2001	436	15,724	15 %	395	3,851	19 %
2002	683	17,552	7 %	395	3,996	14 %
2003	508	15,083	15 %	415	4,114	12 %
2004	310	10,648	25 %	435	3,881	13 %
2005	440	14,322	22 %	513	4,417	11 %
2006	420	13,654	19 %	594	5,130	9 %
<i>Average for All PYs</i>	423	13,863	19 %	458	4,254	13 %

Source: Our analysis of closed examination data for PYs 2001 through 2006 returns from the IRS AIMS for FYs 2002 through 2008.

The differences noted in the productivity trends between RAs and TCOs suggest there may be opportunities to improve how RAs are examining the returns and/or how effectively returns are screened (i.e., finding questionable items that need to be examined) once delivered to RA groups in the field. Although we did not review case files to evaluate the quality of examinations conducted by either RAs or TCOs, the SB/SE Division has controls in place that are designed to ensure examinations are meeting standards and potential problems with the technical aspects of examinations are identified so corrective actions can be initiated.

One control used by the SB/SE Division to measure how well examiners are meeting the technical and procedural aspects of examinations is the National Quality Review System. Under this system, examiners are required to fully document examination case files showing the issues considered and the decision process followed in reaching conclusions. From a control perspective, this documentation is critical because it provides the principal support for the decisions made about how much, if any, additional taxes are owed by the taxpayer. The documentation is also used by National Quality Review System reviewers as the basis for evaluating samples of closed examinations against auditing standards and advising management of potential problems so needed corrective actions can be taken.

Like examinations, return screening at the group level is extremely important because RAs and their managers ultimately decide which DIF selected returns are examined. Consequently, selecting returns for examination that pose little or no compliance risk can have a direct adverse



Potential Opportunities Exist to Enhance the Favorable Productivity Trends for Audits Initiated by the Updated Return Selection Formulas

effect on the amount of recommended additional taxes, no-change rates, and taxpayer burden, regardless of how well the technical and procedural aspects of the examinations are performed.

Unlike controls over examinations, return screening controls are less formalized and rely heavily on the judgment and experience of individual RAs and their managers. Although RAs and their managers can reject (survey) a DIF selected return for a number of reasons, neither are required to document the reason for the survey. For example, RAs and their managers can survey a return to avoid repetitively auditing the same taxpayer. They can also survey a return because they believe it has limited audit potential, even though the DIF formulas and a classifier have indicated otherwise. Besides limited documentation, there is no feedback process in place to evaluate the quality or appropriateness of the survey decisions. The reliance on judgment and experience when combined with the absence of a feedback process can be particularly problematic in today's environment because the IRS is increasingly hiring new RAs and promoting others as new managers to replace the growing loss of experienced RAs and managers to retirement.

Since the updated DIF formulas were introduced, SB/SE Division statistics show RAs and their managers have surveyed 15,483 DIF selected returns due to limited examination potential. As Figure 6 shows, one-third of the surveys involved returns reporting \$200,000 or more of income, which is a segment of the return population (high-income individuals) the IRS believes needs more examination coverage. We believe that if controls were established so that survey decisions based on low examination potential were adequately supported to allow evaluation, the advantages would likely outweigh the disadvantages.

Figure 6: Individual Returns Selected by the Updated DIF Formulas in PYs 2006 through 2008 and Subsequently Surveyed at the RA Group Level Due to Low Examination Potential

<i>Types of Returns</i>	<i>RA Surveys</i>	<i>Manager Surveys</i>	<i>Total Surveys</i>
Nonbusiness – Total Positive Income less than \$200,000.	132	202	334
Business – Total Positive Income less than \$200,000	3,423	6,443	9,866
Subtotal - Total Positive Income less than \$200,000	3,555	6,645	10,200
Nonbusiness – Total Positive Income of \$200,000 but less than \$1 million	158	286	444
Business – Total Positive Income of \$200,000 but less than \$1 million.	1,345	1,895	3,240
Nonbusiness and Business – Total Positive Income of \$1 million or more	881	718	1,599
Subtotal – Total Positive Income greater than \$200,000	2,384	2,899	5,283
Grand Total	5,939	9,544	15,483

Source: Our analysis of closed nonexamined return data for PYs 2006 through 2008 returns from the IRS AIMS for FYs 2006 through 2008.



*Potential Opportunities Exist to Enhance the
Favorable Productivity Trends for Audits Initiated
by the Updated Return Selection Formulas*

In terms of advantages, the documentation and feedback might identify potential opportunities to enhance revenue and reduce taxpayer burden by better ensuring that RAs and their managers are, in fact, only surveying returns with limited or no audit potential and not surveying returns that should be examined because they pose a high compliance risk. Using the recommended taxes generated by RAs on a return basis in PY 2006 and constant dollars, we estimate that even a modest 4 percent reduction in the no-change rate for DIF initiated examinations over the next 5 years would generate an additional \$18.7 million in recommended taxes. The no-change reduction would also eliminate the burden associated with an examination on an estimated 1,341 compliant taxpayers. Moreover, having the documentation and a feedback process in place would be in line with the Federal Government's control standards, which require establishing controls to provide assurances that work is carried out in accordance with the intent of policies and procedures management has in place.

The primary disadvantages involve the time spent documenting the support for the survey decision and evaluating the appropriateness of the decision in relation to the support provided. While we do not have specific evidence to support this position, we believe the time and resources spent documenting and evaluating survey decisions could be mitigated by expanding on existing work practices. Moreover, the documentation and evaluation could be limited to a test period and involve only certain types of DIF selected returns, such as those involving high-income individuals.

According to the IRS procedures, RAs and managers already consider such factors as compliance risk, materiality, and potential dollar yields in deciding to survey DIF selected returns based on examination potential. Consequently, the documentation could be limited to recording the factors considered and conclusions reached on the existing Income Tax Survey After Assignment (Form 1900). Currently, the Form 1900 is mandatory for surveying some top-priority returns, such as returns included in NRP compliance studies, and is forwarded to SB/SE Division's Planning and Special Procedures Office where the survey decision is reviewed against established criteria.

Recommendation

Recommendation 1: To determine the extent that survey decisions based on low examination potential may be affecting examination productivity indicators, we recommend that the Director, Examination, establish a process, at least on a test basis, to evaluate the quality and appropriateness of the survey decisions made by RAs and their managers on DIF selected returns so that corrective actions, if needed, can be identified and taken.

Management's Response: IRS management agreed with our recommendation and will conduct a review of surveyed DIF returns using a modified Form 1900 that includes a listing of common reasons returns are surveyed. Based upon the results of the review, the SB/SE Division will take appropriate actions. IRS management also noted that our



*Potential Opportunities Exist to Enhance the
Favorable Productivity Trends for Audits Initiated
by the Updated Return Selection Formulas*

recommendation will strengthen the SB/SE Division's understanding of the reasons DIF returns are surveyed.



*Potential Opportunities Exist to Enhance the
Favorable Productivity Trends for Audits Initiated
by the Updated Return Selection Formulas*

Appendix I

Detailed Objectives, Scope, and Methodology

The overall objectives of this review were to determine the status of using NRP¹ data to select individual returns for examination in the SB/SE Division and the impact the data are having on examination results. During the review, we relied on databases provided to us by the IRS. We did not conduct audit tests to determine the accuracy and reliability of the information in any of the databases. However, we did assess the completeness of the data as described below and concluded the data were reliable and adequate to conduct our work. To accomplish our objectives, we:

- I. Reviewed Government Accountability Office and Treasury Inspector General for Tax Administration reviews on NRP planning and implementation efforts, NRP newsletters, and SB/SE Division Strategic Plans for FYs 2008-2009 to gain an understanding of the history and current status of the NRP.
- II. Interviewed NRP officials on the process used to measure the performance of DIF and Examination function officials on the return survey process.
- III. Analyzed IRS closed examination data for FYs 2007 and 2008 from AIMS relating to PY 2006 DIF identified and related returns. The analysis focused on 1) no-change rate for returns examined, 2) dollars recommended per examination hour, and 3) dollars recommended per return examined.
- IV. Reviewed a random sample² of 30 agreed examination cases selected from a population of 25,464 cases shown as closed in FY 2004 on AIMS to determine the amount of assessed taxes as a result of the examination and the amount of taxes collected. We also reviewed a random sample³ of 30 unagreed examination cases selected from a population of 3,257 cases shown as closed in FY 2004 on AIMS to determine the amount of assessed taxes as a result of the examination and the amount of taxes collected. We compared the amounts of assessed taxes and collected taxes for both samples.
- V. Determined if examinations of PY 2006 computer-identified and related returns scored by the revised DIF formulas were more productive than the PYs 2001 to 2005 returns scored by the prior DIF formulas by analyzing FYs 2002 to 2007 closed AIMS data and focusing on 1) no-change rate for returns examined, 2) dollars recommended per examination hour, and 3) dollars recommended per return examined.

¹ See Appendix IV for a glossary of terms.

² A random sample was used to ensure that each case had an equal chance of selection.

³ A random sample was used to ensure that each case had an equal chance of selection.



*Potential Opportunities Exist to Enhance the
Favorable Productivity Trends for Audits Initiated
by the Updated Return Selection Formulas*

- VI. Analyzed data on surveyed returns, including determining the number of returns with \$200,000 or more in total positive income surveyed by managers and surveyed by examiners for PYs 2006 through 2008 using AIMS data from FYs 2006 through 2008 for returns closed and not examined by the IRS.
- VII. Assessed the methods used by the IRS National Headquarters Research function and the SB/SE Division Research function to measure the effectiveness of the revised DIF formulas using the Government Accountability Office's *Standards for Internal Control in the Federal Government*.
- VIII. Assessed the completeness of the closed AIMS data used to complete the above objectives.
 - A. Reconciled the closed AIMS data for FYs 2002 through 2008 with the appropriate Table 37 Reports.
 - B. Reconciled the closed AIMS and survey data with Master File data.



*Potential Opportunities Exist to Enhance the
Favorable Productivity Trends for Audits Initiated
by the Updated Return Selection Formulas*

Appendix II

Major Contributors to This Report

Margaret E. Begg, Assistant Inspector General for Audit (Compliance and Enforcement Operations)
Frank Dunleavy, Director
Robert Jenness, Audit Manager
Lisa Stoy, Audit Manager
William Tran, Lead Auditor
Timothy Greiner, Senior Auditor
David Hartman, Senior Auditor



*Potential Opportunities Exist to Enhance the
Favorable Productivity Trends for Audits Initiated
by the Updated Return Selection Formulas*

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
Director, National Research Program RAS:NRP
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



*Potential Opportunities Exist to Enhance the
Favorable Productivity Trends for Audits Initiated
by the Updated Return Selection Formulas*

Appendix IV

Glossary of Terms

Audit Information Management System – A system that the IRS Examination function uses to control returns, input assessments and adjustments to the Master File, and provide management reports.

Discriminant Index Function – Mathematical formulas used by the IRS to calculate and assign a score for all individual returns based on their examination potential.

Fiscal Year – The IRS' Fiscal Year is a 12-month period which runs from October 1 to the following September 30.

Master File – IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

National Research Program – Research conducted by the IRS to determine filing, payment, and reporting compliance by taxpayers for different types of taxes. The IRS established the program in the year 2000 to resume measuring taxpayers' voluntary compliance.

National Quality Review System – The SB/SE Division conducts case reviews from individual audits. The data collected from the reviews are input to the system for analysis on how well examiners are meeting the technical and procedural aspects of examinations.

Processing Year – The calendar year in which a tax return is processed.

Revenue Agents – Conduct examinations involving more complex issues related to business individuals and individuals with higher income levels.

Taxpayer Compliance Measurement Program – The IRS' method of data collection that audits every line on tax returns for a random sample of taxpayers.

Tax Compliance Officers – Conduct examinations on individuals' nonbusiness related, sole proprietorships, and individuals with business and other supplemental income.

Tax Year – Annual accounting period taxpayers use to keep records and report income and expenses on their tax returns. For individuals, it is usually the same as the calendar year.

Total Positive Income – Calculated using only positive income values from specific income fields from a tax return and treating losses as zero.



*Potential Opportunities Exist to Enhance the
Favorable Productivity Trends for Audits Initiated
by the Updated Return Selection Formulas*

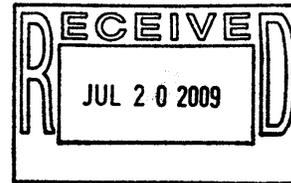
Appendix V

Management's Response to the Draft Report



COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

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



July 17, 2009

MEMORANDUM FOR MICHAEL R. PHILLIPS
DEPUTY INSPECTOR GENERAL FOR AUDIT

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

SUBJECT: Draft Audit Report – Potential Opportunities Exist to Enhance the
Favorable Productivity Trends for Audits Initiated by the Updated
Return Selection Formulas (Audit 200830030)

We have reviewed your report titled "Potential Opportunities Exist to Enhance the Favorable Productivity Trends for Audits Initiated by the Updated Return Selection Formulas." We concur with your recommendation and will conduct a review of surveyed Discriminant Index Function (DIF) returns.

As acknowledged in your report, we consider the National Research Program (NRP) to be very important. This level of importance is reflected in the emphasis given to using the updated DIF formulas developed from NRP data to select returns for examination. Recommendations arising from the review will serve to further strengthen our understanding of the reasons why DIF returns are surveyed.

We appreciate your comments regarding our improved performance in securing agreements, in collecting tax assessments, and our lower no change rate on DIF returns.

A detailed response outlining our corrective action is attached. If you have questions, please call me at (202) 622-0600 or Monica Baker, Director, Examination at (202) 283-2659.

Attachment



*Potential Opportunities Exist to Enhance the
Favorable Productivity Trends for Audits Initiated
by the Updated Return Selection Formulas*

Attachment

RECOMMENDATION 1:

To determine the extent that survey decisions based on low examination potential may be affecting examination productivity indicators, we recommend that the Director, Examination, establish a process, at least on a test basis, to evaluate the quality and appropriateness of the survey decisions made by RAs and their managers on DIF selected returns so that corrective actions, if needed, can be identified and taken.

CORRECTIVE ACTIONS:

We concur with your recommendation. We will conduct a review of surveyed DIF returns using a modified Form 1900 that includes a listing of common reasons returns are surveyed. Based upon the results of the review, we will take appropriate actions.

IMPLEMENTATION DATE:

January 15, 2012

RESPONSIBLE OFFICIAL:

Director, Exam, Planning and Delivery

CORRECTIVE ACTION MONITORING PLAN:

The Director, Examination, Planning and Delivery, will monitor the status and will advise the Director, Examination of any delays in completing the corrective action.