# *Additional Steps Are Needed to Better Ensure Audits Are Expanded to Prior and/or Subsequent Year Returns When Substantial Taxes May Be Owed*

**September 9, 2011**

**Reference Number: 2011-30-084**



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# HIGHLIGHTS

**ADDITIONAL STEPS ARE NEEDED TO BETTER ENSURE AUDITS ARE EXPANDED TO PRIOR AND/OR SUBSEQUENT YEAR RETURNS WHEN SUBSTANTIAL TAXES MAY BE OWED**

# Highlights

**Final Report issued on September 9, 2011**

Highlights of Reference Number: 2011-30-084 to the Internal Revenue Service Commissioner for the Small Business/Self-Employed Division.

## IMPACT ON TAXPAYERS

Internal Revenue Service (IRS) estimates show that $197 billion of the $345 billion of taxes that should have been paid on time but were not (the Tax Gap) is caused by individuals underreporting their income tax liabilities. TIGTA evaluated single-year audits of individual returns for which the taxpayers involved agreed they understated their tax liabilities by more than $4,400. Although similar tax issues may have existed on the returns these individuals filed for the prior and/or subsequent tax years, the audits were not expanded to these other returns in 48 of the 100 sample cases TIGTA reviewed. As a consequence, opportunities may have been missed to address the noncompliance that contributes to the Tax Gap and promote tax system fairness among the vast majority of taxpayers who properly report and pay their taxes year in and year out.

## WHY TIGTA DID THE AUDIT

This audit was initiated to determine whether tax compliance officers in the Small Business/ Self-Employed Division are conducting required filing checks in accordance with IRS policies and procedures. The review is part of our planned Fiscal Year 2011 audit coverage and addresses the major management challenge of Tax Compliance Initiatives.

IRS examiners complete certain filing checks to determine that the taxpayer under audit is complying with all Federal tax return filing requirements. Examiners are also required to evaluate the returns for potential areas of noncompliance. If poorly performed, filing checks can diminish the effectiveness of a process that is designed to ensure voluntary compliance and increase the overall compliance coverage of every audit.

## WHAT TIGTA FOUND

TIGTA identified three factors that likely contributed to our concerns with expanding audits. First, the IRS strives to keep its audit inventories free of old tax year returns. As a result, tax compliance officers seldom expand an audit to a taxpayer's prior year return. Second, case file documentation does not indicate that tax compliance officers are taking full advantage of the IRS's internal sources of information when conducting required filing checks. Third, the IRS's performance feedback mechanisms are not always taken advantage of to hold tax compliance officers accountable for the quality of their filing checks.

## WHAT TIGTA RECOMMENDED

TIGTA recommended that the Director, Exam Policy, Small Business/Self-Employed Division, provide: 1) detailed examples to tax compliance officers on when it would be appropriate to expand audits to prior and/or subsequent year returns, 2) information to tax compliance officers that focuses on using the IRS's automated information systems to enhance the quality of required filing checks, and 3) additional guidance to first-line managers to improve the feedback provided to tax compliance officers on the quality of required filing checks.

In their response to the report, IRS officials agreed with the recommendations and plan to: 1) provide examples in internal publications that show when it is appropriate to expand audits, 2) conduct a workshop on using IRS automated systems, and 3) improve the feedback provided to tax compliance officers on the quality of their filings checks. Although IRS officials agreed with all three recommendations, they did not agree with the potential monetary benefits associated with the recommendations.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

September 9, 2011

**MEMORANDUM FOR** COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED DIVISION

**FROM:** Michael R. Phillips
Deputy Inspector General for Audit

**SUBJECT:** Final Audit Report – Additional Steps Are Needed to Better Ensure Audits Are Expanded to Prior and/or Subsequent Year Returns When Substantial Taxes May Be Owed (Audit #201030042)

This report presents the results of our review to determine whether tax compliance officers in the Small Business/Self-Employed Division are conducting required filing checks in accordance with the Internal Revenue Service's (IRS) policies and procedures. The review was part of our Fiscal Year 2011 Annual Audit Plan and addresses the major management challenge area of Tax Compliance Initiatives.

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

Copies of this report are also being sent to the IRS managers affected by the report recommendations.

Please contact me at (202) 622-6510 if you have questions or Margaret E. Begg, Assistant Inspector General for Audit (Compliance and Enforcement Operations), at (202) 622-8510.

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# Abbreviations

| | |
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| EQRS | Embedded Quality Review System |
| FY | Fiscal Year |
| IRM | Internal Revenue Manual |
| IRS | Internal Revenue Service |
| RFC | Required Filing Check |
| SB/SE | Small Business/Self-Employed |
| TCO | Tax Compliance Officer |

# Background

Internal Revenue Service (IRS) estimates show that $197 billion of the $345 billion of taxes that should have been paid on time but were not (the Tax Gap) is caused by individuals underreporting their income tax liabilities. Spread across four operating divisions, the IRS audit program identifies billions of dollars in additional income taxes owed and is one of the largest compliance programs the IRS uses to help remedy the noncompliance that contributes to the Tax Gap.

The IRS has several sources from which to select individual tax returns for audit. One source is the Discriminant Index Function, which is an automated system for scoring individual tax returns according to their audit potential. In general, the higher the Discriminant Index Function score, the greater the chance the audit will result in a material tax change. The IRS's policy also allows returns to be selected through non-Discriminant Index Function sources (e.g., studies/research projects, third-party document matching, and referrals from other Federal and State Government agencies).

Once selected, audits of individual taxpayers can range from reviewing their tax returns and resolving questionable items by corresponding with them through the mail to a face-to-face audit in an IRS office or at a taxpayer's place of business. In contrast to the more detailed and lengthy face-to-face audit at a taxpayer's place of business, the office audit process typically takes less time and is conducted by an examiner who is referred to as tax compliance officer (TCO). In general, TCOs are trained to deal with and focus on less complex tax issues than examiners who conduct audits at the taxpayer's place of business.

During their audits, TCOs are required to determine whether taxpayers are filing required tax returns. The initial step in this process is to access internal data sources and verify that required prior and subsequent year returns, related returns, information returns, and employment tax returns were filed. In addition to verifying that tax returns were filed, required filing checks (RFC) require TCOs to evaluate the tax returns for potential areas of noncompliance and expand the audit to include additional tax returns as warranted. Properly executed RFCs are designed to ensure voluntary compliance and to leverage resources by increasing the overall compliance coverage of every audit.

This review was performed at the Small Business/Self-Employed (SB/SE) Division Examination function in New Carrollton, Maryland, and the IRS National Headquarters in Washington, D.C., during the period August 2010 through January 2011. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

# Results of Review

Despite an emphasis on case file documentation and layers of management controls, additional steps are needed to better ensure that TCOs expand audits to include the prior and/or subsequent year when substantial taxes may be owed. We found 48 audits where individuals may have avoided tax, interest, and penalty assessments totaling an estimated $461,184 after potential tax issues were not pursued on the prior and/or subsequent year returns they filed. In addition, TCOs did not always check to ensure required information and employment tax returns were filed.

## *Management Controls Are in Place to Help Guide Examiners to Properly Complete Required Filing Checks*

Ultimately, the IRS relies on its examiners to ensure RFCs are properly performed. To assist examiners in meeting this responsibility, the IRS has developed and implemented a number of policies, procedures, and techniques (management controls). At the agency level, broad policy statements provide guidance nationwide to IRS personnel who are involved in IRS programs and activities. Of the 184 IRS Policy Statements, 36 cover examination issues, such as taxpayer rights and examiner responsibilities.

At the division level, the quality measurement staff in the SB/SE Division reviews a statistically valid sample of examination cases to assess the degree to which SB/SE Division examiners complied with RFCs. In addition to reviews by the SB/SE Division quality measurement staff, mid-level managers in the SB/SE Division may evaluate ongoing work during operational reviews. Operational reviews are required to be performed at least annually to ensure work is being done effectively. These processes serve as a quality control by identifying managerial, technical, and procedural problems and providing a basis for corrective actions.

At the examiner level, first-line managers are also 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 RFCs. These techniques include observations and discussions with examiners and reviews of work during examinations 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.

The Internal Revenue Manual (IRM) is another important control component because it contains the official compilation of detailed instructions and explanations of the RFCs for examiners to follow during examinations. Throughout the IRM, examiners are instructed to properly document in examination case files all aspects of their work during the planning, initiating, conducting, and closing phases of examinations. 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, examiner training materials, and the quality measurement standards.

In addition to the above controls, SB/SE Division management has continued to implement various approaches to emphasize the expectation that examiners inspect and select prior and/or subsequent year tax returns for audit, when warranted. Specifically, during Fiscal Years (FY) 2009 and 2010, Examination function management took the following actions as the result of recommendations from a FY 2009 Treasury Inspector General for Tax Administration report:[1]

- Updated IRM 4.10.9, *Examination of Returns, Workpapers,* to require TCOs to utilize the Lead Sheet 130 to document the audit potential of prior and/or subsequent year returns.
- Revised Examination Workpapers (Form 4700) and related workpapers to correspond with the use of lead sheets.
- Highlighted the importance of the RFCs and selecting prior and/or subsequent year returns as part of a quality examination in the July 2009 "Keys to Success" newsletter and the August 2010 issue of "Technical Digest."
- Included a mandatory training module that emphasized the RFCs and proper consideration of the prior and/or subsequent year returns in the FY 2009 Examination All Managers' Continuing Professional Education.
- Discussed requirements with area technical analysts during monthly conference calls and required specific actions to be implemented within the SB/SE Division.

To its credit, our review found that the IRS has successfully implemented procedures to ensure consistent filing verification of prior and/or subsequent year tax returns. Specifically, we found that in 92 (92 percent) of the 100 sample cases reviewed, TCOs inspected and correctly verified the filing status of the prior and/or subsequent year tax returns in the IRS's automated information systems. When we project our sample results to our population of 2,932 closed audits, we are 95 percent confident that the range of correctly inspected and verified cases is between 2,543 and 2,851. By performing these checks, the IRS promotes taxpayer compliance by confirming all required tax returns are filed.

Although there are layers of management controls in place to guide examiners through the RFCs, our results indicate that additional steps can be taken to improve the quality of RFCs.

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[1] *Examiners Did Not Always Properly Select the Prior and/or Subsequent Year Tax Returns* (Reference Number 2009-30-034, dated February 13, 2009).

## Additional Steps Are Needed to Enhance the Quality of Required Filing Checks

We evaluated a statistical sample of 100 single-year audits of individual returns for which the taxpayers involved agreed they understated their tax liabilities by more than $4,400. Although similar tax issues may have existed on the returns these individuals filed for the prior and/or subsequent tax years, the audits were not expanded to these other returns in 48 (48 percent) of the 100 sample cases we reviewed. As a result, opportunities may have been missed to address the noncompliance that contributes to the Tax Gap and promote tax system fairness among the vast majority of taxpayers who properly report and pay their taxes year in and year out.

For example, we found 6 instances where taxpayers agreed they owed additional taxes ranging from $7,700 to $36,900 after audit adjustments were made to their tax liabilities because they underreported their income and/or overstated itemized deductions. In 7 other audits, individuals agreed they owed a total of $98,800 in additional taxes because each individual could not substantiate at least $30,000 of business expenditures.

Overall, we estimate the 48 individuals involved in the audits that were not expanded to include their prior and/or subsequent year returns may have avoided additional tax, interest, and penalty assessments totaling $461,184 for Tax Years 2005 through 2008. When the sample results are projected to our population of 2,932 closed audits, the results indicate that approximately 1,407 taxpayers may have avoided $13.5 million in additional tax, penalty, and interest assessments for Tax Years 2005 through 2008. The projection is based on a 95 percent confidence level. We expect the number of taxpayers who may have avoided additional assessments to fall between 1,124 and 1,691 and the total assessments avoided to range from $9.3 million to $17.7 million.

In contrast to our case review results, the SB/SE Division's quality measurement staff reported that, for FY 2010, examiners appropriately expanded audits to the prior and/or subsequent year returns in 89 percent of the cases they reviewed. Although we did not audit the accuracy of the results reported by the SB/SE Division's quality measurement staff, one reason that could account for the difference between our results and those reported by the SB/SE Division's quality measurement staff was the information sources used to evaluate the cases. We accessed the IRS's automated information systems to supplement case files with hard copy transcripts of prior and/or subsequent year returns so we had a more complete picture of each case. According to IRS officials, the SB/SE Division's quality measurement staff makes their evaluations based on the information contained in closed case files. Another potential reason for the difference could be attributed to the fact that the IRS strictly adhered to the cycle time guidelines when determining whether the examinations should have been expanded to the prior year returns while we did not. Our results related to expanding examinations to the prior year when the end of the audit cycle is imminent or had already expired will be discussed later in this report. Lastly, the differences in our results could also be attributed to the populations from which the samples were selected. Specifically, the SB/SE Division's population included both single-year and multi-year examination cases while our population only included single-year examinations that were not expanded to the prior and/or subsequent year as our objective was to test whether those examinations should have been expanded.

In additional to our concern with expanding audits, TCOs did not properly complete RFCs for information and employment tax returns in 18 (18 percent) of 100 audits that were part of our sample. When we project our sample results to our population of 2,932 closed audits, we are 95 percent confident that the range of returns where the RFCs were not properly completed is between 310 and 746. Although we found only 18 instances where TCOs did not properly complete RFCs, only 33 of the 100 audits had deductions that were taken for commissions, contract labor, and wages, and accordingly, completing RFCs for information and employment tax returns was not applicable for all 100 audits.[2] Of these 33 audits, we found only 15 audits where the TCO properly completed the RFCs for information and employment tax returns. In several audits, case files were documented to indicate there was no need to complete RFCs for information and employment tax returns, even though deductions on the tax returns showed thousands of dollars were paid for contract labor and hundreds of thousands of dollars for employee wages. Verifying that required information and employment tax returns are filed is critical for getting the data in the information return reporting system so the IRS can detect, prioritize, and pursue those individuals who receive compensation and are either not filing tax returns or underreporting the compensation received on the returns they file.

Our evaluation of the RFCs in our sample audits indicates that a combination of factors caused the quality concerns that surfaced during this review. We believe that additional steps can be taken at the examiner and first-line manager levels to improve the quality of RFCs.

### ***Detailed examples in the IRM or other guidance showing when a deviation from IRS audit cycles is appropriate could encourage expanding audits to more prior year returns***

The IRS strives to keep its audit inventories free of old tax year returns so the IRS has sufficient time to complete audits and assess any resulting taxes within the 3-year assessment statute of limitations.[3] Since this is not always possible, each year thousands of taxpayers allow the IRS additional time to complete the audit and assessment processes by consenting to extend the assessment statute of limitations to either a specific period of time or an unlimited, indefinite period. From a taxpayer's perspective, the additional time can be beneficial. For example, a taxpayer might want to pursue other audit issues that are in their favor in offsetting a proposed tax assessment or that might allow for a tax refund. Also, if the remaining time before the statute

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[2] For the remaining 67 audits, completing RFCs for information and employment tax returns were not required.

[3] When the IRS audits a tax return and determines that there is an additional tax liability, the additional tax assessment must generally be processed within 3 years from the date the return was due or from the date on which the return was actually filed, whichever is later.

expires is too short, the IRS might have to prematurely stop the audit process and issue a notice of deficiency that limits the time for the normal appeals process before the taxpayer must file a petition with the United States Tax Court.

To minimize the need to request consents to extend the assessment statute of limitations from taxpayers, the IRS established time periods (audit cycles) decades ago that examiners are expected to strictly adhere to in considering whether to expand audits to prior and/or subsequent year returns. As specified in the IRM, the audit cycle for an individual income tax return spans 26 months and begins on the later of the date when the tax return is due or when it is filed. The audit cycle for a business return (corporate, partnerships, etc.) is 27 months. Available evidence suggests that strict adherence to the audit cycle results in the practice of TCOs rarely expanding audits to the prior year return.

For example, our case review shows that the vast majority (35 of 48) of our concerns with taxpayers potentially avoiding additional assessments involved audits that were not expanded to include the prior year. In addition, our analysis of the 100 single-year audits found that at the time the audit began, there was an average of less than 1 month remaining on the audit cycle for the prior year returns, but an average of about 11 months remaining on the assessment statute of limitations. By the time the single-year audits ended, an average of 6 months remained on the assessment statute of limitations. Moreover, our expanded analysis of 42,187 Discriminant Index Function initiated audits of individual returns closed in FY 2010 shows that about 9 percent of audits included a prior year return, while subsequent year returns were included in about 42 percent of the audits.

IRS officials recognized that potential tax issues existed on the majority (20 of 35) of our exception cases involving a prior year return. Specifically, our review identified additional potential tax, penalty, and interest assessments ranging from approximately $1,200 to $41,400. Although the IRS officials concurred with the potential tax issues, they stated that they agreed with the TCOs decision to not expand these audits to the prior year returns as doing so would be contrary to the audit cycle rule and risk incurring an assessment statute of limitation problem. IRS officials could not point to specific criteria or examples in the IRM or other guidance specifying the type of tax issues or dollar thresholds that would require greater consideration being given to expanding an audit to include a prior year return, such as a mandatory discussion with the group manager.

In contrast, the IRM provides dollar threshold amounts and at least 65 examples of fraud indicators, including the detailed example below, to assist IRS personnel to recognize potential fraud during audits and determine when it would be appropriate to expand audits so fraud can be established.

> *During the examination of a taxpayer's Form 1040,[4] the examiner found numerous errors resulting in additional tax. One of the adjustments was a large amount of unreported income discovered in a concealed bank account. Other adjustments were supported with altered documents. The taxpayer gave false information and misrepresented the facts throughout the examination. All the acts of the taxpayer, when seen as a whole, indicate fraud.*

Like RFCs, the IRM also indicates that the responsibility and decision for identifying and pursuing fraud during audits is largely left to the experience and judgment of examiners and their immediate managers.

## TCOs could take better advantage of IRS automated information systems to complete RFCs

IRM guidance instructs examiners to complete RFCs during the planning phase of audits, using the IRS's automated information systems. These internal sources are designed to provide examiners with fast, reliable data needed to ensure that taxpayers under audit are filing all required Federal tax returns and to evaluate the returns for potential areas of noncompliance. At the same time, the sources also reduce the burden audits impose on taxpayers by avoiding the need to always request copies of the tax returns that taxpayers already filed with the IRS.

We used the following 4 command codes to obtain data from IRS automated information systems when evaluating each of the 100 cases in our sample.

- BMFOL – This provides online access to business returns and documents related to that business that examiners can use to view, compare, and evaluate employment tax returns filed by a taxpayer selected for audit. Consequently, it can be very useful for identifying and verifying whether the taxpayer has filed required employment tax returns.
- IMFOL – This provides online access to individual taxpayer returns that examiners can use to determine whether the individual filed their prior and subsequent year returns. As noted previously, we found that TCOs inspected and correctly verified the filing status of the prior and/or subsequent year tax returns by using the IMFOL command code.
- PMFOL – This provides online access to information reports filed by entities, businesses, and individuals that examiners can use to view, compare, and evaluate information returns filed by a taxpayer selected for audit. Consequently, it can be very useful for identifying and verifying whether the taxpayer has filed required information returns.
- RTVUE – This provides online access to nationwide tax returns data that examiners can use to view, compare, and evaluate specific line items on the individual income tax return selected for audit as well as the prior and subsequent year returns. Consequently, it can

[4] U.S. Individual Income Tax Return (Form 1040).

be very useful for identifying tax issues and tax returns that warrant an audit because they pose a high compliance risk.

In a judgmental sample[5] of 67 TCOs involved in the audits reviewed, we found that although overall the TCOs have and use the IMFOL and RTVUE command codes, 36 had not been provided, or did not use, one or both of the PMFOL and BMFOL command codes.

During discussions with IRS officials over this issue, we were told that in some audit groups the administrative assistants are responsible for accessing IRS automated information systems and obtaining hard transcripts of the BMFOL, IMFOL, PMFOL, and RTVUE data. Once obtained, the transcripts are provided to examiners for use during their audits. We were also told that if the transcripts were obtained and provided to examiners, the documentation should be maintained in the audit case files.

We checked for documentation of these hard copy data in each of our 100 sample audit case files and found that 9 (9 percent) of the 100 case files contained BMFOL and/or PMFOL transcripts. When we project our sample results to our population of 2,932 closed audits, we are 95 percent confident that the range of case files that contained BMFOL and PMFOL transcripts is between 101 and 426. As previously mentioned, 33 of the 100 cases in our sample had deductions taken for commission, contract labor, or wages, and, therefore, copies of the BMFOL and/or PMFOL transcripts would be necessary for the TCOs to verify whether the taxpayer had filed the required employment tax and/or information returns. Of these 33 audits, we found that 4 case files included a BMFOL and/or PMFOL transcript.

### ***First-line managers could hold TCOs more accountable for completing RFCs***

The Treasury Inspector General for Tax Administration,[6] the Government Accountability Office,[7] and the United States Merit Systems Protection Board[8] have previously reported that performance feedback can be a very effective tool in helping employees understand and meet their responsibilities. It also provides opportunities to give meaningful and constructive feedback on performance, pinpoint and address performance gaps, and hold employees accountable for following management directives and delivering results. As the following excerpt from the United States Merit Systems Protection Board report to the President and Congress summarizes, continually monitoring and providing feedback to employees is a critical component of performance management.

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[5] A judgmental sample is a nonstatistical sample, the results of which cannot be used to project to the population.
[6] For example, *Tests for Unreported Income During Sole Proprietor Field Audits Can Be Strengthened* (Reference Number 2010-30-105, dated September 9, 2010).
[7] *Standards for Internal Control in the Federal Government* (GAO/AIMF-00-21.3.1, dated November 1999).
[8] *The Federal Workforce for the 21st Century: Results of the Merit Principles Survey 2000* (September 2003). The United States Merit Systems Protection Board is an independent, quasi-judicial agency that oversees and adjudicates the application of merit system principles within the Executive Branch.

*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.*

We reviewed the performance feedback recorded in the Embedded Quality Review System[9] (EQRS) that first-line managers provided to 17 TCOs in FYs 2008 through 2010 and found that first-line managers were taking advantage of the EQRS to provide written performance feedback to TCOs that generally emphasized the importance of RFCs. However, we also identified some opportunities where the consistency and quality of the feedback could be enhanced. For example, 1 TCO received no written feedback through the EQRS on their RFCs in any of the 3 years reviewed, while another TCO received 20 narrative comments addressing RFCs. Moreover, we found only 12 narrative comments in the EQRS about steps that could be taken to improve the quality of RFCs, which could expedite the process and reduce burden on taxpayers. Examples of such narrative comments include the following:

- *You are initiating, as warranted multi-year examinations. This should be done early on in the exam process to prevent cases from aging.*
- *You are identifying multi-year exams. Make sure to initiate as soon as possible to prevent key case from aging unnecessarily.*

According to IRS officials, the 17 employees in our judgmental sample may have received additional written feedback regarding the quality of their RFCs that was not recorded in the EQRS. We did not attempt to secure and evaluate this additional information because the IRM indicates that although first-line managers may conduct informal, undocumented reviews of case quality, it specifically requires all formal reviews to be documented using the EQRS.

In addition to reviewing the EQRS, we evaluated the narrative comments in the 54 mid-year and annual appraisals the 17 TCOs received for FYs 2009 and 2010 and found similar opportunities for the consistency and quality of feedback regarding RFCs to be enhanced. We found that 10 of the 17 TCOs received specific feedback emphasizing the importance of expanding audits to prior and/or subsequent year returns, while only 3 received specific feedback about verifying that required information and employment tax returns were filed. We also found that 7 of the 17 TCOs did not receive any performance feedback over the 2 year period in either their mid-year or annual appraisals related to expanding their audits to prior and/or subsequent year returns or verifying that required information and employment tax returns were filed. Similar to the EQRS results, we found only two narrative comments in either mid-year or annual appraisals about steps that could be taken to improve the quality of RFCs.

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

## Recommendations

The Director, Exam Policy, SB/SE Division, should provide:

***Recommendation 1:*** Detailed examples to TCOs in the IRM, or in other guidance material, on when it would be appropriate for them to expand audits to the prior and/or subsequent year returns.

> ***Management's Response:*** IRS management agreed with this recommendation and plans to prepare two articles for internal publication. One article will be published in the SB/SE Division's "Keys to Success" and the other in the SB/SE Division's "Technical Digest." The articles will emphasize the mandatory RFCs and provide examples that illustrate when it is appropriate to expand examinations to prior and subsequent year returns.

***Recommendation 2:*** Information to TCOs that focuses on improvement in the use of the IRS's automated information systems to enhance the quality of their RFCs.

> ***Management's Response:*** IRS management agreed with this recommendation. To enhance the quality of office examination RFCs using the IRS's automated information systems, they will prepare a PowerPoint presentation that will be used to conduct a workshop for office examination management and examiners. The RFCs workshop will focus on the use of Integrated Data Retrieval System[10] command codes to accomplish the RFCs required by the IRM.

***Recommendation 3:*** Additional guidance to first-line managers to improve the feedback provided to TCOs in the EQRS and/or in appraisals on the quality of their RFCs and related opportunities for improvement.

> ***Management's Response:*** IRS management agreed with this recommendation and will provide additional guidance to first-line managers to improve the feedback provided to TCOs on the quality of their RFCs and related opportunities for improvement in the EQRS and/or appraisals. In addition, the guidance will cover all feedback provided to TCOs including individual case reviews, inventory management reviews, training sessions, and mid-year and annual appraisals.

> ***Office of Audit Comments:*** Although IRS officials agreed with all three recommendations, they did not agree with the potential monetary benefits associated with the recommendations. Among the concerns, IRS officials noted that our results are based upon a sample from a special population of audits which excluded the vast majority of the cases worked by TCOs. We agree that only single-year audits of individual returns

[10] The Integrated Data Retrieval System is the IRS computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer's account records.

for which the taxpayers involved agreed they understated their tax liabilities by more than $4,400 were included in our case reviews. We purposely limited the cases reviews, and the potential benefit, to this population of audits because of the questions that can be raised under IRS procedures about why the audits were not expanded to include prior and/or subsequent year returns given the substantial amount of taxes that the individuals agreed was owed. Moreover, the accuracy and validity of our potential benefit was confirmed by a statistician in the private sector who provides consulting service to the Treasury Inspector General for Tax Administration. As a result, we maintain that the potential benefit is reasonable as outlined in Appendix IV.

IRS officials also indicated in their response that their internal review process, which they said involves a statistically valid sample of the entire population of examined returns, indicates examiners appropriately expanded audits in 89 percent of the cases reviewed. As for the differences in our findings (48 percent were not appropriately expanded to the prior and/or subsequent year) and the results from the IRS internal review process (11 percent were not appropriately expanded), several factors, as noted in our report, could have contributed to the differences.

Specifically, one reason was the information sources used to evaluate the cases. We accessed the IRS's automated information systems to supplement case files with hard copy transcripts of prior and/or subsequent year returns so we had a more complete picture of each case. According to IRS officials, their internal review process is based on the information contained in closed case files. As previously discussed, we also limited our case reviews to audits of individual returns for which the taxpayers involved agreed they understated their tax liabilities by more than $4,400. In contrast, IRS officials said their internal review process involves a sample from the entire population of audits, which would presumably include audits that resulted in little or no additional recommended taxes. According to IRS procedures, audits that result in little or no tax would not likely provide any reason for expanding the audit to include the prior and/or subsequent year returns.

Finally, IRS officials noted in their response that performance feedback is sometimes provided in attachments, which are stored outside of the EQRS. Consequently, IRS officials indicated that our review may have missed some of the feedback given to examiners regarding RFCs. We did not attempt to secure and evaluate this additional information because the IRM indicates that although first-line managers may conduct informal, undocumented reviews of case quality, it specifically requires all formal reviews to be documented using the EQRS.

**Appendix I**

# Detailed Objective, Scope, and Methodology

Our overall objective was to determine whether TCOs in the SB/SE Division are conducting RFCs in accordance with IRS policies and procedures. To accomplish this objective, we:

I. Determined the policies, procedures, and techniques (management controls) the IRS has in place to ensure that TCOs adequately perform RFCs.

II. Determined how well TCOs are complying with policies and procedures applicable to RFCs and if expanding audits to include additional returns would enhance revenues by performing the following:

  A. Obtained an extract from the Audit Information Management System[1] Closed Case FY 2009 data file to identify the population of return cases closed by TCOs (group codes 2000–2999) which were also Audit Information Management System Activity Codes 274–281 (sole proprietor and high-income returns), had an agreed assessment of more than $4,400, and were not expanded to the prior and/or subsequent year returns.

  B. Validated the data by comparing the data to the Integrated Data Retrieval System[2] files to ensure that there was examination activity during FY 2009.

  C. Selected a statistical sample of 100 closed audits to review from the population of 2,932 closed single-year audits identified in Step II.A using a 95 percent confidence level, ± 9.68 percent precision, and 50 percent occurrence rate. A statistical sample was taken because we wanted to estimate the number of taxpayers and amount of dollars associated with not properly complying with RFCs during audits for a population of 2,932 single-year audits involving 2,932 taxpayers.

  D. Assessed whether TCOs complied with RFCs and if there may be opportunities to enhance revenue. For revenue enhancements, we calculated the potential penalties, taxes, and interest missed because audits were not expanded to include prior and/or subsequent year returns.

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

III. Identified potential reasons for the problems identified in the cases reviewed by assessing the quality and amount of performance feedback TCOs received on their RFCs from their managers and the level of access they have to the Integrated Data Retrieval System.

A. Analyzed the feedback given to a judgmental sample of 17 TCOs included in our case reviews during FYs 2008 through 2010 by extracting the information recorded in the EQRS attributes (i.e., Attributes 104 and 108)[3] dealing with prior year returns, subsequent year returns, related tax returns, and full compliance checks. We used judgmental sampling to select the TCOs because we did not plan to project our results.

B. Reviewed the FYs 2009 and 2010 mid-year and annual appraisals to identify feedback related to RFCs that was given to the judgmental sample of 17 TCOs in Step III.A.

C. Determined whether the TCOs in Step III.A had access to and/or used the Integrated Data Retrieval System command codes, such as BMFOL, IMFOL, PMFOL and RTVUE, that are needed to complete filing checks.

D. Obtained an extract from the Audit Information Management System Closed Case FY 2010 data file to identify the population of Discriminant Index Function initiated closed cases with Source Code "02" and Source Code "20" with Special Project Code "0158" closed by TCOs (group codes 2000–2999) that were also Activity Codes 266 or 274–281 (individual tax returns) to determine how often the primary year examination is expanded to the prior and/or subsequent year.

## ***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 determining, during income tax audits, whether TCOs are examining all prior and subsequent year returns, when warranted, and verifying full compliance with information return requirements. We evaluated these controls by reviewing source materials and reviewing a sample of 100 examined closed cases.

[3] EQRS attributes are concise statements of SB/SE Division's expectations for quality examinations and are guidelines to assist examiners in fulfilling their professional responsibilities. Attribute 104 measures if the examiner considered the prior year, subsequent year, and related returns during the examination when warranted. Attribute 108 measures if the examiner performed RFCs for returns other than those measured by Attribute 104 (e.g., information returns and employment tax returns).

**Appendix II**

# Major Contributors to This Report

Margaret E. Begg, Assistant Inspector General for Audit (Compliance and Enforcement Operations)
Frank Dunleavy, Director
Michelle Philpott, Audit Manager
Cynthia Dozier, Lead Auditor
Malissa Livingston, Lead Auditor
Kristi Larson, Senior Auditor
William Tran, Senior 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, Campus Compliance Services, Small Business/Self-Employed Division  SE:S:CCS
Director, Communications, Liaison, and Disclosure, Small Business/Self-Employed Division SE:S:CLD
Director, Examination, Small Business/Self-Employed Division  SE:S:E
Director, Campus Reporting Compliance, Small Business/Self-Employed Division SE:S:CCS:CRC
Director, Exam Planning and Delivery, Small Business/Self-Employed Division  SE:S:E:EPD
Director, Exam Policy, 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

**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; $13.5 million in additional taxes, penalties, and interest owed by 1,407 taxpayers; $67.6 million over 5 years (see page 5). Our calculation assumes that tax issues present on the prior and/or subsequent year return would be disallowed at the same rate as the tax issues disallowed on the primary year return. The value of the outcome measure does not include amounts (revenue) that would partially offset this benefit as a result of directing examination resources away from other taxpayer returns in order to expand audits to include the prior and/or subsequent year returns.

## *Methodology Used to Measure the Reported Benefit:*

- We reviewed a statistically valid sample of 100 cases from a population of 2,932 closed single-year return examinations of sole proprietors and high-income taxpayers in FY 2009 who had agreed assessments of more than $4,400 each.
- We identified 48 cases that may have warranted expanding the audit to the prior and/or subsequent year return due to similar tax issues being present on these returns.
- Based on our sample error rate of 48 percent (48/100) and a confidence level of 95 percent (9.67 percent precision), we calculated the number of taxpayers who may owe additional taxes, penalties, and interest to be 1,407 taxpayers [2,932 x 48 percent], with a range of 1,124 to 1,691.
- To estimate the potential amount of additional taxes, penalties, and interest that may have been assessed for these 48 cases, we computed the additional tax liabilities for the prior and/or subsequent year if tax issues similar to those that resulted in adjustments to the primary year return were present. Based on this analysis, we estimated that had the audit been expanded to the prior and/or subsequent year for the 48 cases in our sample, $363,045 in additional taxes, $19,293 in penalties, and $78,846 in interest could have been assessed.[1]

[1] Amounts are rounded to the nearest dollar.

- We calculated the average additional taxes, penalties, and interest for all 100 cases in our sample [$461,184/100 = $4,612].[2]
- We then multiplied the number of cases in the total population by the average amount due from our sample cases to get the total amount of additional taxes, penalties, and interest owed for these examination cases closed in FY 2009 [2,932 x $4,612 = $13,522,384].[3]
- To estimate the amount of additional taxes, penalties, and interest owed that could be assessed over 5 years if the IRS expanded audits to the prior and/or subsequent year returns when similar tax issues are present, we multiplied the total amount of additional taxes, penalties, and interest we estimated is owed for the examination cases closed in FY 2009 by 5 to obtain the amount of taxes, penalties, and interest that would be owed over 5 years [$13,522,384 x 5 = $67,611,920]. Our calculation assumes that all estimated taxes, penalties, and interest would be owed based upon audits of the taxpayers' books and records and that conditions such as economic factors, tax law, compliance rates, and IRS audit coverage remains the same.

[2] Amounts are rounded to the nearest dollar.
[3] Using the computed standard deviation of $7,235 for our sample, we are 95 percent confident that the total amount owed for the examination cases closed in FY 2009 will be between $9,385,262 and $17,658,572.

## Appendix V

# Management's Response to the Draft Report

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

COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

RECEIVED AUG - 3 2011

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MEMORANDUM FOR MICHAEL R. PHILLIPS
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Faris R. Fink
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – Actions Are Needed To Better Ensure Audits Are Expanded To Prior Year Returns When Substantial Taxes May Be Owed (Audit # 201030042)

Thank you for the opportunity to review your draft report entitled, "Actions are Needed to Better Ensure Audits are Expanded to Prior Year Returns when Substantial Taxes may be Owed". We appreciate your recognition of the emphasis we have had on case file documentation and the management controls we have instituted to ensure our examiners properly consider expanding audits to the prior and/or subsequent years.

We are pleased your review found we successfully implemented procedures to ensure consistent filing verification of prior and/or subsequent year tax returns. Specifically, you found that in 92 of the 100 cases you sampled, examiners inspected and correctly verified the filing of the prior and/or subsequent year tax returns using our automated information systems.

In your report, you noted that the feedback in the Embedded Quality Review System (EQRS) generally emphasized the importance of required filing checks (RFCs), but found opportunities for improving the consistency and quality of this feedback. In addition to the information in the EQRS system, case specific feedback is sometimes provided in attachments, which are stored outside of the EQRS system. The information summarized in the EQRS may not contain all of the detail captured in the attachments and thus your review may have missed some of the feedback given to examiners regarding RFCs.

Your report indicates our examiners did not expand the audit to the prior and/or subsequent year in nearly half of the tax returns you sampled. However, our internal review process, which involves a statistically valid sample of the entire population of examined returns, indicates our examiners appropriately expanded audits in 89 percent of the cases reviewed. We believe this internal review process more accurately reflects our examiners' performance.

We do not agree with the methodology used to determine the Outcome Measures included in your report. Your results are based upon a sample from a special population of audits which excluded the vast majority (over 90 percent) of the cases worked by tax compliance officers (TCOs). Therefore, the projections are not a valid representation of our TCO performance rates for RFCs. Using our internal review data, which shows 89 percent of our examinations are properly expanded to prior and subsequent years, and adjusting the tax for the lost opportunity cost from exams we would not be able to complete if we shifted resources, we believe a more accurate potential Outcome Measure is less than $2.5 million in tax.

Our response to your recommendations is included in the attachment.

If you have any questions, please contact me, or a member of your staff may contact Shenita Hicks, Director, Examination, and Small Business/Self Employed Division at (859) 669-5526.

Attachment

Attachment

**RECOMMENDATION 1:**
The Director, Exam Policy, Small Business/Self Employed (SB/SE) Division, should provide detailed examples to tax compliance officers (TCOs) in the Internal Revenue Manual (IRM), or in other guidance material, on when it would be appropriate for them to expand audits to the prior and/or subsequent year returns.

**CORRECTIVE ACTION:**
We agree with this recommendation. We will prepare two articles for internal publication. One article will be published in the SB/SE "Keys to Success" and the other in the SB/SE "Technical Digest". The articles will emphasize the mandatory required filing checks and provide examples that illustrate when it is appropriate to expand examinations to prior and subsequent year returns.

**IMPLEMENTATION DATE:**
February 15, 2012

**RESPONSIBLE OFFICIAL(S):**
Director, Examination Policy, SB/SE Division

**CORRECTIVE ACTION MONITORING PLAN:**
We will monitor this action as part of our internal management control process.

**RECOMMENDATION 2:**
The Director, Exam Policy, SB/SE Division, should provide information to TCOs that focuses on improvement in the use of the IRS's automated information systems to enhance the quality of their RFCs.

**CORRECTIVE ACTION:**
We agree with this recommendation. To enhance the quality of office examination RFCs using IRS's automated information systems, we will prepare a PowerPoint presentation that will be used to conduct a workshop for office examination management and examiners. The RFC workshop will focus on the use of Integrated Data Retrieval System (IDRS) command codes to accomplish the RFCs required by the IRM.

**IMPLEMENTATION DATE:**
May 15, 2012

**RESPONSIBLE OFFICIAL(S):**
Director, Examination Policy, SB/SE Division

**CORRECTIVE ACTION MONITORING PLAN:**
We will monitor this action as part of our internal management control process.

**RECOMMENDATION 3:**
The Director, Exam Policy, SB/SE Division, should provide additional guidance to first-line managers to improve the feedback provided to TCOs in the EQRS and/or in appraisals on the quality of their RFCs and related opportunities for improvement.

**CORRECTIVE ACTION:**
We agree with this recommendation. We will provide additional guidance to first-line managers to improve the feedback provided to TCOs on the quality of their RFCs and related opportunities for improvement in the EQRS and/or appraisals. In addition, our guidance will cover all feedback provided to TCO's including individual case reviews, inventory management reviews, training sessions, and mid-year and annual appraisals, etc.

**IMPLEMENTATION DATE:**
February 15, 2012

**RESPONSIBLE OFFICIAL(S):**
Director, Examination Policy, SB/SE Division

**CORRECTIVE ACTION MONITORING PLAN:**
We will monitor this action as part of our internal management control process.