
TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION



*Currency Report Data Can Be
a Good Source for Audit Leads*

September 17, 2010

Reference Number: 2010-30-104

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

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HIGHLIGHTS

CURRENCY REPORT DATA CAN BE A GOOD SOURCE FOR AUDIT LEADS

Highlights

Final Report issued on September 17, 2010

Highlights of Reference Number: 2010-30-104 to the Internal Revenue Service Commissioner for the Small Business/Self-Employed Division.

IMPACT ON TAXPAYERS

Individuals who fail to file required returns or underreport their income can create unfair burdens on honest taxpayers and diminish the public's respect for the tax system. While currency reports may be commonly associated with money laundering, TIGTA identified a number of individuals who have enough cash to engage in currency transactions totaling at least \$20,000, but did not file tax returns even though they appeared to have a filing requirement.

A number of other individuals engaged in similar currency transactions filed tax returns, but reported income that does not appear sufficient to cover their basic living expenses. The difference between income and expenses raises questions about whether there are additional income sources that should have been reported.

WHY TIGTA DID THE AUDIT

The objectives of this review were to determine the success the Small Business/Self-Employed Division is achieving in using currency reports to address nonfilers and underreporters and if additional steps could be taken to further enhance this success. The review was initiated as part of our Fiscal Year 2010 Annual Audit Plan and addresses the major management challenge of Tax Compliance Initiatives.

WHAT TIGTA FOUND

The Internal Revenue Service (IRS) recognizes the benefits of using Currency Transaction Reports (CTR) in its criminal and civil enforcement efforts. The IRS Criminal Investigation Division has obtained a number of convictions for tax evasion that either originated

from CTR data or for which CTR data served as a roadmap to establish a crime was committed. Additionally, IRS examiners closed several hundred audits that were initiated from CTR data and, in the process, recommended additional taxes of \$13.6 million.

TIGTA evaluated 2 statistical samples of individuals with currency reports totaling at least \$20,000 that were filed by financial institutions and casinos with the IRS for Tax Year 2007. In the first sample, 31 of 100 individuals appeared to have a filing requirement for Tax Year 2007, but had not filed a tax return. TIGTA estimates the 31 individuals may owe as much as \$417,091 in delinquent taxes, penalties, and interest. In the second sample, 17 of the 100 individuals sampled had expenses which seemed too large for the gross income they reported earning. If these 17 individuals have additional income sources that should have been reported, TIGTA estimates they may owe as much as \$163,648 in additional taxes, penalties, and interest.

WHAT TIGTA RECOMMENDED

TIGTA recommended that, as resources become available, the Director, Examination, Small Business/Self-Employed Division, explore the feasibility of making greater use of CTRs to pursue additional nonfilers and underreporters for audit.

IRS management agreed with the recommendation and plans to evaluate opportunities during their work planning process to expand audit coverage of nonfilers using CTR data. However, IRS management did not commit to pursuing additional potential underreporters for audit, nor did they agree with the outcome measure because of concerns with the selection criteria used.

While TIGTA is pleased that IRS management agrees with the recommendation, it is surprised by the absence of a commitment to pursue additional underreporters given the potential revenue at stake. Regarding the disagreement over the outcome measure, TIGTA maintains that the potential \$1.3 billion of increased revenue is reasonable considering the assumptions used to make the estimate.



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

September 17, 2010

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED
DIVISION

Michael R. Phillips

FROM:

Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT:

Final Audit Report – Currency Report Data Can Be a Good Source for
Audit Leads (Audit # 200930028)

This report represents the results of our review to determine the success the Small Business/
Self-Employed Division is achieving in using currency reports to address nonfilers and
underreporters and if additional steps could be taken to further enhance this success. The review
was included in our Fiscal Year 2010 Annual Audit Plan and addresses the major management
challenge of Tax Compliance Initiatives.

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

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



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Abbreviations

BSA	Bank Secrecy Act
CBRS	Currency Banking and Retrieval System
CTR	Currency Transaction Report
DIF	Discriminant Index Function
IRS	Internal Revenue Service
SB/SE	Small Business/Self-Employed
TY	Tax Year



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Background

Enacted in 1970, the Bank Secrecy Act¹ (BSA) authorized the Secretary of the Treasury to establish currency reporting as an anti-money laundering mechanism to help protect the stability of our Nation's financial system. Since it was established, currency reporting has expanded and taken on increased importance following the tragic events of September 11, 2001.

There are now numerous types of Currency Transaction Reports² (CTR) that both financial and nonfinancial institutions are required to file to report information on currency and suspicious transactions. The documents are in turn used by law enforcement officials to assist, deter, detect, and prosecute a range of financial crimes, such as narcotics trafficking, tax evasion, and financing of terrorist activities.

While the Treasury Department's Financial Crimes Enforcement Network has overall responsibility for administering the BSA, the Internal Revenue Service (IRS) collects, stores, and maintains the currency and suspicious activity reports filed by the financial and nonfinancial institutions. In Calendar Year 2008, the IRS reported receiving nearly 18 million currency and suspicious activity reports. As detailed in Appendix V, the vast majority were filed by financial institutions to report currency transactions exceeding \$10,000. Appendix V also provides descriptions and other information about the various CTRs received by the IRS in Calendar Year 2008.

Once received from the reporting institutions, the IRS enters CTR data into the Currency Banking and Retrieval System (CBRS), which is a centralized database used to store and manage the information. After the documents are entered into the CBRS, they are accessible electronically, through the Financial Crimes Enforcement Network, to law enforcement and regulatory agencies, both internationally and domestically. Besides collecting and storing CTRs, the IRS has roles in BSA criminal and civil matters.

The IRS' Criminal Investigation Division has a major role during the investigation of potential criminal BSA violations. The Criminal Investigation Division is the IRS law enforcement component that has long been charged with enforcing the criminal provisions of the Internal Revenue Code and related financial crimes. In civil matters, IRS examiners may access CTR data stored in the CBRS to assist in ongoing audits.

In addition, BSA examiners in the IRS are responsible for conducting compliance checks of nonfinancial institutions, such as money transmitters and check cashers, for compliance with the

¹ Pub. L. No. 91-508, 84 Stat. 1114 (1970) (codified as amended in scattered sections of 12 U.S.C., 18 U.S.C., and 31 U.S.C.). Regulations for the Bank Secrecy Act and other related statutes are 31 C.F.R. §§ 103.11-103.77 (2009).

² The acronym CTR is being used in this report to identify all types of currency reports shown in Appendix V.



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BSA. During these checks, BSA examiners may encounter large and suspicious currency transactions between the businesses and their customers that may have material income tax compliance potential. If so, the BSA examiner is to prepare a referral. The referral is forwarded to the Program and Special Planning section within the Small Business/Self-Employed (SB/SE) Division, where it is evaluated to determine if individuals' income tax returns may warrant an audit.

This review was performed in the SB/SE Division's Examination and Fraud/BSA Programs in New Carrollton, Maryland, and Detroit, Michigan, during the period October 2009 through May 2010. Except for not auditing IRS databases to validate the accuracy and reliability of the information and evaluating the adequacy of IRS internal controls over the various CTR forms, this audit was conducted 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 objectives, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.



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Results of Review

While the IRS has experienced success using CTR data in its enforcement efforts, our samples of CTRs show the documents may provide additional audit leads for the Examination function. We identified a number of individuals who have enough cash to engage in currency transactions totaling at least \$20,000, but did not file tax returns even though they appear to have a filing requirement.

A number of other individuals engaged in similar currency transactions filed tax returns, but reported income that does not appear sufficient to cover their basic living expenses. The differences between income and expenses for these individuals raise questions about whether there are additional income sources that should have been reported to cover the expenses.

Currency Transaction Reporting Has a Key Role in Tax Administration

CTRs may be commonly associated with money laundering investigations and used as a tool for identifying and intercepting terrorist funding. However, the IRS recognizes the potential benefits of incorporating CTRs into its criminal and civil enforcement efforts. The IRS Criminal Investigation Division has obtained a number of convictions for tax evasion that either originated from CTR data or for which CTR data served as a roadmap to establish that a crime was committed. Additionally, IRS examiners closed several hundred audits that were initiated from CTR data and, in the process, recommended additional taxes of \$13.6 million.

The IRS has reported that CTR data are extremely useful in identifying and pursuing individuals who are intentionally evading taxes or involved in other financial crimes

In written congressional testimony, high-ranking IRS officials cited criminal convictions related to CTRs and indicated that many of the crimes would have gone undetected had it not been for the CTRs. For example, in one income tax evasion case, a review of CTRs filed on an individual led investigators to identifying nearly half a million dollars of business income that was not reported on the individual's tax returns. The individual used the funds to purchase a home for cash and securities worth hundreds of thousands of dollars.

In another tax evasion case, an individual wrote checks totaling several million dollars to an associate's company and later conspired with others in a scheme to intentionally structure withdrawals in amounts that would not trigger the filing of currency reports. The cash withdrawn from the accounts was subsequently used to pay workers in cash, thereby evading employment taxes.



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In yet another case involving tax evasion, an investigation was initiated after a financial institution directly contacted IRS special agents and provided several questionable CTRs on a business owner who was making cash deposits in amounts of less than \$10,000. The investigation ultimately identified approximately \$620,000 of business income that was not included on the individual's income tax returns, which resulted in a tax loss to the Government of \$250,000.

CTRs also plays a role in IRS civil enforcement efforts through its audit process

As reflected in the following excerpts from IRS examiner guidelines and training materials, the IRS considers currency transactions a high compliance risk area and recommends a number of techniques that examiners can use to address these risks in planning and executing audits.

- *Currency transactions can be an indicator of many compliance issues, and these indicators need to be specifically incorporated in the audit plan and compliance effort. The CBRS should be checked initially to determine the nature of the transactions that were netted up and matched to the return. Cash transactions over \$10,000 just by nature are a very strong indication of possible underreporting of income and must be considered in every aspect of the audit.*
- *Casino transactions must be analyzed from the source of funds perspective. While gaming may be a net loss operation, the sources of the seed money must be addressed. It may be income of a nongaming source before it becomes a net loss.*
- *Any time an individual is using large amounts of currency personally or in the conduct of a trade or business, those transactions should be considered for their potential to be a source of unreported funds or transactions. In today's environment where businesses could operate by never using hard currency, you must always consider, "why would the person(s) take the risk and incur the trouble of using large amounts of currency to conduct transactions?"*
- *While there are definite cash-intensive businesses such as gas stations, retail stores, and many service providers, there are just as many reasons not to conduct transactions in large amounts of currency, including ease of transaction, risk, attention, and sources of fund considerations.*

While the IRS does not precisely track the number of audits in which CBRS data were accessed or used, it does have statistics from returns that were selected for audit³ as a result of referrals from BSA compliance checks.

³ In this report, returns selected for audit include related returns.



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Currency Transaction Data May Be Useful to Pursue Additional Potential Nonfilers and Underreporters

The IRS' primary objective in selecting returns for audit is to promote the highest degree of voluntary compliance on the part of taxpayers. To meet this objective, the IRS has developed a number of sources from which it selects returns for audit. One important source the IRS has long used to select returns for audit is the Discriminant Index Function (DIF) system, which calculates and assigns a computer-generated DIF score for all individual returns based on their audit potential. The higher the score, the greater the chance an audit will result in a material tax change.

As we reported in August 2009,⁴ the SB/SE Division is increasingly taking advantage of the DIF system to select individual tax returns for audit (see Figure 1). The increase is due, in large part, to the IRS updating its DIF system with new compliance data from its National Research Program and using this data to score individual tax returns.

Figure 1: SB/SE Division's Individual Tax Return Audit Closures by Revenue Agents⁵ and Tax Compliance Officers in Fiscal Years 2007–2009

<i>Fiscal Year</i>	<i>DIF Initiated</i>	<i>Other Sources*</i>	<i>Total Audits</i>	<i>Percentage DIF</i>	<i>Percentage Other</i>
2007	81,834	141,872	223,706	37 %	63%
2008	103,302	139,241	242,543	43%	57%
2009	116,255	139,660	255,915	45%	55%
Totals	301,391	420,773	722,164	42%	58%

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

Source: Our analysis of closed examination data from the Audit Information Management System for Fiscal Years 2007 through 2009.

The IRS also has at least 53 other sources (non-DIF) to select returns for audit. These non-DIF sources typically involve specific types of suspected noncompliance and collectively produced greater audit yields than DIF-initiated audits in terms of additional recommended taxes generated on a per return basis. From Fiscal Years 2007 through 2009, SB/SE Division statistics show examiners closed 420,773 audits initiated from non-DIF sources and recommended

⁴ *Potential Opportunities Exist to Enhance the Favorable Productivity Trends for Audits Initiated by the Updated Return Selection Formulas* (Reference Number 2009-30-105, dated August 5, 2009).

⁵ See Appendix VI for a glossary of terms.



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\$8.6 billion in additional taxes. This indicates that for each tax return audited from a non-DIF source, examiners recommended an average of about \$20,445 in additional taxes.⁶

These non-DIF source audits include those originated based on CTRs, and the statistics above include 493 audits that generated \$13.6 million (an average of \$27,700 for each return audited) as a result of referrals from compliance checks of CTRs. In addition, another 2,042 audits generated \$68 million from a project that involved auditing individuals with large aggregate CTR amounts. By comparison, audits initiated under the updated DIF produced about \$9,600 in recommended additional taxes on a return basis from Fiscal Years 2007 through 2009.

Given the compliance risks associated with individuals dealing in cash and the substantial audit yields involving CTRs, we used a sample of 100 individuals identified on CTRs for Tax Year (TY) 2007 to test their usefulness as leads for potential nonfiler audits. From the 100 individuals sampled, we estimate there are some 42,804 individuals who were involved in large cash transactions and did not file tax returns for TY 2007. Our work also shows that CTRs may be useful in identifying additional individuals for audits who are filing returns but underreporting their income.

CTR's may be useful for pursuing additional taxpayers who are involved in large cash transactions and not filing tax returns

To develop potential leads for nonfiler audits, we used a four-step process. First, we identified individuals for which aggregate CTRs totaling at least \$20,000⁷ were filed with the IRS in TY 2007 by financial institutions and casinos and matched those to information on the IRS' Individual Return Transaction File. The match identified 138,077 individuals without corresponding tax returns for TY 2007. Second, we selected a statistical sample of 100 out of the 138,077 potential nonfilers for review and identified 31 individuals who appeared to have filing requirements for TY 2007, but had not been contacted by the IRS according to the Individual Master File.

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⁶ This average and those in the next two paragraphs may differ from those calculated using the figures presented because the averages were calculated using the actual figures rather than the rounded figures presented here.

⁷ We are not presenting any opinion that the minimum \$10,000 requirement for CTR transactions be changed. Our choice of \$20,000 was simply a criterion used to determine the populations from which we selected our samples.

⁸ We used Accurant software in our analysis, which aggregates public information such as property records, etc.



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In the third step, we determined the amount of taxes the 31 potential nonfilers may owe by following the cash transaction analysis process IRS examiners use to obtain an estimate of an individual's income. The cash transaction analysis process is based on the assumption that individuals pay a certain amount of money to cover their expenses, including basic living expenses and, absent other information, should be reporting an income that is large enough to cover the expenses. We used basic living expense estimates published by the Bureau of Labor Statistics and other information, if available, in comparing an individual's expenditures to their income sources. If an individual's expenditures exceed their income and the source to pay for such expenditures cannot be explained, the excess represents potential unreported income.

For the final step, we used IRS procedures for preparing proposed assessments in situations where it estimates the taxes owed and prepares a "substitute" return and found the 31 individuals may owe \$282,930 in delinquent taxes and \$134,161 in penalties and interest. When projected to the population of 138,077 potential nonfilers, our results indicate 42,804 potential nonfilers may collectively owe as much as \$576 million in delinquent taxes, penalties, and interest for TY 2007. This projection is based on a 95 percent confidence level. We expect the number of potential nonfilers to fall between 30,229 and 55,379, with amounts owed ranging between \$387,581,655 and \$764,233,252.

CTRs may be useful to address additional individuals involved in large cash transactions, but may be underreporting their income

To develop potential audit leads for individuals who filed returns but may have underreported their income, we used a similar four-step process as we did with the nonfiler audit leads. We first matched the Taxpayer Identification Numbers for individuals with aggregate CTRs totaling at least \$20,000 filed in TY 2007 by financial institutions and casinos to the IRS' Individual Return Transaction File. This match identified 463,354 individuals who reported less adjusted gross income on their tax returns than the amounts reflected on their CTRs. After selecting a statistically valid sample of 100 of the 463,354 individual returns for review, we used the cash transaction analysis process and identified 17 individuals whose expenses were significantly larger than the gross income they reported earning.

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Overall, our sample results indicate the 17 potential underreporters may owe \$143,398 in delinquent taxes and \$20,250 in penalties and interest. When projected to the population of 463,354 individuals, our results indicate there are 78,770 potential underreporters who may owe



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\$758 million in additional taxes, penalties, and interest for TY 2007. The projection is based on a 95 percent confidence level. We expect the number of potential underreporters that may owe delinquent taxes to fall between 44,489 and 113,052, with the amounts owed ranging between \$409,298,600 and \$1,107,238,717.

It is important to recognize that there can be reasons expenditures exceed income on a tax return

Individuals who underreport their income or fail to file required returns can create unfair burdens on honest taxpayers and diminish the public's respect for the tax system. However, there are a number of legitimate reasons an individual's expenditures may exceed the income reported on his or her return. For example, some individuals may have received loan proceeds or are receiving financial help from relatives or friends. Still others may be paying their expenses from savings accumulated in previous years. However, we do not know, without the IRS investigating such items, if the potential underreporters owe additional taxes, penalties, and interest.

It is equally important to recognize the fact that just because individuals were involved in large cash transactions does not mean they were required to file tax returns. This will similarly require an IRS investigation to determine whether their incomes were large enough to require filing a return, and making such a determination could prove challenging. The IRS typically has third-party information reporting documents, such as wage statements, so it can quickly estimate the taxes owed and prepare a "substitute" return for a nonfiler. We found very few third-party information documents in IRS records that specifically show income sources for the nonfilers in our sample results.

However, as we previously stated, the IRS does identify returns for audit from various sources. The sources not related to the DIF system are typically developed from special projects where the IRS uses its experience and statistics to explore and evaluate new approaches for addressing potential areas of noncompliance. For example, some suspected areas of noncompliance within various taxpayer segments are currently evaluated and managed through various Compliance Initiative Projects within the IRS' operating divisions. With years of experience to draw upon, the IRS staff involved in these and other projects are well positioned to develop the support data needed for deciding how much, if any, resources could be allocated to broadening the use of currency reports in IRS compliance efforts.

Recommendation

Recommendation 1: The Director, Examination, SB/SE Division, should explore the feasibility of making greater use of CTRs to pursue additional nonfilers and underreporters for audit.

Management's Response: IRS management agreed with the recommendation and will evaluate opportunities during their work planning process to expand audit coverage



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of nonfilers using CTR data. However, IRS management did not commit to exploring the feasibility of making greater use of CTRs to pursue additional underreporters for audit. As noted in the report, these are individuals who file tax returns but may have additional sources of income that should have been reported. IRS management additionally stated they did not agree with the outcome measure because of concerns over the selection criteria used.

Office of Audit Comment: We are pleased that IRS management agrees with the recommendation. However, we are surprised by the absence of a commitment to pursue additional underreporters for audit given the potential revenue at stake. Regarding the disagreement over the outcome measure, we maintain that the potential \$1.3 billion of increased revenue is a reasonable estimate considering the assumptions used to make the estimate. Moreover, the accuracy and validity of sampling methodologies and estimate were confirmed by a statistician.



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Appendix I

Detailed Objectives, Scope, and Methodology

The objectives of this review were to determine the success the SB/SE Division is achieving in using currency reports to address nonfilers and underreporters and if additional steps could be taken to further enhance this success. Unless otherwise noted, our limited tests of the reliability of data obtained from various IRS systems did not identify any material errors. We tested the reliability of the data by scanning the data received for blank, incomplete, illogical, or improper data. In addition, we traced a judgmental sample for each data set to the source IRS files to ensure accuracy. To accomplish our objective, we:

- I. Determined whether the IRS effectively uses currency reports provided by third parties to identify individuals who are not reporting all of their income for tax purposes.
 - A. Identified what processes are in place for the IRS to use CTR data to identify unreported income.
 - B. Analyzed CTRs, information returns, and individuals' tax records on IRS systems and public records available through Accurant¹ to determine whether there is a potential for identifying unreported income.
 1. Identified whether the taxpayers who had high-dollar CTRs reported on them from financial institutions and casinos had filed tax returns and reported sufficient income to account for the currency transactions.
 2. Analyzed and compared the CTR data against income data on the Individual Return Transaction File² to identify potential for underreporting of income. We chose individuals with combined CTRs totaling \$20,000 or more for TY 2007. Two factors affected our data analysis.
 - The TY 2007 CTR data did include some CTRs dated late in TY 2006. This was due to how the Information Returns Master File processes the CTRs. The TY 2006 CTRs were not considered in any tax computations on our cases. This does not affect the results shown in our analysis.
 - Due to issues with the accuracy of validity digits on the Individual Return Transaction File, we limited our analysis of nonfiler cases to individuals with valid Taxpayer Identification Numbers.

¹ Software that aggregates public information such as property records, etc.

² See Appendix VI for a glossary of terms.



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3. Used the available income, CTR, and other expense data to identify the amount of income reasonably needed to be able to meet estimated personal living expenses.
 4. Selected a statistical sample of 100 taxpayers from a population of 463,354 taxpayers who had filed tax returns in TY 2007 with \$20,000 or more of CTR transactions reported and with adjusted gross income less than the total CTR amount. The expected error rate was 5 percent and precision, as computed based on our sample analysis using a 95 percent confidence level, was 7.40 percent.
 5. Selected a statistical sample of 100 taxpayers from a population of 138,077 nonfiling taxpayers with CTRs reported of at least \$20,000 in TY 2007. The expected error rate was 5 percent and precision, as computed based on our sample analysis using a 95 percent confidence level, was 9.11 percent.
 6. Analyzed the filing and payment compliance history for both samples of taxpayers to identify (a) any tendencies towards noncompliance and unreported income and (b) whether the IRS has taken any enforcement actions on these taxpayers for TY 2007.
 7. Used variable sampling techniques to quantify the potential unreported and underreported income, taxes, penalties, and interest for the cases in both samples with a 95 percent confidence level.³
 8. Confirmed the accuracy and validity of our sampling methodologies and projections with an outside statistician.
- II. Determine whether the IRS has effectively implemented correction action proposed in response to recommendations made in the prior report.⁴
- A. Identified corrective action that was taken as a result of the recommendations in the report and discussed this with SB/SE Division personnel.
 - B. Obtained data from the Fraud/BSA Program showing the case results from BSA referrals for FYs 2007 and 2008.
 - C. Extracted Audit Information Management System data for FYs 2007 through 2009 to validate the information provided from the Fraud/BSA Program and to identify actual case results generated from the referrals.

³ For the filer sample, the average adjustment was \$1,636.48 and the standard deviation was \$3,843.03. For the nonfiler sample, the average adjustment was \$4,170.92 and the standard deviation was \$6,961.42.

⁴ *The Use of Anti-Money Laundering Referrals and Currency Transaction Information in the Income Tax Examination Process Could Be Improved* (Reference Number 2004-30-074, dated March 30, 2004).



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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:

- IRS operating procedures and systems related to the receipt, editing, and input of CTR documents for processing to IRS systems. We did a limited evaluation of these controls by observing the processes and interviewing management.
- IRS policy and procedures for determining which individuals identified in the BSA examination process are referred for income tax audits. We did a limited evaluation of these controls by reviewing policy and procedures, interviewing management, and reviewing documentation for cases referred.



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Appendix II

Major Contributors to This Report

Margaret E. Begg, Assistant Inspector General for Audit (Compliance and Enforcement Operations)
Frank Dunleavy, Director
Steven Stephens, Audit Manager
Alan Lund, Lead Auditor
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William Tran, Senior Auditor
Richard Hillelson, Information Technology Specialist



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Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Deputy Commissioner for Services and Enforcement SE
Deputy Commissioner, Small Business/Self-Employed Division SE:S
Director, Collection, Small Business/Self-Employed Division SE:S:C
Director, Communications, Liaison, and Disclosure, Small Business/Self-Employed Division
SE:S:CLD
Director, Examination, Small Business/Self-Employed Division SE:S:E
Director, Fraud/BSA Program SE:S:F/BSA
Chief Counsel CC
National Taxpayer Advocate TA
Director, Office of Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis RAS:O
Office of Internal Control OS:CFO:CPIC:IC
Audit Liaison: Commissioner, Small Business/Self-Employed Division SE:S



Appendix IV

Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective action 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; 121,574 taxpayers owe \$1.3 billion¹ in additional taxes, penalties, and interest (see page 5). This potential outcome does not include amounts (cost) that would offset the benefit due to reallocating resources from other IRS audits and will be substantially less if resources are available to only focus on the most egregious cases. In computing the potential outcome, we assumed that there were no legitimate reasons for the discrepancies and therefore they would result in the assessment of the additional income taxes, self-employment taxes, and interest described in this appendix.

Methodology Used to Measure the Reported Benefit:

Outcome calculation methodology for the nonfiler exception cases:

- We selected a statistical sample of 100 taxpayers from a population of 138,077 potential nonfilers that had CTRs reporting at least \$20,000 during TY 2007.
- We identified 31 individuals who appear to have a filing requirement for TY 2007, but had yet to be contacted by the IRS. These individuals also had a negative cash flow of at least \$25,000 based on a cash transaction analysis, not including the CTR amounts.
- Based on our sample error rate (31/100), we calculated the number of potential nonfilers in the total nonfiler population that would: 1) appear to have a filing requirement for TY 2007 but had yet to be contacted by the IRS and 2) had a negative cash flow of at least \$25,000. $[138,077 \times (31/100) = 42,804]^2$
- To estimate the potential amount of delinquent taxes, penalties, and interest these 31 potential nonfilers may owe, we used the Examination function's cash transaction

¹ This number is rounded. The actual figure is \$1,334,176,111, which is the sum of \$575,907,453 for nonfilers and \$758,268,658 for underreporters. We are 95 percent confident that the estimated total amount owed is between \$937,632,661 and \$1,730,719,561.

² We are 95 percent confident that there are between 30,229 and 55,379 (9.11 percent precision) potential nonfilers that appear to have a filing requirement and have not been contacted by the IRS.



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analysis process to estimate the annual expenses and minimum income needed for each taxpayer. Based on this analysis, we estimate that these 31 nonfilers in our sample may owe \$282,930 in delinquent taxes and \$134,161 in penalties and interest.

Specific computations:

- Additional Taxes Due\$282,930
 - Includes Self-Employment Tax\$177,649
 - Penalties Applied\$106,762
 - Failure to File\$63,659
 - Failure to Pay\$33,952
 - Estimated Tax\$9,151
 - Interest.....\$27,399
 - Total Additional Tax, Penalty, and Interest Due\$417,092³
- We calculated the average additional taxes, penalties, and interest for all 100 taxpayers in our sample. [$\$417,092/100 = \$4,170.92$]
 - We then multiplied the number of nonfilers in the total nonfiler population by the average taxes, penalties, and interest due from each sample case to get the total amount of delinquent taxes, penalties, and interest owed by the total nonfiler population for TY 2007. [$138,077 \times \$4,170.92 = \$575,907,453$]⁴

Outcome calculation methodology for the filer exception cases:

- We selected a random sample of 100 taxpayers from a population of 463,354 filers that had CTRs reporting at least \$20,000 during TY 2007 and had adjusted gross income reported on their TY 2007 tax returns that was less than the total CTR amounts.
- We identified 17 filers that reported income that was insufficient to cover their basic living expenses as determined by using a cash transaction analysis. Each of the taxpayers had a negative cash flow of at least \$25,000, not including the CTR amounts.
- Based on our sample error rate (17/100), we calculated the number of filers in the total filer population that would have claimed income that was insufficient to cover their basic living expenses by at least \$25,000. [$463,354 \times (17/100) = 78,770$]⁵

³ Total adjusted due to rounding to whole dollars.

⁴ Total adjusted due to rounding to whole dollars. Using the computed standard deviation of \$6,961.42 for our sample, we are 95 percent confident that the total amount owed by the projected nonfilers (exception cases) will be between \$387,581,655 and \$764,233,252.

⁵ We are 95 percent confident that the number of filers in the total filer population that would have claimed income that was insufficient to cover their basic living expenses by at least \$25,000 will be between 44,489 and 113,052 (7.40 percent precision).



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- To estimate the potential amount of additional taxes, penalties, and interest these 17 filers may owe the IRS, we used the IRS' cash transaction analysis process to estimate the annual expenses and minimum income needed for each taxpayer. Based on this analysis, we estimate that these 17 filers in our sample may owe \$143,398 in additional taxes and \$20,250 in penalties and interest.

Specific computations:

- Additional Taxes Due\$143,398
 - Includes Self-Employment Tax\$80,109
 - Penalties Applied\$6,363
 - Failure to File\$6,363
 - Interest.....\$13,887
 - Total Additional Tax, Penalty, and Interest Due\$163,648
- We calculated the average additional taxes, penalties, and interest for all 100 taxpayers in our sample. [$\$163,648/100 = \$1,636.48$]
 - We then multiplied the number of filers in the total filer population by the average taxes, penalties, and interest due from each sample case to get the total amount of delinquent taxes, penalties, and interest owed by the total filer population for TY 2007. [$463,354 \times \$1,636.48 = \$758,268,658$]⁶

⁶ Using the computed standard deviation of \$3,843.03 for our sample, we are 95 percent confident that the total amount owed by the projected filers (exception cases) will be between \$409,298,600 and \$1,107,238,717.



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Appendix V

Bank Secrecy Act Forms Processed by the Internal Revenue Service

This appendix, as published on IRS.gov, lists the various currency reports, descriptions of the reporting requirements, and the number filed in Calendar Year 2008.

Report	Requirements	Filed in Calendar Year 2008
Currency Transaction Report (CTR)	Filed by financial institutions that engage in a currency transaction in excess of \$10,000.	15,449,549
Currency Transaction Report Casino (CTRC) (includes Form 8362 & Form 8852)	Filed by a casino to report currency transactions in excess of \$10,000.	452,075
Report of Foreign Bank and Financial Accounts (FBAR)	Filed by individuals to report a financial interest in or signatory authority over one or more accounts in foreign countries if the aggregate value of these accounts exceeds \$10,000 at any time during the calendar year.	349,667
IRS Form 8300, Report of Cash Payments Over \$10,000 Received in a Trade or Business	Filed by persons engaged in a trade or business who, in the course of that trade or business, receives more than \$10,000 in cash in one transaction or two or more related transactions within a twelve month period.	173,345
Suspicious Activity Report (SAR)	Filed on transactions or attempted transactions involving at least \$5,000 that the financial institution knows, suspects, or has reason to suspect the money was derived from illegal activities. Also filed when transactions are part of a plan to violate federal laws and financial reporting requirements (structuring).	733,543
Suspicious Activity Report Casino (SARC)	Filed on transactions or attempted transactions if it is conducted or attempted by, at, or through a casino, and involves or aggregates at least \$5,000 in funds or other assets, and the casino/card club knows, suspects, or has reason to suspect that the transactions or pattern of transactions involves funds derived from illegal activities. Also filed when transactions are part of a plan to violate federal laws and transaction reporting requirements (structuring).	11,162



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Report	Requirements	Filed in Calendar Year 2008
Registration of Money Services Business (RMSB)	Each Money Services Business (MSB), except one that is a money services business solely because it serves as an agent of another MSB, must register.	21,263
Suspicious Activity Report by Money Services Businesses (SARM)	Filed on transactions or attempted transactions if it is conducted or attempted by, at, or through a MSB, involving or aggregating funds or other assets of at least \$2,000 in funds or other assets, and the MSB knows, suspects, or has reason to suspect that the transactions or pattern of transactions involves funds derived from illegal activities. Also filed when transactions are part of a plan to violate federal laws and transaction reporting requirements (structuring) or when the transaction has no business or apparent lawful purpose and the MSB knows of no reasonable explanation for the transaction after examining the available facts. When transactions are identified from a review of records of money orders or traveler's checks that have been sold or processed, an issuer of money orders of traveler's checks shall be required to report a transaction or a pattern of transactions that involves or aggregates funds or other assets of at least \$5000.	531,763
Suspicious Activity Report by the Securities & Futures Industries	Filed on transactions, or attempted transactions, if it is conducted by, at, or through a broker-dealer, it involves aggregates funds or other assets of at least \$5,000, and the broker-dealer knows, suspects, or has reason to suspect that the transaction involves funds derived from illegal activities or is intended or conducted in order to hide or disguise funds or assets derived from illegal activity. Also filed when transactions are designed, whether through structuring or other means, to evade filing requirements. Also filed when transaction has no business or apparent lawful purpose or is not the sort in which the particular customer would normally be expected to engage, and the broker-dealer knows of no reasonable explanation for the transaction after examining the available facts. Also filed when the transaction involves the use of the broker-dealer to facilitate criminal activity.	15,105
Designation of Exempt Person	Used by bank or other depository institution to designate an eligible customer as an exempt person from currency transaction reporting rules.	52,149



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Appendix VI

Glossary of Terms

Audit Information Management System	A computer system used by the SB/SE Division Examination function and others to control returns, input assessments and adjustments to the Master File, and provide management reports.
Individual Master File	The IRS database that maintains transactions or records of individual tax accounts.
Individual Return Transaction File	A database the IRS maintains that contains information on the individual tax returns it receives.
Information Returns Master File	An IRS database containing all information returns transcribed or electronically received by the IRS. It contains data about both the payer and the payee from various forms, including Mortgage Interest Statements (Form 1098) and Wage and Tax Statements (Form W-2), among others.
Master File	The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.
Revenue Agent	An employee in the Examination function who conducts face-to-face examinations of more complex tax returns such as businesses, partnerships, corporations, and specialty taxes (e.g., excise tax returns).
Tax Compliance Officer	An employee in the Examination function that primarily conducts examinations of individual taxpayers through interviews at IRS field offices. The position title was changed in 2002 from Tax Auditor to Tax Compliance Officer.



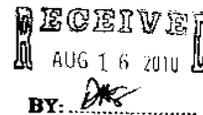
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Appendix VII

Management's Response to the Draft Report



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



August 16, 2010

MEMORANDUM FOR MICHAEL R. PHILLIPS
DEPUTY INSPECTOR GENERAL FOR AUDIT

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

SUBJECT: Draft Audit Report – Currency Report Data Can Be
A Good Source for Audit Leads (Audit No 200930028)

Thank you for the opportunity to review your draft report titled: "Currency Report Data Can Be a Good Source for Audit Leads." We agree with your recommendation and appreciate your acknowledgement of the efforts we have already taken to develop examination referrals from the filing of Currency Transaction Reports (CTR).

Your report cites numerous cases where the use of CTR information has led to hundreds of thousands of dollars in additional tax assessments, penalties, interest and even criminal prosecutions. The collaborative partnership between our Examination and Fraud/BSA Divisions will continue to provide substantive leads to ensure individuals who attempt to use cash as a mechanism to avoid Federal Tax obligations will be brought into compliance.

We do, however, disagree with the proposed Outcome Measure:

Increased Revenue – Potential; 121,574 taxpayers owe \$1.3 billion in additional taxes, penalties, and interest.

The threshold amount used to calculate the outcome measures was based on an arbitrary amount, \$20,000, selected by you, per your audit report, "...simply as a criterion used to determine the populations from which we selected our samples." It was not selected due to empirical evidence indicating use of \$20,000 is the correct threshold to use, nor are you recommending that we use this threshold. The outcome measures should be based on our selection criteria.

Attached is a detailed response outlining our corrective action. If you have questions, please call me at (202) 622-0600 or members of your staff may contact Monica Baker, Director, Examination, Small Business/Self-Employed Division, at (202) 283-2659.

Attachment



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Attachment

RECOMMENDATION 1:

The Director, Examination, SB/SE Division, should explore the feasibility of making greater use of Currency Transaction Reports (CTRs) to pursue additional nonfilers and underreporters for audit.

CORRECTIVE ACTION:

During the work planning process for the next two years, SB/SE Examination Planning and Delivery will continue to evaluate opportunities for expanding coverage of nonfilers using CTR data.

IMPLEMENTATION DATE:

June 15, 2013

RESPONSIBLE OFFICIAL(S):

Director, Examination Planning and Delivery, Small Business/Self-Employed Division (SB/SE)

CORRECTIVE ACTION MONITORING PLAN:

The Director, Examination Planning and Delivery, SB/SE will advise the Director, Examination, SB/SE of any delays in implementing this corrective action.