Significant Tax Issues Are Often Not Addressed During Correspondence Audits of Sole Proprietors

February 24, 2010

Reference Number: 2010-30-024

Phone Number | 202-622-6500
Email Address | inquiries@tigta.treas.gov
Web Site | http://www.tigta.gov

TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

February 24, 2010

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED DIVISION

FROM: Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Significant Tax Issues Are Often Not Addressed During Correspondence Audits of Sole Proprietors (Audit # 200830054)

This report presents the results of our review to determine whether correspondence examinations effectively address the compliance risks of sole proprietors. The review was conducted as part of our Fiscal Year 2009 Annual Audit Plan under the major management challenge of Tax Compliance Initiatives.

Impact on the Taxpayer

Estimates by the Internal Revenue Service (IRS) show that $68 billion of the $345 billion tax gap[1] in 2001 was due to sole proprietors who underreported their income. We evaluated closed correspondence audits of individual returns reporting sole proprietor operations and found significant tax issues were not addressed during these audits. Sole proprietors who underreport their income can create unfair burden on honest taxpayers and diminish the public's respect for the tax system.

Synopsis

To its credit, the IRS has successfully expanded audit coverage, using the correspondence process as one of several ways to help remedy the noncompliance that contributes to the estimated $345 billion annual tax gap. However, the absence of required minimum checks for unreported income and unfiled returns in correspondence audits involving sole proprietors may

[1] The difference between taxes that are legally owed and taxes that are paid on time.

be undermining the effectiveness of a process designed to verify that the correct amount of tax is reported.

We evaluated a statistically valid sample of 298 closed correspondence audits of individual returns reporting sole proprietor operations that were closed by tax examiners in the IRS Campus Compliance Services operations during Fiscal Year 2007. While examiners adequately documented audit case files to support audit findings, we found 129 audits where sole proprietors may have avoided tax and interest assessments totaling more than $1.7 million after significant potential income misstatements were not addressed during the audits.

We believe many of the problems identified in the audits can be attributed to two procedures that are not required by correspondence examiners, but are required by field examiners, when auditing an individual return reporting sole proprietor business income. Unlike procedures for audits conducted in the field, the procedures for correspondence audits do not require examiners to complete minimum checks for unfiled returns (employment tax and information returns) and to probe for unreported income.

Given the compliance risks associated with sole proprietors and the potential revenue at stake, the advantages associated with requiring examiners to include checks for unfiled returns and probe for unreported income during correspondence audits would seem to outweigh the disadvantages. The advantages include identifying unreported income that might otherwise go undetected, which could increase the amount of revenue from audits. Also, the procedures could be performed without increasing burden on compliant taxpayers and provide a more sound and objective basis for transferring audits to the field. The disadvantages involve the time and costs spent training examiners to use and document the new procedures in audit case files. There would also be costs involved with establishing controls to provide assurance that examiners are properly following the procedures once implemented. However, we believe these costs would not be significant because they could be mitigated to some degree by expanding on existing work practices and processes.

Recommendations

We recommended that the Director, Campus Compliance Services, Small Business/Self-Employed Division, require examiners to conduct and document, in audit case files, checks to identify unfiled employment tax and information returns and the results of automated preliminary cash transactions analyses, including consideration given to transferring the audit to the field if issues are identified. In addition, we recommended that the Director, Campus Compliance Services, expand controls that provide assurance that examiners are properly performing checks for unfiled employment tax and information returns and conducting preliminary cash transaction analyses so corrective actions can be identified and taken, if needed.

Response

IRS management partially agreed with our three recommendations by responding with alternative corrective actions. IRS management stated they would work with the Small Business/Self-Employed Division's Research Division to develop inventory selection filters to identify sole proprietors that did not file required employment tax or information returns and those with indicators of unreported income. To the extent possible, these cases would be excluded from correspondence examination inventory and made available to field examination. IRS management agreed to provide additional guidance to campus correspondence examiners on documenting case files and transferring cases to the field, when warranted. IRS management also agreed to ensure appropriate actions were taken on sole proprietor audits during quality reviews of open and closed cases. Feedback from the quality reviews would be provided to the respective Campus Director and Campus Examination Operations Manager and would also be considered during updates to inventory selection filters.

Management did not agree with our outcome measure because they had concerns that our calculations were based on preliminary cash transaction analyses and assumed all potential underreporting was actual underreporting. They also had concerns that our computation did not include implementation costs, such as training and lost opportunity costs. Management's complete response to the draft report is included as Appendix V.

Office of Audit Comment

We agree the IRS' alternative corrective actions may help reduce the number of significant tax issues that are not addressed during correspondence audits of sole proprietors. However, the absence of a specific commitment from the IRS requiring that examiners conduct a preliminary cash transaction analysis during sole proprietor examinations is surprising to us given the high number of correspondence examinations closed in recent years, including those involving a sole proprietor. In Fiscal Year 2008, IRS records show that it closed 125,045 examinations involving a sole proprietor using correspondence techniques. This is roughly a 7 percent increase over the 117,064 sole proprietor examinations using correspondence techniques that were closed in Fiscal Year 2004.

As outlined in this report, a preliminary cash transaction analysis can identify considerable differences between expenditures and income. This difference raises very serious questions about whether expenses may be overstated on the return and/or whether there may be additional sources of income that should have been reported. Moreover, the IRS readily admitted in its response that sole proprietor underreporting is a serious compliance issue and that this type of analysis is necessary for an effective audit of the issue.

Regarding the disagreement over the outcome measure, we maintain that the potential $82.6 million of increased revenue is a reasonable estimate, and we included qualifiers to our outcome measure to clarify that our numbers assume all estimated taxes and interest would be owed based upon audits of the taxpayers' books and records. We also clarified that additional costs related to implementation, training, and lost opportunities are not factored into the computation.

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.

Table of Contents

Abbreviations

FY	Fiscal Year
IRS	Internal Revenue Service

Background

Each year, the Internal Revenue Service (IRS) identifies billions of dollars in additional income taxes owed through audits of individual income tax returns. Such audits, which occur in a variety of forms, are critical to the IRS' enforcement strategy for ensuring individuals are paying the amount of taxes they owe.

Audits of individual income tax returns range from reviewing tax returns and resolving questionable items by corresponding with taxpayers through the mail to a detailed face-to-face examination of a taxpayer's financial records at his or her place of business. In contrast to the more labor intensive face-to-face examination, the correspondence audit process is less intrusive, more automated, and conducted by examiners who are trained to deal with and focus on less complex tax issues. Importantly, correspondence audits also enable the IRS to reach more taxpayers at a lower cost.

Typically, a correspondence audit begins with the IRS mailing a computer generated letter to a taxpayer that outlines the examination process, identifies one or more items on the tax return being questioned, and requests supporting information to resolve the questionable items. Once returned, examiners review the information to see whether it resolves the questions. If the questions can be sufficiently answered by the information provided, the audit is generally closed without any tax changes; if not, the taxpayer is sent a letter requesting more information or indicating a recommended tax change. The taxpayer at this point can agree with the examiner, provide the examiner with clarifying information, or appeal the decision to the IRS' Office of Appeals. In instances where the taxpayer does not respond to IRS letters, the examiner's recommended tax changes are assessed by default and the taxpayer will generally have to petition the court system to contest the assessment.

This review was performed in the IRS Small Business/Self-Employed Division Headquarters Office in New Carrollton, Maryland, during the period July 2008 through August 2009. Except for auditing IRS databases to validate the accuracy and reliability of the information, 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.

Results of Review

To its credit, the IRS has successfully expanded audit coverage using the correspondence process. However, despite the billions of dollars in assessments this process generates, additional steps are needed to ensure the risks posed by sole proprietors are mitigated in correspondence audits.

The Recommended Additional Taxes From Correspondence Audits Are Substantial

In Fiscal Years (FY) 2004 through 2008, IRS statistics show it conducted more than 5.1 million correspondence examinations and, in the process, recommended approximately $35 billion in additional taxes. This represents about 60 percent of the estimated $58 billion in total recommended additional taxes from all individual examinations during these years. It also indicates that for each tax return examined, a correspondence examination generated about $6,800 in recommended additional taxes. Considering the seemingly high return from the correspondence examination process, it is not too surprising the number of examinations conducted through correspondence is increasing. As shown in Figure 1, the number of individual tax returns examined through correspondence increased from 828,262 in FY 2004 to more than 1.1 million in FY 2008 and accounted for the vast majority of individual tax returns that were examined in each of these years.

Figure 1: Audit Results for FYs 2004 Through 2008

	2004	2005	2006	2007	2008
Total Number of Audits	997,028	1,199,035	1,283,950	1,384,563	1,391,581
Number of Correspondence Audits	828,262	1,007,891	1,055,979	1,135,556	1,138,695
Percentage of Correspondence Audits	83%	84%	82%	82%	82%
Recommended Additional Taxes From All Audits (in billions)	$5.6	$12.9	$12.2	$15.0	$11.9
Recommended Additional Taxes From All Correspondence Audits (in billions)	$3.6	$7.5	$7.8	$9.6	$6.8
Percentage of Recommended Additional Taxes From Correspondence Audits	64%	58%	64%	64%	57%

Source: Our analysis of FYs 2004–2008 data from the Audit Information Management System, which is an IRS computer system used to control tax returns during examination, input assessments and adjustments to taxpayer accounts, and provide management reports.

Besides the seemingly high return from correspondence audits, there are other important reasons correspondence audits will likely continue to have a large compliance role in the coming years. One of the most important is the tax gap.[2] Estimated to be costing the Federal Government $345 billion annually, the tax gap is considered by many to be one of the most serious problems facing tax administration today, and correspondence audits are one process the IRS uses to help remedy the noncompliance that contributes to it.

Another reason the number of correspondence examinations will likely continue to increase is the focus the IRS has on reversing many of the downward trends in compliance activities that were noted in previous years.[3] We noted in a recent report[4] that only 617,765 individual returns, or 1 of every 202 returns, were examined in FY 2000. Since then, the number of tax returns examined has continuously increased and 1,391,581 individual returns, or 1 of every 99 returns, were examined in FY 2008.

Additional Steps Are Needed to Ensure the Risks Posed by Sole Proprietors Are Mitigated in Correspondence Audits

According to estimates from the IRS' 2001 National Research Program, most sole proprietors (57 percent) misreported their income and collectively accounted for $68 billion of the $345 billion tax gap in 2001.[5] In contrast to wage earners, for whom taxes are collected primarily through the withholding requirements, the same taxes owed by sole proprietors are collected mainly through a voluntary assessment process. Businesses have no requirement to withhold taxes from the compensation paid to sole proprietors, nor do they have any reporting obligations to the IRS if the payment to a sole proprietor totals less than $600 in any given year.

Instead, sole proprietors bear full responsibility for estimating, setting aside, reporting, and paying the income, Social Security, and Medicare taxes they determine are due from their earnings. Those sole proprietors who take advantage of this process to underreport their income can create unfair burden on honest taxpayers and diminish the public's respect for the tax system.

We evaluated 298 closed correspondence audits of individual returns reporting sole proprietor operations that were closed by tax examiners in the IRS Campus Compliance Services operations and found the absence of required minimum checks for unreported income and unfiled returns may be undermining the effectiveness of a process designed to verify that sole proprietors report the correct amount of tax. While examiners adequately documented audit case files to support

---

[2] The difference between taxes that are legally owed and taxes that are paid on time.
[3] *Opportunities Exist to Improve the Correspondence Examination Process for High-Income Nonfilers* (Reference Number 2008-30-156, dated September 16, 2008).
[4] *Trends in Compliance Activities Through Fiscal Year 2008* (Reference Number 2009-30-082, dated June 10, 2009).
[5] *Tax Gap: A Strategy for Reducing the Gap Should Include Options for Addressing Sole Proprietor Noncompliance* (GAO-07-1014, dated July 2007).

audit findings, our statistically valid sample of 298 correspondence audits identified 129 where sole proprietors may have avoided tax and interest assessments totaling $1.7 million after significant tax issues were not addressed during the audits. When projected to our population of 2,798 sole proprietors whose examinations were closed in FY 2007, our results indicate that 1,211 sole proprietors may have collectively avoided $16.5 million in taxes and interest.

Specifically, we found the following tax issues:

1. Business expenditures and other items deducted on the return that, when combined with estimated personal living expenses, exceeded the income on the return by more than $10,000 in 31 percent of the audits (93 of 298 audits). In 15 of these 93 instances, the expenses exceeded the income on the return by more than $50,000. The considerable differences noted between expenditures and income raise very serious questions about whether expenses on the return are overstated or if there were additional sources of income that should have been reported on the returns.

2. Deductions for paying wages and/or compensation to others, but no records with the IRS showing employment tax or information returns were filed in 12 percent of the audits (36 of 298 audits). The absence of information reporting in these cases creates opportunities for the recipients to underreport the income on their tax returns and avoid detection by the IRS. Those who take advantage of such opportunities to underreport their income can create unfair burden on honest taxpayers and diminish the public's respect for the tax system.

3. Refunds from earned income credits that sole proprietors may not have been entitled to if the significant differences we noted between the expenditures and income were, in fact, caused by overstating expenses and/or underreporting income (114 of 298 audits).

4. Tax return preparers were used in preparing the vast majority of the tax returns for which we identified significant tax issues that were not addressed during the audits (94 of 129 audits). Many in tax administration consider tax return preparers critical to facilitating compliance with the tax law. However, the large number of questionable returns that involved paid preparers raises concerns about the competence, and possibly the integrity, of some in the tax preparer community. These questionable returns also point to the need to enhance tax return preparer compliance and ethical standards so the IRS can better detect and sanction incompetent or unethical tax return preparers.

Examiners need to be better prepared to conduct sole proprietor audits through correspondence

We believe many of the problems identified in the audits can be attributed to two procedures that are not required by correspondence examiners, but are required by field examiners, when auditing an individual return reporting sole proprietor business income. During our reviews, we obtained information from the IRS' Integrated Data Retrieval System[6] to assess whether the sole proprietors in our sample met their obligations to file individual, employment tax, and information returns. In addition, we accessed the IRS intranet[7] site and obtained estimates of personal living expenses published by the Bureau of Labor Statistics that we used in a preliminary cash transaction analysis to identify potential unreported income.

Unlike procedures for audits conducted in the field, the procedures for correspondence audits do not require examiners to complete minimum checks to detect unfiled employment tax and information returns or unreported income. However, correspondence audit procedures do require the examiners and their managers to consider transferring the audit to the field if there are deductions that cannot be supported by unfiled returns or substantial amounts of income that may not have been reported. We found no evidence in the case files we reviewed that consideration was given to transferring any of the audits to the field.

Given the compliance risks associated with sole proprietors and the potential revenue at stake, the advantages associated with requiring examiners to expand checks for unfiled returns and probe for unreported income during correspondence audits would seem to outweigh the disadvantages. In terms of advantages, the additional audit procedures could be:

- Used to potentially increase revenue from sole proprietor audits by identifying unreported income that might otherwise go undetected. Using the recommended taxes and interest that sole proprietors in our sample may have avoided, we estimate that sole proprietors' correspondence audits for 6,055 taxpayers over a 5-year period may potentially increase tax and interest revenue by $82.6 million[8]
- Performed without increasing burden on compliant taxpayers. The IRS has implemented online automated information systems that examiners can access before initiating taxpayer contact in verifying that required returns were filed and completing a preliminary cash transaction analysis. Consequently, the data from the systems reduce or eliminate the need to request the information from taxpayers during audits.
- Used to provide a more sound and objective basis for transferring audits to the field. Currently, procedures instruct correspondence examiners to transfer audits to the field when there are unfiled returns or substantial amounts of unreported income. However, this procedure is largely left to the judgment of individuals and their managers. As a result, needed transfers are not always made as evidenced by our case reviews and a

[6] The IRS computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer's account records.
[7] The IRS intranet is a computer network that can be accessed only by authorized persons.
[8] This figure assumes that all estimated taxes and interest would be owed based upon audits of the taxpayers' books and records and that conditions such as tax rates and IRS audit coverage remain the same.

1999 Government Accountability Office report.[9] In 1999, the Government Accountability Office reported finding that less than an estimated 1 percent of the returns that should have been transferred from correspondence audit to the field were transferred.

The primary disadvantages involve the time, and hence the costs, spent training examiners to use and document the new procedures in audit case files. There would also be costs involved with establishing controls to provide assurance that examiners are properly following the procedures once implemented. However, we believe these costs would not be significant because they could be mitigated to some degree by expanding on existing work practices and processes. For example, IRS correspondence audit procedures already require examiners to check IRS automated information systems for IRS activity on the taxpayers' accounts.

Controls are also in place to help confirm examiners are following procedures and to initiate needed corrective actions. Examination managers are responsible for ensuring correspondence audits meet quality standards. To meet this responsibility, the IRS' Internal Revenue Manual recommends they use a variety of processes, including in-process case reviews, closed case reviews, time on case reviews, and on-the-job reviews. These reviews, among other things, assist the manager in determining whether examiners followed procedures, auditing standards were met, and to identify areas for improvement.

Recommendations

We recommend that the Director, Campus Compliance Services, should:

Recommendation 1: Require examiners to conduct and document, in audit case files, checks to identify unfiled employment tax and information returns, including consideration given to transferring the audit to the field if issues are identified.

> ***Management's Response:*** IRS management partially agreed with this recommendation by responding with alternative corrective actions. The Director, Campus Reporting Compliance, will work with the Small Business/Self-Employed Division's Research Division to determine how best to identify sole proprietors that did not file the required employment tax or information returns in an effort to exclude these cases from correspondence examination inventory through inventory selection filters. IRS management will pilot the filters to test their effectiveness and make these cases available to field exam.

Recommendation 2: Require examiners to conduct and document, in audit case files, the results of automated preliminary cash transaction analyses, including consideration given to transferring the audit to the field if issues are identified.

[9] *IRS Audits: Weaknesses in Selecting and Conducting Correspondence Audits* (GAO/GGD-99-48, dated March 1999).

Management's Response: IRS management partially agreed with the recommendation by responding with alternative corrective actions. The Director, Campus Compliance Services, will coordinate with the Director, Exam Planning and Delivery, to make sole proprietor returns with indicators of unreported income available to field examination. Supplementary guidance will be provided to campus examiners on documenting case files and taking the appropriate actions to transfer cases to the field, when warranted.

Office of Audit Comment: We agree the IRS' alternative corrective actions may help reduce the number of significant tax issues that are not addressed during correspondence audits of sole proprietors. However, the absence of a specific commitment from the IRS requiring that examiners conduct a preliminary cash transaction analysis during sole proprietor examinations is surprising to us given the high number of correspondence examinations closed in recent years, including those involving a sole proprietor. In FY 2008, IRS records show that it closed 125,045 examinations involving a sole proprietor using correspondence techniques. This is roughly a 7 percent increase over the 117,064 sole proprietor examinations using correspondence techniques that were closed in FY 2004.

As outlined in this report, a preliminary cash transaction analysis can identify considerable differences between expenditures and income. This difference raises very serious questions about whether expenses may be overstated on the return and/or whether there may be additional sources of income that should have been reported. Moreover, the IRS readily admitted in its response that sole proprietor underreporting is a serious compliance issue and that this type of analysis is necessary for an effective audit of the issue.

Recommendation 3: Expand controls that provide assurance that examiners are properly performing checks for unfiled employment tax and information returns and conducting preliminary cash transaction analyses so corrective actions can be identified and taken, if needed.

Management's Response: IRS management partially agreed with the recommendation by responding with alternative corrective actions. The Director, Campus Compliance Services, will work with the Small Business/Self-Employed Division's Research Division to refine inventory selection filters to reduce the number of cases with these issues from correspondence examination inventory. During quality reviews of correspondence examinations, management will identify inventory where these issues may be present to ensure appropriate actions have been taken. Feedback from the case reviews will be provided to the respective Campus Director and Campus Examination Operations Manager and the information may be used to refine inventory selection filters.

Office of Audit Comment: Although IRS management partially agreed with our three recommendations by responding with alternative corrective actions, they did not agree with our outcome measure because they had concerns that our calculations were based on preliminary cash transaction analyses and assumed all potential underreporting was actual underreporting. They also had concerns that our computation did not include implementation costs, such as training and lost opportunity costs. However, we maintain that the potential $82.6 million of increased revenue is a reasonable estimate and included qualifiers to our outcome measure to clarify that our numbers assume all estimated taxes and interest would be owed based upon audits of the taxpayers' books and records. We also clarified that additional costs related to implementation, training, and lost opportunities are not factored into the computation.

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of the review was to determine whether correspondence examinations effectively address the compliance risks of sole proprietors. To meet our objective, we relied upon IRS internal management reports and databases. We did not establish the reliability of these data because extensive data validation tests were outside the scope of this audit and would have required a significant amount of time. To accomplish our objective, we:

I. Evaluated the workload selection process to determine how cases are being selected for correspondence examinations including classification criteria and distribution of correspondence examination work nationwide.

II. Determined whether correspondence audits are being effectively conducted.

   A. Identified the population of correspondence audits closed in FY 2007 on the Audit Information Management System[1] for taxpayers who filed a U.S. Individual Income Tax Return (Form 1040) with Profit or Loss From Business (Schedule C) with total gross receipts more than $100,000 and total positive income less than $200,000. The audits resulted in either a no change to the taxpayers' liability or the taxpayer agreed to the examiner's adjustments.

   B. Conducted limited data validation testing.

      1. Matched the universe of correspondence examination cases on the Audit Information Management System to the IRS Data Book.[2]

      2. Selected a judgmental sample of 20 examinations on the Audit Information Management System and verified selected taxpayer information to the IRS' Integrated Data Retrieval System.[3]

   C. Identified 2,798 cases (high dollar Schedule C with disposal codes 01, 02, and 03[4]) from the population of correspondence audits closed by tax examiners in the IRS

[1] A computer system used to control returns, input assessments and adjustments to the Master File, and provide management reports. The Master File is the IRS database that stores various types of taxpayer account information.
[2] The Data Book is published annually by the IRS and contains statistical tables and organizational information on a fiscal year basis.
[3] The IRS computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer's account records.
[4] The IRS uses these two digit codes to indicate the disposition of an examination. The three codes cited indicate that these examinations resulted in either a no change to the taxpayers' liability or the taxpayer agreed to the examiner's adjustments.

Campus Compliance Services operations during FY 2007 and reviewed a statistical sample of 298 cases from that population. The precision level, as computed based on our sample analysis using a 95 percent confidence level and an error rate of 43.29 percent, was ± 5.32 percent.

D. Reviewed the 298 closed cases to evaluate if sole proprietors (Schedule C taxpayers) were properly examined through correspondence by:

1. Determining whether all classified items were properly addressed during the examination.
2. Determining whether all large, unusual, or questionable items were adequately addressed by completing a 3-year comparative analysis of return information and a cash transaction analysis for each return examined.
3. Securing agreement to our case reviews from IRS management.

III. Based on the results of our case analyses, calculated the number of sole proprietors who may have understated their tax liabilities and the amount of taxes and interest associated with these cases.

Internal controls methodology

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined the following internal controls were relevant to our audit objective: Campus Correspondence Examination's policies, procedures, and practices for selecting and examining including classification criteria and distribution of correspondence examination work nationwide. We evaluated these controls by reviewing source materials, interviewing management, reviewing correspondence examination case files, and researching taxpayer accounts.

Appendix II

Major Contributors to This Report

Margaret E. Begg, Assistant Inspector General for Audit (Compliance and Enforcement Operations)
Frank Dunleavy, Director
Lisa Stoy, Audit Manager
Kristi Larson, Lead Auditor
Cynthia Dozier, Senior Auditor
Craig Pelletier, Senior Auditor
Donna Saranchak, Senior Auditor
Erlinda Foye, Auditor

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, Campus Compliance Services, Small Business/Self-Employed Division SE:S:CCS
Director, Communications, Liaison, and Disclosure, Small Business/Self-Employed Division SE:S:CLD
Director, Examination, Small Business/Self-Employed Division SE:S:E
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

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; $82.6 million in additional taxes and interest owed by 6,055 taxpayers over 5 years (see page 3). Our calculation assumes that all estimated taxes and interest would be owed based upon audits of the taxpayers' books and records and that conditions such as tax rates and IRS audit coverage remains the same. The figure does not take into consideration implementation costs, such as training and lost opportunity costs.

Methodology Used to Measure the Reported Benefit:

- We reviewed a statistically valid sample of 298 taxpayers from a population of 2,798 sole proprietors with closed correspondence examinations in FY 2007.
- We identified 129 sole proprietors that may have misstated their taxable income by overstating expenses and/or understating income.
- Based on our sample error rate of 43.29 percent (129/298) and a confidence level of 95 percent, we calculated the number of sole proprietors audited by the IRS who may have misstated their taxable incomes but avoided detection to be 1,211 sole proprietors [2,798 x 43.29 percent], with a range of 1,062 to 1,360.
- To estimate the potential amount of additional taxes and interest these 129 sole proprietors may owe, we recomputed the additional tax liabilities for each sole proprietor based on the potential amount by which they may have misstated their taxable income. Based on this analysis, we estimate that the 129 sole proprietors in our sample may owe $1,360,627.51 in additional taxes and $399,613.45 in interest.
- To estimate the average amount due from our sample cases, we added the taxes and interest together [$1,360,627.51 + $399,613.45 = $1,760,240.96] and divided this figure by the 298 sole proprietors in our sample [$1,760,240.96/298 = $5,906.85].
- We then multiplied the number of sole proprietors in the total population by the average amount due from our sample cases to get the total amount of additional taxes and interest

owed for these examination cases closed in TY 2007 [2,798 x $5,906.85 = approximately $16,527,366].

- To estimate the number of sole proprietors who may have misstated their taxable income over 5 years if the IRS does not change its procedures, we multiplied the number of sole proprietors who may have misstated their taxable income that we estimated to be in our population by 5 to obtain the number of taxpayers who may misstate their taxable income over 5 years [1,211 x 5 = 6,055].
- To estimate the amount of additional taxes and interest owed by the taxpayers that we estimate may misstate their taxable income over 5 years if the IRS does not change its procedures, we multiplied the total amount of additional taxes and interest we estimated is owed for the examination cases closed in TY 2007 by 5 to obtain the amount of taxes and interest that would be owed over 5 years [$16,527,366 x 5 = approximately $82,636,830].

Appendix V

Management's Response to the Draft Report

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

COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

RECEIVED
JAN 29 2010

January 29, 2010

MEMORANDUM FOR MICHAEL R. PHILLIPS
DEPUTY INSPECTOR GENERAL FOR AUDIT

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

SUBJECT: Draft Audit Report - Significant Tax Issues Are Often Not Addressed During Correspondence Audits of Sole Proprietors (Audit Number 200830054)

Thank you for the opportunity to review the draft report titled "Significant Tax Issues Are Often Not Addressed During Correspondence Audits of Sole Proprietors."

The Correspondence Examination Program is one audit method used in an enterprise-wide examination plan that seeks to balance adequate coverage of a stratified taxpayer population with effective use of limited resources. These examinations are conducted in our Campuses, in an automated environment.

We agree that sole proprietor underreporting is a serious compliance issue, which creates unfair burden on compliant taxpayers. However, campus employees are not able to address these issues in the correspondence exam environment. The type of critical analysis necessary for an effective audit of this issue is normally performed by field examiners and is beyond the ability, training, and grade structure for campus examiners.

Based on the results of your audit, we will collaborate with our SB/SE Research Division to develop inventory selection filters to limit the number of cases containing these issues within the campus audit stream in the future. We will pilot the use of these filters to ensure their effectiveness. This will ensure these types of cases will be made available for the Field Examination selection pool using field examination criteria. However, as campus examinations contribute to the overall audit coverage of sole proprietors, we will evaluate the impact on coverage before making a final determination on exclusion of cases in the campus inventory. Further, we will continue to support efforts to expand electronic analysis of filed returns. Such analysis could result in systemic evaluation of related return filing compliance and the taxpayer's cash position for use in the campus environment.

We do not agree with the related outcome measure, which reflects increased potential revenue of $82.6 million from additional taxes and interest over a 5-year period. Our concern is the study is primarily based on preliminary cash transaction analyses and assumes all potential underreporting is actual underreporting. We are also concerned that no implementation costs, such as training, were considered and lost opportunity costs were not factored into the computation.

Attached is our response to your specific recommendations. If you have questions, please call me at (202) 622-0600 or a member of your staff may contact Cheryl Sherwood, Director, Campus Compliance Services at (202) 283-2200.

Attachment

Attachment

RECOMMENDATION 1:
Require examiners to conduct and document, in audit case files, checks to identify unfiled employment tax and information returns, including consideration given to transferring the audit to the field if issues are identified.

CORRECTIVE ACTION:
We partially agree with this recommendation. We will work with our Research Division to determine how best to identify Schedule C filings that did not file the required employment tax or information returns in an effort to exclude these cases from Campus Examination inventory, where possible. We will pilot the filters to test their effectiveness. Those cases excluded will be made available to Field Exam. The case history will chronicle the decision and reasoning involved. However, any decisions to exclude cases from Campus inventory will be made in conjunction with the need for coverage of all return filings.

IMPLEMENTATION DATE:
October 1, 2010

RESPONSIBLE OFFICIAL:
Director, Campus Reporting Compliance

CORRECTIVE ACTION MONITORING PLAN:
IRS will monitor this corrective action as part of our internal management system of controls.

RECOMMENDATION 2:
Require examiners to conduct and document, in audit case files, the results of automated preliminary cash transaction analyses, including consideration given to transferring the audit to the field if issues are identified.

CORRECTIVE ACTION:
We partially agree with this recommendation. Since we believe these types of audits are beyond the scope of a correspondence exam, we will coordinate the availability of Schedule C filings with indicators of unreported income to Field Examination with the Director, Exam Planning and Delivery based on the needs and goals of Field Exam. We will also provide supplementary guidance to campus examiners on documenting the case file and taking the appropriate action to transfer a case, when warranted.

IMPLEMENTATION DATE:
October 1, 2010

2

RESPONSIBLE OFFICIAL:
Director, Campus Compliance Services

CORRECTIVE ACTION MONITORING PLAN:
IRS will monitor this corrective action as part of our internal management system of controls.

RECOMMENDATION 3:
Expand controls that provide assurances that examiners are properly performing checks for unfiled employment tax and information returns and conducting preliminary cash transaction analyses so corrective actions can be identified and taken, if needed.

CORRECTIVE ACTION:
We partially agree with this recommendation. As stated in our response to Recommendation 1, we will work with Research to refine our inventory selection filters to reduce the number of returns with these issues in our inventory. During closed and open case reviews of correspondence examinations, we will identify inventory where these issues may still be present to ensure appropriate actions have been taken. As warranted, we will provide feedback to the respective Campus Director and Campus Examination Operations Manager. We will also consider this information for necessary refinements to the inventory selection filters.

IMPLEMENTATION DATE:
October 1, 2010

RESPONSIBLE OFFICIAL:
Director, Campus Compliance Services

CORRECTIVE ACTION MONITORING PLAN:
IRS will monitor this corrective action as part of our internal management system of controls.