



Tests for Unreported Income During Sole Proprietor Field Audits Can Be Strengthened

September 9, 2010

Reference Number: 2010-30-105

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.

Redaction Legend:

1 = Tax Return/Return Information



HIGHLIGHTS

TESTS FOR UNREPORTED INCOME DURING SOLE PROPRIETOR FIELD AUDITS CAN BE STRENGTHENED

Highlights

Final Report issued on September 9, 2010

Highlights of Reference Number: 2010-30-105 to the Internal Revenue Service Commissioner for the Small Business/Self-Employed Division.

IMPACT ON TAXPAYERS

Tests for unreported income during Internal Revenue Service (IRS) audits of sole proprietors are a key part of a process designed to verify that the correct amount of tax is reported. In turn, the audit process helps remedy the noncompliance that can create unfair burdens on honest taxpayers and diminish the public's respect for the tax system.

WHY TIGTA DID THE AUDIT

This audit was initiated to determine whether minimum probes for unreported income during sole proprietor audits are conducted in accordance with IRS policies and procedures. This audit was conducted as part of our Fiscal Year 2010 Annual Audit Plan and addresses the major management challenge of Tax Compliance Initiatives. Tax gap estimates created after the National Research Program for Tax Year 2001 showed that unreported business income by sole proprietors accounted for \$68 billion (20 percent) of the estimated \$345 billion gross tax gap. Despite the size of the tax gap attributed to sole proprietors, the IRS audits only a relatively small portion of these individuals each year.

WHAT TIGTA FOUND

As called for in IRS policies and procedures, field examiners are generally checking for unreported income during audits of sole proprietors. However, steps could be taken to increase the consistency and accuracy of preliminary cash transaction analyses. A preliminary cash transaction analysis provides

the basis for performing more indepth audit testing by identifying differences between expenditures and income. If considerable, the differences should be addressed during the audit because it raises questions such as whether there are additional sources of income that should have been reported, if expenses are overstated, or if the taxpayer had a source of non-taxable income.

TIGTA found 30 audits where sole proprietors may have avoided tax and interest assessments totaling \$289,251 because of quality problems with the preliminary cash transaction analyses. The majority of the quality problems involved examiners not considering applicable personal living expense data in their preliminary cash transaction analyses.

The 30 audits were identified from a statistical sample of 227 audits closed by field examiners in Fiscal Year 2008. When projected to the population of 6,438 closed audits from which the sample was selected, our results indicate that 851 sole proprietors may have avoided tax and interest assessments of approximately \$8.2 million in Fiscal Year 2008.

WHAT TIGTA RECOMMENDED

TIGTA recommended that the Director, Exam Policy, Small Business/Self-Employed Division, issue guidance to group managers to increase the specific written performance feedback given to examiners on the adequacy of their tests for unreported income. In addition, TIGTA recommended that the Director, Exam Policy, issue guidance to group managers and examiners to reinforce the requirement and importance of using appropriate personal living expense data in preliminary cash transaction analyses.

IRS management agreed with the recommendations and plans to issue a memorandum emphasizing the importance of providing specific evaluative feedback on the adequacy of minimum income probes. IRS management also plans to issue a memorandum emphasizing the importance of using appropriate personal living expense data in preliminary cash transaction analyses.



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

September 9, 2010

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED
DIVISION

FROM:

Michael R. Phillips

Michael R. Phillips

Deputy Inspector General for Audit

SUBJECT:

Final Audit Report – Tests for Unreported Income During Sole
Proprietor Field Audits Can Be Strengthened (Audit #200930020)

This report presents the results of our review to determine whether minimum probes for unreported income during sole proprietor examinations are conducted in accordance with Internal Revenue Service (IRS) policies and procedures. This audit was conducted as part of 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 VI.

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

EQRS	Embedded Quality Review System
FY	Fiscal Year
IRM	Internal Revenue Manual
IRS	Internal Revenue Service
NQRS	National Quality Review System
PLE	Personal Living Expense
SB/SE	Small Business/Self-Employed
TIGTA	Treasury Inspector General for Tax Administration



Tests for Unreported Income During Sole Proprietor Field Audits Can Be Strengthened

Background

Sole proprietors own a wide variety of unincorporated businesses and report the net profit or loss from their businesses on the U.S. Individual Income Tax Return (Form 1040) using Profit or Loss from Business (Schedule C). Schedule C is designed to capture the type of business and requires sole proprietors to report the gross receipts and income from their business and classify their business expenses into various categories.

According to a 2007 Government Accountability Office report,¹ adjusted results from Internal Revenue Service (IRS) National Research Program² audits for Tax Year 2001 found that sole proprietors underreported their net income by 57 percent. The National Research Program audits did not determine how much misreporting was intentional and how much was unintentional. However, one reason for the misreporting may be that, unlike wage earners, 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.

The National Research Program audits also estimated that almost 6.9 million sole proprietors (39 percent of all sole proprietors) made an error reporting gross income on Schedule C, and 11 million sole proprietors overstated expenses on Schedule C by \$40 billion, which reduces net income and thus taxes. Tax gap estimates created after the National Research Program showed that unreported business income by sole proprietors accounted for \$68 billion (20 percent) of the estimated \$345 billion gross tax gap.

Despite the size of the tax gap attributed to sole proprietors, the IRS audits only a relatively small portion of these individuals each year. This is due in large part to resource constraints and the need to balance audit coverage across other segments of the tax return filing population, such as corporations and partnerships. According to the Fiscal Year (FY) 2008 IRS Data Book,³ more than 4.9 million sole proprietors filed returns with total gross receipts of \$25,000 or more and the IRS performed 72,803 field audits⁴ of these returns, recommending more than \$1.1 billion in additional taxes.

¹ *Tax Gap: A Strategy for Reducing the Gap Should Include Options for Addressing Sole Proprietor Noncompliance* (GAO-07-1014, dated July 2007).

² Research conducted by the IRS to determine filing, payment, and reporting compliance by taxpayers for different types of taxes. The IRS established the program in Calendar Year 2000 to resume measuring taxpayers' voluntary compliance.

³ The IRS Data Book is published annually by the IRS and contains statistical tables and organizational information on a fiscal year basis.

⁴ Field audits are generally performed by revenue agents, tax compliance officers, tax examiners, and revenue officer examiners, in person or through correspondence (in selected cases).



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Audits of sole proprietors range from reviewing tax returns and resolving questionable items by corresponding with the individuals through the mail to a detailed face-to-face audit at their place of business. In contrast to the more labor intensive face-to-face audit, 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. Correspondence audits also enable the IRS to audit more sole proprietors, as well as other taxpayers, at a lower cost.

Regardless of the type of audit, the process typically involves an IRS examiner notifying the sole proprietor of the audit and its scope, evaluating supporting information, and advising the sole proprietor or their representative of the additional taxes being recommended, if any. The sole proprietor 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 sole proprietor does not respond to the examiner or appeal, the recommended tax changes are assessed by default and the sole proprietor will generally have to petition the court system to contest the assessment.

This review was performed at the IRS Small Business/Self-Employed (SB/SE) Division National Headquarters in New Carrollton, Maryland, during the period May 2009 through April 2010. Except for not 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.



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Results of Review

Tests for unreported income during IRS audits of sole proprietors are a key part of a process designed to verify that the correct amount of tax is reported. In turn, the audit process helps remedy the noncompliance that can create unfair burdens on honest taxpayers and diminish the public's respect for the tax system. To assist examiners in conducting audits properly, the IRS has a number of policies, procedures, and techniques in place at the national and local (divisional and group) levels.

As outlined in IRS policies and procedures, we found that field examiners are generally checking for unreported income during audits of sole proprietors. However, two steps could be taken to increase the consistency and accuracy of preliminary cash transaction (Cash-T) analyses. The first step involves taking greater advantage of performance feedback mechanisms, while the other step involves ensuring that appropriate personal living expense (PLE) data are used in preliminary Cash-T analyses.

Policies, Procedures, and Techniques Are Available to Assist Examiners in Conducting Audits Properly

Ultimately, the IRS relies on its examiners to ensure audits are properly conducted. To assist examiners in meeting this responsibility, the IRS has a number of control activities (policies, procedures, and techniques) in place that are recommended in the Government Accountability Office's *Standards for Internal Control in the Federal Government*.⁵ At the national level, broad policy statements provide guidance to IRS personnel that are involved in IRS programs and activities. Of the 184 IRS Policy Statements, 36 cover audit issues, including examiner responsibilities. In addition, the Internal Revenue Manual (IRM) serves as an important control component nationally because it contains the official compilation of detailed instructions and explanations of the statutory and administrative procedures for examiners to follow in conducting audits.

Throughout the IRM, examiners are instructed to properly document, in audit files, all aspects of their work during audit planning, testing of income and expense items, and in closing of audits. This documentation is important because it provides the principal evidence that procedures were followed, as well as the foundation for other control processes such as managerial reviews and the quality measurement systems. The importance of examiner documentation is further emphasized in management directives, newsletters, examiner training materials, and the quality measurement standards.

⁵ GAO/AIMD-00-21.3.1, dated November 1999.



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At the divisional level, the quality measurement staffs in the IRS operating divisions review samples of audit cases to assess the degree to which SB/SE Division examiners complied with audit procedures. In addition to reviews by the quality measurement staff, mid-level managers may evaluate ongoing work in open audits during their operational reviews. Operational reviews are required to be performed at least annually to ensure work is being done in conformance with procedures. These processes serve as a quality control by identifying managerial, technical, and procedural problems and providing a basis for corrective actions.

At the group level, first-line managers are an important control component because they are responsible for the quality of work performed by the examiners they supervise. They use a variety of techniques to ensure examiners' work is meeting acceptable standards and procedures are followed in planning, initiating, and conducting audits. These techniques, as the Treasury Inspector General for Tax Administration (TIGTA) has previously reported,⁶ include observations and discussions with examiners and reviews of work during audits and after they are closed. Through these observations, discussions, and reviews, first-line managers attempt to identify problems so examiners can take prompt corrective actions.

Steps Could Be Taken to Increase the Consistency and Accuracy of Preliminary Cash Transaction Analyses

The IRM generally requires examiners to conduct a preliminary Financial Status Analysis in the early stages of every sole proprietor audit as part of the minimum tests for unreported income. Also referred to as a preliminary Cash-T analysis, the audit procedure provides the basis for performing more indepth audit testing by identifying differences between expenditures and income. If considerable, the differences should be addressed during the audit because they raise the possibility that there are additional sources of income that should have been reported and/or expenses that are overstated.

Notably, the preliminary Cash-T analysis generally involves little or no burden on a taxpayer because examiners use only information from the tax return and PLE data published by the United States Bureau of Labor Statistics, or comparable statistics from another reliable source, to determine whether the sole proprietor's income and expenses are roughly equal. However, the requirements of indepth testing will likely be far more burdensome and intrusive on the taxpayer, due to the extra procedures required to address the differences between income and expenses.

TIGTA reviewed a statistical sample of 227 of 6,438 sole proprietor audits completed by field examiners in FY 2008 and found 30 audits (13 percent) where our preliminary Cash-T determinations show the business and personal expenses of the sole proprietor exceeded the income on the return by more than \$10,000 and the discrepancy was not accounted for in the

⁶ *Additional Managerial Involvement Is Needed to Promote Consistent Use of Accuracy-Related Penalties* (Reference Number 2009-30-124, dated September 11, 2009).



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examination. The considerable difference between income and expenditures on the 30 exception returns raise questions such as whether there are additional sources of income that should have been reported, if the expenses deducted on the return are overstated, or if the taxpayer had a source of non-taxable income.

*****1*****

*****. It is important to recognize that there are a number of legitimate reasons that a taxpayer’s cash expenditures may exceed the income reported on their 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, without additional testing, the IRS does not know if the understatement shown on the preliminary Cash-T analysis represents underreported income or overstated expenses that could result in additional taxes, penalties, and interest.

As summarized in Figure 1, we attributed the majority of the quality problems in the audits to preliminary Cash-T analyses that were inaccurately completed because PLE data were not used, as required by the IRM. We found that examiners did not consider PLE data in their preliminary Cash-T analysis in a total of 22 of the 30 exception cases, either because no PLE data were used in the analysis (14 cases) or because no preliminary Cash-T analysis was found in the examination workpapers (8 cases).

**Figure 1: Results of Review of Minimum Income Probes for
Sole Proprietor Audits Closed in FY 2008**

<i>Reason for Inadequate Income Probe</i>	<i>Number of Exceptions</i>	<i>Percentage of Exceptions</i>	<i>Percentage of Sample</i>
Examiner’s preliminary Cash-T analysis did not use PLE data	14	47 %	6 %
No preliminary Cash-T analysis found in examination workpapers	8	27 %	4 %
Examiner’s preliminary Cash-T analysis used PLE data that was less than indicated by regional Bureau of Labor Statistics data	***1***	***1***	***1***
Examiner’s preliminary Cash-T analysis did not include all appropriate income and expense items	***1***	***1***	***1***
TOTAL	30	100 % ⁷	13 %

Source: Our analysis of 227 sole proprietor audits closed in FY 2008.

⁷ Percentages do not add to 100 due to rounding.



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Problems with tests for unreported income have also been identified by IRS quality review staff

Recent reports issued by the SB/SE Division National Quality Review System (NQRS)⁸ staff have also noted problems with the quality of income probes performed by examiners. For example, in its March 2010 report, the NQRS staff reported that examiners met the standard for determining the accuracy of reported income in just 59 percent of the audits reviewed. While this is a higher rate of quality problems than was identified in our report, the sample of field audits reviewed by the NQRS includes both business and nonbusiness taxpayers. The NQRS also reviews a broader range of procedures, such as the proper application of tax law to income issues.

To address the concerns identified by NQRS reviews, the SB/SE Division provided additional directions in the IRM and reemphasized the importance of minimum tests to examiners and their managers using online publications, such as the Division's "Technical Digest" newsletter. However, based on our work, we have two additional steps that officials may find useful to incorporate into ongoing efforts to improve the quality of income testing during sole proprietor audits. The first step involves taking better advantage of performance feedback mechanisms, while the other step involves emphasizing the need to ensure that PLE data is used in preliminary Cash-T determinations.

Greater advantage could be taken of existing performance feedback mechanisms to hold examiners more accountable for properly completing minimum income probes

Although the IRM indicates that group managers may conduct informal, undocumented reviews of case quality, it specifically requires all formal reviews to be documented using the SB/SE Division Embedded Quality Review System⁹ (EQRS). TIGTA used the EQRS to assess the formal performance feedback given by first-line managers to a judgmental sample of 47 examiners involved in the 227 audits we reviewed. Except for one examiner, we found no written feedback to examiners in the EQRS to document managerial reviews of open and closed audits that addressed the quality of income probe determinations or other tests for unreported income.

As we have reported previously,¹⁰ performance feedback can be a very effective tool in helping examiners understand and meet their responsibilities. It also provides opportunities to give meaningful and constructive feedback on examiners' performance, pinpoint and address

⁸ NQRS reviewers evaluate audit case files to determine whether examiners complied with quality attributes established by the IRS.

⁹ The EQRS allows field managers to provide timely feedback to individual employees through performance case reviews.

¹⁰ *Performance Management in the Large and Mid-Size Business Division's Industry Case Program Needs Strengthening* (Reference Number 2005-30-084, dated May 27, 2005).



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performance gaps, and hold examiners accountable for results. According to the United States Merit Systems Protection Board,¹¹ continually monitoring and providing feedback to employees is perhaps the most important component of managing performance. In a 2003 report¹² to the President and Congress, the Merit Systems Protection Board stated:

This component, more than any other, can give employees a sense of how they are doing and can motivate them to be as effective as possible. Ideally, through these ongoing interactions between employees and supervisors, employees learn how their work fits into the goals of the work unit and how it contributes to the larger mission of the agency.

An existing automated spreadsheet for making Cash-T determinations could be used to ensure that personal living expenses are considered in sole proprietor audits

During our case reviews, we used the automated Cash-T analysis spreadsheet¹³ provided with the IRS Report Generation Software to make our Cash-T determinations. While the automated spreadsheet is designed to guide examiners and ensure that Cash-T determinations are completed accurately, the IRM does not specifically require examiners to use it during audits. As a result, we did not see this tool being used consistently in the audits we reviewed even though we found the spreadsheet to be well designed, automated, and easily accessible by examiners through the IRS Intranet.

Notably, the spreadsheet also solicits answers to the items needed to make accurate preliminary Cash-T determinations and provides immediate access to current Bureau of Labor Statistics PLE data for various geographical locations across the country. The IRM also allows examiners to use data from other sources if they are more applicable to a taxpayer's situation. Whatever the source, the use of accurate estimated PLE data is vital for evaluating whether the income reported on the tax return is sufficient to pay for the business expenses deducted on the tax return plus cover a taxpayer's basic living expenses such as rent and food, which are not included on the tax return.

Given the compliance risks and the portion of the tax gap associated with sole proprietors, the benefits associated with taking steps to provide additional feedback to examiners on the quality of their tests for unreported income and reinforcing the use of appropriate PLE data in preliminary Cash-T analyses would seem to outweigh the costs. The costs should be minimal considering the fact that performance feedback mechanisms currently exist and Bureau of Labor Statistics PLE data are readily available in the automated Cash-T spreadsheet. However, there

¹¹ The Merit Systems Protection Board is an independent, quasi-judicial agency that oversees and adjudicates the application of merit system principles within the Executive Branch.

¹² *The Federal Workforce for the 21st Century: Results of the Merit Principles Survey 2000* (dated September 2003).

¹³ See Appendix V for the format of the automated Cash-T analysis spreadsheet.



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would be additional examiner labor costs from any expansion of audit effort based on a preliminary Cash-T analysis using appropriate PLE data.

However, in terms of benefits, the additional steps may lead to potentially increasing revenue from audits by identifying unreported income and/or overstated expenses that might otherwise go undetected without increasing burden to compliant sole proprietors. Using the recommended taxes and interest that sole proprietors in our sample may have avoided, we estimate that improving the quality of preliminary Cash-T analyses in audits may potentially increase tax and interest revenue by \$41 million over a 5-year period.¹⁴

Recommendations

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

Recommendation 1: Issue guidance to group managers to provide written feedback to examiners that specifically addresses the adequacy of minimum income probes and incorporate the feedback into examiners' mid-year progress reports and annual performance appraisals, when appropriate.

Management's Response: IRS management agreed with this recommendation and will issue a memorandum emphasizing the importance of providing specific evaluative feedback on the adequacy of minimum income probes on cases reviewed. When appropriate, the feedback will be incorporated into the examiner's mid-year progress reviews and annual performance appraisals.

Recommendation 2: Issue guidance to group managers and examiners to reinforce the requirement and importance of using appropriate PLE data in preliminary Cash-T analyses.

Management's Response: IRS management agreed with this recommendation and will issue a memorandum emphasizing the importance of using appropriate PLE data in preliminary Cash-T analyses.

¹⁴ See Appendix IV for details.



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Appendix I

Detailed Objective, Scope, and Methodology

Our overall objective was to determine whether minimum probes for unreported income during sole proprietor examinations are conducted in accordance with IRS policies and procedures. We did not conduct audit tests to determine the accuracy and reliability of the information in any of the databases. However, we did assess the completeness and reliability of the data as described below and concluded the data were complete, reliable, and adequate to conduct our work. To meet our objective, we reviewed a statistically valid sample of closed sole proprietor examinations, evaluated the adequacy of controls that ensure that examiners properly perform minimum income probes, and assessed the status of any ongoing or anticipated changes to the process for conducting minimum income probes. To accomplish our audit objective, we:

- I. Evaluated the adequacy of controls to ensure that adequate income probes are being conducted during sole proprietor examinations.
 - A. Documented the applicable Internal Revenue Code sections, Department of the Treasury Regulations, IRM (policy and procedural) sections, management directives, examiner training materials, and IRS public announcements and notices that provide the authority and procedures for conducting income probes during examinations.
 - B. Prepared a memo using the information from Step I.A., along with other pertinent information, to describe the management controls that ensure examiners are properly conducting minimum income probes, including a description of the factors that should be developed and documented in examination case files to support income probes.
 - C. Used the results from the FYs 2008 and 2009 quality reviews (NQRS and EQRS)¹ to identify weaknesses in the use of income probes and assess the effectiveness of corrective actions taken in response to the weaknesses identified.
 - D. Evaluated the training that group managers and examiners received on considering and applying income probes by reviewing the timing and extent of training with SB/SE Division officials.
 - E. Assessed how well group managers are holding examiners accountable for properly considering income probes by evaluating the FY 2009 performance feedback

¹ NQRS reviewers evaluate audit case files to determine whether examiners complied with quality attributes established by the IRS. The EQRS allows field managers to provide timely feedback to individual employees through performance case reviews.



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- (workload reviews, closed case reviews, on-the-job visits, etc.) given to a judgmental sample² of 47 examiners involved in the 227 audits included in our review, as documented in EQRS.
- II. Reviewed a statistically valid sample of closed sole proprietor examinations to determine if examiners are properly considering income probes.
- A. Obtained an extract from the Data Center Warehouse³ Audit Information Management System⁴ Closed Case data file to identify a population of 6,438 sole proprietor returns that were closed with no change or with agreement to changes between October 1, 2007, and September 30, 2008, and involved nonfarm businesses filing a Profit or Loss From Business (Schedule C) with total positive income of less than \$200,000.
 - B. Worked with IRS Statistics of Income personnel to design a statistically valid sample of the population of closed sole proprietor returns identified in Step II.A. We selected a statistically valid sample of 227 closed examined sole proprietorship returns using a confidence level of 90 percent, a precision rate of ± 5 percent, and an expected error rate of 30 percent. We requested the examination workpapers for the 227 returns and any related tax return years that could contain workpapers for the selected returns.
 - C. Reviewed the examination workpapers for the 227 closed sole proprietor returns to determine if examiners are properly considering the income probes described in Step III.
 - D. Conducted limited data validation testing by matching the universe of sole proprietor examinations on the Audit Information Management System to the FY 2008 IRS Data Book⁵ and selecting a judgmental sample² of 20 examinations and verifying selected taxpayer information to the IRS Integrated Data Retrieval System.⁶
 - E. Secured agreement to the case review results from IRS management.

² Judgmental sampling was used because of limited resources and time available to complete the audit in a reasonable time period.

³ The Data Center Warehouse is a TIGTA Office of Information Technology function that obtains and stores numerous IRS data files and makes them available to auditors and investigators via the Intranet.

⁴ A computer system used by the SB/SE Division Examination Operations function and others to control returns, input assessments/adjustments to the Master File, and provide management reports.

⁵ The IRS Data Book is published annually by the IRS and contains statistical tables and organizational information on a fiscal year basis.

⁶ IRS computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer's account records.



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- III. Determined if field examiners performed the following minimum income probes.
 - A. Conducted a Financial Status Analysis using the United States Bureau of Labor information or other comparable statistics from a reliable source to estimate the taxpayer's personal living expenses for the Financial Status Analysis, including the preliminary cash transaction analysis spreadsheet (see Appendix V for an example). If the analysis indicated a material imbalance, the excess expenditures were considered to be a potential understatement of taxable income that requires further development during the audit.
 - B. Evaluated internal controls to determine the reliability of the books and records (including electronic books and records), identify high-risk issues, and determine the depth of the examination of income.
 - C. Reconciled the income reported on the return to the books and records, including a test of business gross receipts.
 - D. Analyzed the taxpayer's personal and business bank accounts (including investment accounts) to evaluate the accuracy of gross receipts reported on the tax return.
 - E. Determined whether any deviations from the minimum income probes were approved by the group manager and documented in the case file.
- IV. Based on the results of the case analyses, calculated the amount of unreported income that was not detected along with the taxes and interests owed, and projected into the population. We validated the projections with TIGTA's contracted statistician.
- V. Assessed the status of ongoing changes to improve the quality of field examinations by requiring examiners to perform appropriate income probes during face-to-face examinations.
 - A. Interviewed SB/SE Division management and program analysts to identify ongoing changes, such as policy and procedural changes and examiner training that are aimed at enhancing the use of minimum income probes.
 - B. Assessed the effectiveness of any ongoing changes identified in Step V.A.

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 policies, procedures, and practices for conducting examinations of sole proprietor tax returns. We evaluated these controls by



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reviewing source materials, interviewing management, reviewing examination case files, and researching taxpayer accounts.



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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
Robert Jenness, Audit Manager
Stanley Pinkston, Lead Auditor
Cynthia Dozier, Senior Auditor
Debra Mason, Senior Auditor
William Tran, Senior Auditor
Ali Vaezazizi, Auditor



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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, Examination, Small Business/Self-Employed Division SE:S:E
Director, Research, Small Business/Self-Employed Division SE:S:R
Director, Exam Policy/Research, Small Business/Self-Employed Division SE:S:E:EP
Chief Counsel CC
National Taxpayer Advocate TA
Director, Office of Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis RAS:O
Office of Internal Control OS:CFO:CPIC:IC
Audit Liaison: Commissioner, Small Business/Self-Employed Division SE:S



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Appendix IV

Outcome Measure

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

Type and Value of Outcome Measure:

- Increased Revenue – Potential; \$8,206,086 per year; \$41,030,428 over 5 years under current conditions (see page 4). The potential revenue increase is related to a projected 851 sole proprietors¹ with \$10,000 or more in discrepancies between the income and expenses reflected in our preliminary Cash-T analyses. In making the projection, 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 Report Benefit:

To estimate the potential additional income taxes, self-employment taxes, and interest associated with the projected 851 sole proprietors with significant unreported income that examiners failed to detect, we:

1. Analyzed a statistically valid sample of 227 audits selected from a population of 6,438 sole proprietor returns with audits completed in FY 2008, using a confidence level of 90 percent, a precision level of ± 5 percent, and an expected error rate of 30 percent.
2. Ordered the administrative case files (audit workpapers) for the returns and evaluated whether examiners had documented the performance of appropriate minimum income probes in each audit and found that examiners failed to adequately perform one or more required minimum income probes (Financial Status Analysis, evaluation of internal controls, reconciliation of income reported on the return to books and record, and analysis of taxpayer's personal and business bank accounts) for 30 (13 percent) of the 227 audits reviewed.
3. Reviewed the 227 returns by preparing a Financial Status Analysis using the automated Cash-T analysis spreadsheet² developed by the IRS. For the 30 returns found in Step 2, our

¹ We are 95 percent confident that the number of sole proprietors in our population with potential unreported income is between 572 and 1,130.

² See Appendix V for the format of the automated Cash-T analysis spreadsheet.



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preliminary Cash-T analysis showed a potential understatement of income (estimated expenses exceeding reported income) of \$10,000 or more. For these returns, we determined whether the examiner performed other steps to account for the income shortfall, such as documenting the taxpayer's use of non-taxable sources of income (for example, loans or liquidation of an asset, including real estate or retirement funds). Also, if the examiner made sufficient adjustments during the audit to cover the shortage, no exception was taken. However, if expenses still exceeded income by at least \$10,000 after the examiner's review, we considered this an exception and assumed the excess of expenses over income to be unreported self-employment income.

4. Using the methodology in Step 3, we found that the 30 exception returns had \$974,949 in additional potential unreported income that was not addressed by examiners. We computed that a total of \$248,745 in additional self-employment taxes and income taxes could have been assessed on the potential unreported self-employment income found in the 30 exception cases. We used IRS computer programs to calculate that \$40,506 in interest would have been owed on the additional taxes at the applicable Federal interest rate, for a total of \$289,251 in income taxes, self-employment taxes, and interest.
5. Used the sample results to project that \$27,659,420 in unreported income for as many as 851 sole proprietors was not addressed by examiners in FY 2008. We computed that a total of \$8,206,086 in self-employment tax, additional income tax, and interest could have been assessed on the potential unreported self-employment income for the projected 851 sole proprietors, using the methods described in Step 4.
6. Shared our sampling methodology with an outside statistical expert who confirmed the accuracy of our methodology and projection.



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Appendix V

*Cash-T Analysis Spreadsheet for
Individual Business Return Taxpayer*

The cash transaction (Cash-T) analysis spreadsheet is a useful tool in making a preaudit or a post audit determination of the amount of income a taxpayer may need to support his or her lifestyle. A large negative number at the conclusion of the preliminary Cash-T analysis may indicate an understatement of income and suggests that an expansion of income probes is warranted.

Taxpayer: _____		Examiner: _____		
TIN: _____		Date: _____		
Tax Form: _____				
2007 Cash T				
	Pre Cash T	Post Cash T	Pre Cash T	Post Cash T
Wages				
Interest				
Dividends				
Refunds (State)				
Pension				
Social Security				
Unemployment				
Alimony				
Schedule C				
Schedule F				
Schedule D				
Schedule E				
Child Support				
IRA Distribution				
Assets Sold				
Non-Taxable				
From Partnership				
From S Corp				
From Estates				
From Trusts				
Cash on hand 1/1				
Cash in bank 1/1				
Loan proceeds				
	_____	_____	_____	_____
Total Income	0.00	0.00	0.00	0.00
Less Adj Expend.	0.00	0.00	0.00	0.00
	_____	_____	_____	_____
	0.00	0.00	0.00	0.00
Pre-Cash T indicates an		OVERSTATEMENT	of \$	-
Post-Cash T indicates an		OVERSTATEMENT	of \$	-



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The estimated PLE computation can be very subjective, due to examiner decisions about items to include or exclude. Using the automated estimated PLE worksheet gives examiners the same starting point from which to begin their estimates. Since the automated worksheet has United States Bureau of Labor Statistics cost of living data built in, examiners can save time by not having to look up data for each taxpayer under review.

Taxpayer: 0 _____	Examiner: 0 _____
TIN: 0 _____	Date: _____
Tax Form: 0 _____	

2007 Estimated Personal Living Expenses (PLE) from BLS

Personal Living Expenses (PLE) were estimated utilizing U.S. Bureau of Labor Statistics tables for size of consumer unit, housing tenure, number of earners in consumer unit, and region of residence. Utilizing various statistical data allows greater accuracy in the estimation of PLE. Adjustments were made using case file and interview information. See WP 400-2.4

Only select ONE box per column

Number of person(s) on the return <input type="checkbox"/> One person <input type="checkbox"/> Two persons <input type="checkbox"/> Three persons <input type="checkbox"/> Four persons <input type="checkbox"/> Five or more persons	Number of earner(s) on the return <input type="checkbox"/> Single w/ NO earner <input type="checkbox"/> Single w/ earner <input type="checkbox"/> Joint w/ NO earners <input type="checkbox"/> Joint w/ One earner <input type="checkbox"/> Joint w/ Two Earners	Housing Tenure <input type="checkbox"/> Homeowner w/ mortgage <input type="checkbox"/> Homeowner w/o mortgage <input type="checkbox"/> Renter <input type="checkbox"/> Unknown	Region <input type="checkbox"/> Northeast <input type="checkbox"/> Midwest <input type="checkbox"/> South <input type="checkbox"/> West
---	--	---	--

Estimated PLE based on Bureau of Labor Statistics	\$	-
Adjustments to Preliminary Cash T		
Return / IRP	BLS Tables	Adjustment
Schedule A - Medical & Dental Expenses	0.00	0.00
Schedule A - Real Estate Taxes	0.00	0.00
Schedule A - Mortgage Interest & Points	0.00	0.00
Schedule A - Contributions	0.00	0.00
Schedule A - Miscellaneous (other than EBE)	0.00	0.00
IRP data - Primary Social Security WH	0.00	0.00
IRP data - Primary Medicare WH		
IRP data - Secondary Social Security WH		
IRP data - Secondary Medicare WH		
IRP data - Primary pension expenses (traditional & roth)	0.00	0.00
IRP data - Secondary pension expenses (traditional & roth)		
Estimated Personal Living Expenses (PLE) for the Preliminary Cash T	\$	-



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Taxpayer: 0 _____ Examiner: 0 _____
 TIN: 0 _____
 Tax Form: 0 _____ Date: _____

2007 Estimated Personal Living Expenses (PLE)

Estimated Personal Living Expense	Weekly	Monthly	Yearly	BLS Tables	Omit BLS	PLE Amount used for Cash T
Food at home, groceries, snacks, soft drinks				0.00	<input type="checkbox"/>	0.00
Food away from home, dining out				0.00	<input type="checkbox"/>	0.00
Alcoholic Beverages				0.00	<input type="checkbox"/>	0.00
Tobacco products and smoking supplies				0.00	<input type="checkbox"/>	0.00
Housing						
Mortgage w/ escrow				0.00	<input type="checkbox"/>	0.00
Mortgage interest & charges			0.00	0.00	<input type="checkbox"/>	0.00
Real estate taxes			0.00	0.00	<input type="checkbox"/>	0.00
Insurance					<input type="checkbox"/>	0.00
Maint, repairs, other				0.00	<input type="checkbox"/>	0.00
Rent or unknown housing situation				0.00	<input type="checkbox"/>	0.00
Utilities: natural gas, electricity, telephone, water				0.00	<input type="checkbox"/>	0.00
Household operations: personal services, other				0.00	<input type="checkbox"/>	0.00
Housekeeping supplies						
Laundry, dry cleaning & cleaning supplies				0.00	<input type="checkbox"/>	0.00
Other household products				0.00	<input type="checkbox"/>	0.00
Postage & stationery				0.00	<input type="checkbox"/>	0.00
Household furnishings & equipment						
Household textiles				0.00	<input type="checkbox"/>	0.00
Furniture				0.00	<input type="checkbox"/>	0.00
Floor coverings				0.00	<input type="checkbox"/>	0.00
Major appliances				0.00	<input type="checkbox"/>	0.00
Small appliances				0.00	<input type="checkbox"/>	0.00
Miscellaneous household equipment				0.00	<input type="checkbox"/>	0.00
Clothing and services				0.00	<input type="checkbox"/>	0.00
Transportation: vehicle costs						
Vehicle payments				0.00	<input type="checkbox"/>	0.00
Gasoline & motor oil				0.00	<input type="checkbox"/>	0.00
Other: maintenance, repairs, tires, insurance				0.00	<input type="checkbox"/>	0.00
Public transportation costs, parking				0.00	<input type="checkbox"/>	0.00
Personal property taxes				0.00	<input type="checkbox"/>	0.00
Health care: medical & dental expenses			0.00	0.00	<input type="checkbox"/>	0.00
Entertainment & vacations				0.00	<input type="checkbox"/>	0.00
Personal care products and services				0.00	<input type="checkbox"/>	0.00
Reading: books, magazines, newspapers				0.00	<input type="checkbox"/>	0.00
Education: tuitions, books, room and board				0.00	<input type="checkbox"/>	0.00
Miscellaneous			0.00	0.00	<input type="checkbox"/>	0.00
Contributions			0.00	0.00	<input type="checkbox"/>	0.00
Life & personal insurance				0.00	<input type="checkbox"/>	0.00
Social security and Medicare			0.00	0.00	<input type="checkbox"/>	0.00
Cost of pensions			0.00	0.00	<input type="checkbox"/>	0.00
Stocks & bonds						0.00
Loans to others						0.00
Boats						0.00
Jewelry						0.00
						0.00
						0.00
						0.00
						0.00
						0.00

Estimated Personal Living Expenses (PLE) for the Post Cash T \$ -



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Appendix VI

Management's Response to the Draft Report



COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

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

RECEIVED
AUG 18 2010

BY: *DAS*

August 18, 2010

MEMORANDUM FOR MICHAEL R. PHILLIPS
DEPUTY INSPECTOR GENERAL FOR AUDIT

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

SUBJECT: Draft Audit Report – Tests for Unreported Income During
Sole Proprietor Field Audits Can Be Strengthened
(Audit No. 200930020)

Thank you for the opportunity to review your draft report titled: "Tests for Unreported Income During Sole Proprietor Field Audits Can Be Strengthened."

We agree with the recommendations contained in your report. We appreciate your acknowledgement that our examiners are generally checking for unreported income during examinations of sole proprietors. In addition, you acknowledge the steps we have already taken to address this issue, including the additional guidance provided in the Internal Revenue Manual and the reemphasis of the importance of minimum income probes in our online publication, "Technical Digest."

We have performed a concurrence review of the exception cases and agree with your findings. We also concur with the outcome measures.

Attached is a detailed response outlining our corrective actions. If you have any questions, please contact me, or a member of your staff may contact Monica Baker, Director, Examination, Small Business/Self-Employed Division, at (202) 283-2658.

Attachment



*Tests for Unreported Income During
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Attachment

RECOMMENDATION 1:

The Director, Exam Policy, SB/SE Division should issue guidance to group managers to provide written feedback to examiners that specifically addresses the adequacy of minimum income probes and incorporate the feedback into examiners' mid-year progress reports and annual performance appraisals, when appropriate.

CORRECTIVE ACTION:

We concur with this recommendation. The Director, Examination (SB/SE) will issue a memorandum emphasizing the importance of providing specific evaluative feedback on the adequacy of minimum income probes on cases reviewed. When appropriate, this feedback will be incorporated into the examiner's mid-year progress reviews and annual performance appraisals.

IMPLEMENTATION DATE:

February 15, 2011

RESPONSIBLE OFFICIAL(S):

Director, Examination Policy, Small Business/Self-Employed Division (SB/SE)

CORRECTIVE ACTION MONITORING PLAN:

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

RECOMMENDATION 2:

The Director, Exam Policy, SB/SE Division should issue guidance to group managers and examiners to reinforce the requirement and importance of using appropriate Personal Living Expense (PLE) data in preliminary Cash Transaction (Cash-T) analyses.

CORRECTIVE ACTION:

We concur with this recommendation. The Director, Examination (SB/SE) will issue a memorandum emphasizing the importance of using appropriate PLE data in preliminary Cash-T analyses.

IMPLEMENTATION DATE:

February 15, 2011

RESPONSIBLE OFFICIAL(S):

Director, Examination Policy, Small Business/Self-Employed Division (SB/SE)

CORRECTIVE ACTION MONITORING PLAN:

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