



*National Research Program Audits  
of Individuals Are Closely Monitored,  
but the Quality of Tests for  
Unreported Income Is a Concern*

**September 15, 2011**

**Reference Number: 2011-30-102**

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

Redaction Legend:

1 = Tax Return/Return Information

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## HIGHLIGHTS

### **NATIONAL RESEARCH PROGRAM AUDITS OF INDIVIDUALS ARE CLOSELY MONITORED, BUT THE QUALITY OF TESTS FOR UNREPORTED INCOME IS A CONCERN**

## Highlights

**Final Report issued on  
September 15, 2011**

Highlights of Reference Number: 2011-30-102 to the Internal Revenue Service Commissioner for the Small Business/Self-Employed Division and the Director, Office of Research, Analysis, and Statistics.

### **IMPACT ON TAXPAYERS**

The Internal Revenue Service (IRS) is conducting a multiyear National Research Program (NRP) study to measure the reporting compliance among individual taxpayers. The IRS must ensure the data collected are as reliable as possible because the data are used as planning tools for formulating strategies to meet the goals of improving service and enforcing the tax laws so everyone meets their obligation to pay taxes.

### **WHY TIGTA DID THE AUDIT**

This audit was initiated to determine whether the NRP is being properly implemented and providing reliable results for making strategic planning decisions. The NRP is a unique program because it gives the IRS the capability to make statistically reliable estimates of tax reporting compliance nationwide from a relatively small sample of audits.

This, in turn, provides data needed for measuring the difference between the taxes that taxpayers should pay and the amount that is paid voluntarily and on time (Tax Gap), updating audit selection and resource allocation systems, identifying ways to improve voluntary compliance, and estimating the revenue from proposed legislative and administrative changes.

### **WHAT TIGTA FOUND**

Because of its statistical validity, legislators and policy makers consider the NRP an extremely important program, and IRS management reflected this priority in the emphasis given to the current phase of individual audits. IRS management closely monitored the sampling methodology and implementation schedule for NRP audits. As a result, the NRP is on track to begin providing updated Tax Gap estimates by the end of Calendar Year 2011.

Although the IRS was successful in implementing the NRP schedule, the tests for unreported income during audits need to be improved. TIGTA evaluated a nonstatistical sample of closed Tax Years 2006, 2007, and 2008 NRP audits (10 for each year) and identified that the income reported on the return was not properly verified in four of the 30 audits, which may have adversely affected the accuracy of the audit results for each of the four audits by \$10,000 or more. NRP quality reviewers found an even higher percentage of audits (roughly 40 percent) in their nonstatistical samples for which the income reflected on returns was not properly verified during NRP audits conducted in Fiscal Years 2008, 2009, and 2010.

### **WHAT TIGTA RECOMMENDED**

TIGTA has already made recommendations in prior reports to strengthen the weaknesses identified in the tests for unreported income during audits. The SB/SE Division has responded with improvement efforts that are currently underway to address these weaknesses. Consequently, TIGTA is not making any additional recommendations at this time.

Although TIGTA made no recommendations in this report, IRS officials were provided an opportunity to review the draft report. IRS management did not provide any report comments.



TREASURY INSPECTOR GENERAL  
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

September 15, 2011

**MEMORANDUM FOR** COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED  
DIVISION  
DIRECTOR, OFFICE OF RESEARCH, ANALYSIS, AND  
STATISTICS

*Margaret E. Begg*

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

**SUBJECT:** Final Audit Report –National Research Program Audits of Individuals  
Are Closely Monitored, but the Quality of Tests for Unreported Income  
Is a Concern (Audit # 201030011)

This report presents the results of our review to determine whether the National Research Program Individual Reporting Compliance Study is being properly implemented and providing reliable results for making strategic planning decisions. This review was part of our Fiscal Year 2010 Annual Audit Plan and addresses the major management challenge of Tax Compliance Initiatives.

Although we made no recommendations in this report, we did provide Internal Revenue Service (IRS) officials an opportunity to review the draft report. IRS management did not provide us with any report comments.

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

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*

FY	Fiscal Year
IRS	Internal Revenue Service
NQRS	National Quality Review System
NRP	National Research Program
SB/SE	Small Business/Self-Employed
TIGTA	Treasury Inspector General for Tax Administration
TY	Tax Year



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## *Background*

The Internal Revenue Service (IRS) has two strategic goals. The first is to improve service to make voluntary compliance easier, and the second is to enforce the laws to ensure that everyone meets their obligations to pay taxes. To achieve its goals, the IRS depends on voluntary compliance, which relies on individual citizens to report their income freely and voluntarily, calculate their tax liability correctly, and file a tax return on time. There are three primary measures of voluntary compliance:

- Filing compliance – the percentage of taxpayers with a filing requirement who file returns on time.
- Payment compliance – the percentage of tax reported on timely filed returns that is paid on time.
- Reporting compliance – the accuracy of tax reported on time.

In Fiscal Year (FY) 2000, the IRS established the National Research Program (NRP)<sup>1</sup> Office and charged it with addressing voluntary compliance in these three areas. The NRP Office completed its first reporting compliance study of taxpayers who file U.S. Individual Income Tax Returns (Form 1040) using information from Tax Year (TY)<sup>2</sup> 2001. The results of this study were used to help the IRS estimate the Tax Gap, which is the difference between the total taxes that taxpayers should have paid and the total taxes that were actually paid timely. The IRS estimated the yearly gross Tax Gap at approximately \$345 billion. Within the gross Tax Gap, late filing and nonfiling of tax returns accounted for about \$27 billion and underpayment of reported taxes accounted for approximately \$34 billion. The remaining \$284 billion (approximate) was due to improper reporting, and the vast majority of that improper reporting came from individual taxpayers.

The IRS selects the majority of tax returns for audit based on the data obtained from the TY 2001 NRP study. That study involved examining a sample of about 46,000 tax returns and strained the IRS's examination work plan for that year. Working NRP study examinations all in 1 year used IRS resources that would have normally been used to work higher productive cases.

Recognizing the need for more current information and balancing that need with performing its annual examination work plan, the NRP Office initiated a new Individual Reporting Compliance

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<sup>1</sup> The NRP Office is responsible for determining filing, payment, and reporting compliance by taxpayers for different types of taxes.

<sup>2</sup> A 12-month accounting period for keeping records on income and expenses used as the basis for calculating the annual taxes due. For most individual taxpayers, the tax year is synonymous with the calendar year.



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Study (hereafter referred to as the NRP study or the study), beginning in October 2007. The methodology for this study lessens the impact on the annual examination work plan because it spreads out the NRP study examinations over 3 consecutive years. The new study also calls for collecting data every year for the foreseeable future, which should allow the information to be more current and updated regularly.

The current NRP study was designed to use random samples of about 13,200 Forms 1040 for 3 consecutive years. The samples are intended to be representative of the individual taxpayer populations. The examinations that began in October 2007 were comprised of TY 2006 returns. The IRS continued the similar methodology the following year to examine a comparable sample of TY 2007 returns. When data from the third year of the study (TY 2008) are ready for analysis, the resulting estimates, based on combined data for all 3 tax years, should have a statistical precision comparable to that of the TY 2001 study. This methodology will also allow the IRS to update compliance estimates and workload identification models annually.

The NRP study audit process can be more detailed than the regular enforcement audit process and place greater burden on examiners. As part of the audit, examiners must respond to a comprehensive set of NRP study research questions about the taxpayer. The questions are designed to capture the various characteristics of the taxpayer. NRP study audits also require additional oversight by managers at the national, area, and local levels.

At the national level, the NRP study is coordinated by the IRS's Office of Research, Analysis, and Statistics. At the Area Office level, an NRP Area Territory Manager is the key contact point and oversees the quality of the examinations. In addition, an NRP Coordinator (appointed by Planning and Special Programs management) assists with planning and monitoring NRP study audits. At the local level, each NRP study audit must be reviewed and approved by the group manager. Thereafter, the examinations may be selected for review by the Area Office NRP Quality Review Team and the staff of the National Quality Review System (NQRS).

This review was performed at the Office of Research, Analysis, and Statistics in Washington, D.C., and the Small Business/Self-Employed (SB/SE) Division Headquarters Office in New Carrollton, Maryland, during the period August 2010 through April 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 objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. Detailed information on our audit objectives, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.



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## *Results of Review*

The NRP is an extremely important program, and IRS management reflected this priority in the emphasis given to the first series of individual audits using the 3-year rolling methodology.<sup>3</sup> All levels of IRS management closely coordinated efforts in monitoring the implementation of the NRP study schedule. As a result, the program is on track to issue the preliminary updated Tax Gap estimates, based on TYs 2006 and 2007 examination results, at the end of Calendar Year 2011. The final Tax Gap estimate, based on TYs 2006 through 2008 examination results, is planned for May 2012. The new workload selection and resources allocation systems will go into effect in Calendar Year 2013.

Although the IRS was very successful in implementing the NRP study schedule, the quality of tests for unreported income during audits needs to be improved. Both the Treasury Inspector General for Tax Administration (TIGTA) and the IRS have identified quality concerns with income testing that may be adversely affecting the accuracy of NRP study audit results.

### ***The Sampling Methodology and Implementation Schedule for National Research Program Study Audits Were Closely Monitored***

The NRP is a unique program because it gives the IRS the capability to make statistically reliable estimates of tax reporting compliance nationwide from a relatively small sample of audits. This, in turn, provides data needed for measuring the Tax Gap, updating audit selection and resource allocation systems, identifying ways to improve voluntary compliance, and estimating the revenue from proposed legislative and administrative changes. Legislators and policy makers consider the NRP an extremely important program because of its statistical validity. For example, in June 2009,<sup>4</sup> we reported that the IRS had taken the extra steps of contracting with an outside research firm to evaluate the planned methodology for the NRP. The firm concluded the 3-year sampling methodology developed by IRS statisticians was appropriate for providing estimates of reporting compliance and the data needed to update computer formulas for selecting returns for audits. We also reported, using a statistician who independently verified that the sample size was sufficient to measure the statistical reliability of results, the related formulas and calculations were accurate and consistent, and a multiyear strategy is an acceptable approach for

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<sup>3</sup> An individual reporting compliance study will be conducted every year, and the 3 most recent tax years will be combined to achieve optimal statistical precision. For example, when the TY 2009 study is completed, the results from TYs 2007–2009 will be combined (TY 2006 will be dropped off) to arrive at the new individual reporting compliance measures.

<sup>4</sup> *An Appropriate Methodology Has Been Developed for Conducting the National Research Program Study to Measure the Voluntary Compliance of Individual Income Taxpayers* (Reference Number 2009-30-086, dated June 17, 2009).



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performing the study. Additionally, we found that examiners had received the nationally developed NRP study training for conducting individual audits.

Overall, the NRP study sample includes about 42,637 returns and is designed to be representative of the population from about 424 million individual returns filed for TYs 2006 through 2008. The success of any project of this magnitude and importance hinges on effective planning and monitoring. During this NRP study review, we found that IRS management at all levels closely coordinated efforts in monitoring the progress of the NRP study schedule.

Figure 1 summarizes our evaluation of the NRP study audit workload and shows that after the 42,637 sample cases were selected, the tax returns were timely retrieved from IRS files and forwarded to the IRS Cincinnati Campus.<sup>5</sup> The personnel in the Austin Campus also promptly initiated the case building process.<sup>6</sup> The tax return and case building information was packaged into NRP study cases at the Cincinnati Campus, where classification by technically proficient and experienced revenue agents<sup>7</sup> and tax compliance officers<sup>8</sup> also took place. Based on their review of the tax returns and the case building information, the classifiers determined which returns would be audited and which could be accepted as filed. For the returns that were selected for audit, the case files were sent to the IRS Area Offices<sup>9</sup> or Cincinnati Campus Correspondence function for audit initiation.

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<sup>5</sup> The data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.

<sup>6</sup> Case building is the process of adding information from IRS sources to the case file prior to classification.

<sup>7</sup> Revenue agents conduct independent onsite examinations of income tax returns that cover a diverse spectrum of individual and business taxpayers using a wide range of financial and other investigative skills.

<sup>8</sup> Tax compliance officers plan and conduct examinations that are conducive to being performed in an office setting.

<sup>9</sup> An Area Office is a geographic organizational level used by IRS business units and offices to help their specific types of taxpayers understand and comply with tax laws and issues.



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**Figure 1: Key Milestones for NRP Study Audits**

<b>Key Milestone</b>	<b>Planned Start</b>	<b>Actual Start</b>	<b>Status as of March 31, 2011</b>
<b>TY 2006 Cases</b>			
<b>Locate Cases</b>	February 2007	February 2007	Forty-nine audits remain to be completed of 12,379 returns selected for examination. The IRS is analyzing and perfecting the examination data collected.  The total sample was 13,402 cases, which included 1,023 returns the Classification function accepted as filed.
<b>Case Build</b>	March 2007	March 2007	
<b>Classification</b> <sup>10</sup>	July 2007	July 2007	
<b>Start Audits</b>	October 2007	October 2007	
<b>TY 2007 Cases</b>			
<b>Locate Cases</b>	February 2008	February 2008	Three hundred fifty-nine audits remain to be completed of 13,115 returns selected for examination. The IRS is analyzing and perfecting the examination data collected.  The total sample was 14,560 cases, which included 1,445 returns the Classification function accepted as filed.
<b>Case Build</b>	March 2008	March 2008	
<b>Classification</b>	July 2008	July 2008	
<b>Start Audits</b>	October 2008	October 2008	
<b>TY 2008 Cases</b>			
<b>Locate Cases</b>	February 2009	February 2009	Approximately 6,383 audits remain to be completed of the 13,776 selected for examination.  The total sample was 14,675 cases, which included 899 returns the Classification function accepted as filed.
<b>Case Build</b>	March 2009	March 2009	
<b>Classification</b>	July 2009	July 2009	
<b>Start Audits</b>	October 2009	October 2009	

Source: NRP officials.

While we only reviewed workload and inventory management through the audit initiation phase, we concluded that controls had been effectively implemented to ensure NRP study audits are receiving the proper attention. Besides effectively implementing workload and inventory controls, quality controls were implemented over NRP study audits that are more extensive than the quality controls over regular audits.

Unlike regular audits, a nonstatistical sample of closed NRP study audits are evaluated by Area Office NRP study quality reviewers using the NQRS to document their reviews. The purpose of NQRS reviews is to collect information about audit quality and communicate areas of concern to

<sup>10</sup> The NRP Office conducts four 2-week classification sessions each year. The first session occurs during the last week in July or the first week of August, and the final session takes place the following March.



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management for corrective action, if needed. To define audit quality, the NRP study uses 10 quality attributes (see Appendix IV for details on the quality attributes and their definitions).

At the local level, group managers have the primary responsibility for ensuring the examiners they supervise conduct quality NRP study audits. To assist group managers in meeting this responsibility, NRP study guidelines require that group managers evaluate at least one open and one closed NRP study audit for each examiner they supervise as part of the examiner's performance evaluation. Guidelines also require group managers assess the overall quality of every NRP study audit before the IRS closes the case. The foremost reasons for the reviews are to reinforce the importance of adhering to the audit quality attributes, as well as to pinpoint and correct performance and quality gaps.

***The Quality of Tests for Unreported Income Conducted During  
National Research Program Study Audits Needs Improvement***

We evaluated a nonstatistical sample of 10 closed NRP study audits from each TY (2006 through 2008) and identified that for 4 of the 30 audits the income reported on the return was not properly verified. This condition may have adversely affected the accuracy of the audit results for each of the 4 audits by \$10,000 or more. In conducting our reviews, we obtained estimates of personal living expenses published by the Bureau of Labor Statistics that are also used by the IRS. We used the estimated Bureau of Labor Statistics personal living expenses along with available information in the audit documentation to do a cash transaction (Cash T) analysis for our sample cases. We found that 4 audits were closed without addressing the reason business expenditures and other items deducted on the returns, when combined with estimated personal living expenses of the taxpayers, exceeded the income reported by more than \$10,000. In 3 of the 4 audits, the estimated expenses exceeded the income on the return by more than \$35,000. The considerable differences noted between expenditures and income raise serious questions about whether there were additional sources of income that should have been reported on the returns or if expenses were overstated.

To determine whether this quality problem was more widespread, we evaluated the quality results reported by the Area Office NRP study quality reviewers. As summarized in Figure 2, in their nonstatistical samples, the Area Office NRP study quality reviewers found an even higher percentage of cases (roughly 40 percent) where the income reported on returns was not properly verified during NRP study audits conducted in FYs 2008, 2009, and 2010. IRS officials told us that failing the income determination standards does not mean there is unreported income. It could mean the case file was not properly documented or audit steps were not performed in accordance with established guidelines. Nevertheless, without proper documentation or the completion of necessary audit steps, the examiners have not verified the accuracy of the income reported.



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Figure 2: Percentage of NRP Study Cases  
for Which Income Determination Standards Were Not Met

Report Period	Percentage of Revenue Agent Audits	Percentage of Tax Compliance Officer Audits
FY 2008	34%	40%
FY 2009	47%	46%
FY 2010	38%	39%

Source: IRS NQRS Quality Attribute Accuracy Reports for FYs 2008 - 2010.

Although Area Office NRP quality reviewers did not always quantify the potential dollar effect for the problems they identify when reviewing NRP study audits, they did complete narrative comments that described their findings for the cases reviewed and provided feedback within their areas on the trends identified in their reviews. As the following excerpts from some of their comments between March 15, 2010, and May 30, 2010, indicate, properly verifying income during NRP study audits is a concern nationwide.

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According to IRS officials, the reviewers are instructed to focus on what steps in the minimum income probe were not properly completed. Reviewers do not document information on income probes that were correctly completed due to time constraints when reviewing the cases. As a result, the narratives may not be balanced since they focus solely on what audit step(s) were not properly completed.

In considering the significance of the quality problems identified, it is important to recognize that there are a number of legitimate reasons a taxpayer's cash expenditures may exceed the income reported on his/her return. For example, some individuals may have received loan proceeds or are receiving financial help from relatives or friends. Still others may be paying their expenses from savings accumulated in previous years. However, 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.

We believe it is equally important to recognize that the quality problems detected in NRP study audits raise questions about the overall quality of the tests for unreported income during audits in the SB/SE Division. If NRP study audits are among the most important and closely scrutinized audits and have quality problems with tests for unreported income, it is reasonable to assume that the thousands of enforcement audits conducted daily have similar problems.

In February 2010, the TIGTA reported<sup>11</sup> finding 93 correspondence audits for which business expenditures and other items deducted on the return, when combined with estimated personal living expenses, exceeded the income on the return by more than \$10,000. In 15 of the 93 audits, the expenses exceeded the income on the return by more than \$50,000. These audits were identified from a statistically valid sample of 298 closed correspondence audits of individual returns reporting sole proprietorship operations.

<sup>11</sup> *Significant Tax Issues Are Often Not Addressed During Correspondence Audits of Sole Proprietors* (Reference Number 2010-30-024, dated February 24, 2010).



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In a subsequent audit, the TIGTA reported<sup>12</sup> finding 30 audits for which sole proprietors may have avoided tax and interest assessments totaling \$289,251 because of quality problems with the preliminary Cash T analyses. The 30 audits were identified from a statistical sample of 227 audits closed by field examiners. When the review results from the 30 audits were projected to the population of 6,438 closed audits from which the sample was selected, the TIGTA estimated, and the Commissioner, SB/SE Division, agreed, that 851 sole proprietors may have avoided tax and interest assessments of approximately \$8.2 million in 1 tax year.

***The SB/SE Division is taking steps to better hold group managers and examiners accountable for the quality of income testing during audits***

The TIGTA made recommendations in our prior reports to strengthen the weaknesses identified in the tests for unreported income during audits. The SB/SE Division responded with improvement efforts that are currently underway and include taking better advantage of performance feedback and other mechanisms in the IRS performance management system to help ensure income is properly verified during audits, including those conducted under the NRP. Consequently, the TIGTA is not making any additional recommendations at this time.

For example, the Director, Examination, SB/SE Division, issued written instructions on how group managers can enhance the performance feedback they provide to examiners on the adequacy of tests for unreported income. Enhancing performance feedback is important because, as the TIGTA has previously reported,<sup>13</sup> it can be a very effective tool in helping personnel understand and meet their responsibilities. It also provides opportunities to give meaningful and constructive performance feedback, pinpoint and address performance gaps, and hold personnel accountable for following management directives and delivering results. The SB/SE Division additionally formed the Examination Process Improvement Challenge team to develop solutions to address income probe deficiencies. For example, this team published articles devoted to examination of income and minimum income probes in the SB/SE Division's newsletter.

To its credit, the SB/SE Division also recognized the need to hold group managers more accountable for improving the quality of the tests performed for unreported income and began establishing a related commitment in their FY 2011 performance agreements, which indicates an effort on behalf of SB/SE Examination to improve the quality of income probes.

The commitments are intended to be tailored to individual developmental needs and provide the basis for linking group manager critical job responsibilities with IRS balanced measures and strategic goals and holding group managers accountable for their individual and group performances. The commitments should also, according to the IRS, be clear, specific, and easily

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<sup>12</sup> *Tests for Unreported Income During Sole Proprietor Field Audits Can Be Strengthened* (Reference Number 2010-30-105, dated September 9, 2010).

<sup>13</sup> *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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monitored and should include a numeric target or some other means of measurement. Structuring each commitment so it contains these features enhances the ability of Territory managers to hold group managers responsible for meeting these expectations.

As outlined below, the FY 2011 performance agreements for 10 of the group managers who were associated with the closed NRP study audits we reviewed contained commitments related to improving tests for unreported income similar to 1 of the following 4 examples.

- 1. I will improve overall case quality and EQ<sup>14</sup> Attribute 300 (Income Determination) as measured by NQRS by developing and implementing actions that will improve income probes and discussing and providing guidance on specific EQ attributes on a monthly basis .... Success will be measured based on ... written feedback on EQ Attribute 300 (Income Determination).*
- 2. I will improve the quality, effectiveness, and efficiency of income probes .... I will deliver tools and training to examiners supporting income examination techniques. ... Success will be measured by supporting and contributing to improvement in overall quality scores with emphasis and focus on NQ Attribute 300 (Income Determination).*
- 3. I will take proactive steps to improve the quality, effectiveness, and efficiency of income probes .... I will take proactive steps to improve quality measured by Attribute 300 (Income Determination), by focusing on this attribute during my reviews and by providing additional training to group members, as warranted .... Success will be measured by supporting a 5 [percent] Area Improvement in NQ Attribute 300 (Income Determinations) and an improvement in overall quality scores.*
- 4. I will improve the quality, effectiveness, and efficiency of income probes .... I will deliver tools and training to examiners supporting income examination techniques. ... Success will be measured by supporting an improvement in overall Area quality scores; and delivering improvement in NQ Attribute 300 (Income Determination) by providing tools and training through Income Determination Workshops and discussions at the group level.*

Because we did not perform an in-depth review of group manager commitments, we do not have a basis for recommending specific changes to how the commitments were developed, were established, and will be ultimately rated. However, we did conduct a cursory review of the commitments listed above and have some observations that SB/SE Division officials may find useful in their continuing efforts to improve the quality of tests for unreported income.

Specifically, we believe that while each of the above commitments is a worthwhile goal, the first three commitments have some shortcomings that could make it difficult to judge whether the individual group manager met the commitment because the statements are either vague about

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<sup>14</sup> EQ and NQ are referring to the examination quality attributes in the NQRS.



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how success will be measured (commitment number 1) or what specifically the group manager intends to do (commitment numbers 2 and 3). By comparison, commitment number 4 specifically indicates the type of tools and training that will be delivered to improve income probes and the potential impact of delivering the specified tools and training. A mid-level manager could monitor whether this group manager provided the tools and training and held discussions as promised. A mid-level manager may be able to also use statistics in assessing whether the tools, training, and discussions had the intended impact.



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## **Appendix I**

### *Detailed Objectives, Scope, and Methodology*

The overall objectives of this review were to determine whether the NRP Individual Reporting Compliance Study is being properly implemented and providing reliable results for making strategic planning decisions. Unless otherwise noted, our limited tests of the reliability of data obtained from NRP inventory tracking system did not identify any errors. We tested the reliability of the data by scanning the data received for blank, incomplete, illogical, or improper data. In addition, we traced a judgmental sample from TYs<sup>1</sup> 2006 through 2008 data sets to the source IRS files to ensure accuracy. To accomplish the objectives, we:

- I. Reviewed source material to gain an understanding of the NRP and rules, procedures, and processes used for the study. These sources included the Internal Revenue Manual and NRP training modules.
- II. Interviewed NRP management to assist in identifying and evaluating the procedures and process used to implement the sampling methodology.
- III. Analyzed the TYs 2006 through 2008 tax returns selected for the NRP study. We compared the sampling implementation to the sampling plan and consulted the TIGTA's contracted statistician regarding the impact that deviations of the number of tax returns in the planned sampling strata have on the statistical validity of the results.
- IV. Evaluated the quality of NRP study examinations and determined if quality controls were established and properly followed by reviewing a judgmental sample of 10 examination cases from each of TYs 2006 through 2008. We judgmentally selected the 30 cases because, due to time constraints, we wanted to probe if there are significant problems.
  - A. For TY 2006, selected the sample from the 12,478 examinations that were closed as of May 2010.
  - B. For TYs 2007 and 2008, selected the sample from the population of NRP study tax returns with Profit or Loss From Business (Schedule C) or Supplemental Income and Loss (Schedule E), income less than \$200,000,<sup>2</sup> and examinations closed during the period FY 2008 through the third quarter of FY 2010. The TYs 2007 and 2008 population sizes were 3,052 and 271 cases, respectively.

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<sup>1</sup> A 12-month accounting period for keeping records on income and expenses used as the basis for calculating the annual taxes due. For most individual taxpayers, the tax year is synonymous with the calendar year.

<sup>2</sup> We used Activity Codes 271 and 274-277, which represent U.S. Individual Income Tax Returns with total positive income less than \$200,000.



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- V. Analyzed the results from the FYs 2008 through 2010 Area Office NRP quality reviews of closed examinations.
- VI. Determined the effect of poor quality examination of income issues by reviewing a sample of 23 cases from the 78 cases that the FY 2010 third Quarter Area Office NRP quality review identified as not meeting income determination standards. We judgmentally selected the 23 taxpayers because, due to time constraints, we wanted to focus on situations where the IRS quality review narrative comments provided specific examples.
- VII. Reviewed the FYs 2010 and 2011 group manager performance agreements for 10 managers involved in the 23 cases reviewed to assess the opportunities that may exist to improve accountability of the IRS's expectations for the quality of the audits under their supervision.

**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 objectives: the NRP's policies, procedures, and practices for selecting and examining individual tax returns and its quality review of examination results. We evaluated these controls by reviewing source material, interviewing management, and reviewing a judgmental sample of NRP study examinations and Area Office NRP quality review results.



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**Appendix II**

*Major Contributors to This Report*

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



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**Appendix IV**

*Summary of Quality Attributes Considered  
During Area Office National Research Program  
Quality Review of Examinations*

<b>Attribute Group</b>	<b>Attributes</b>	<b>Issues Considered by Quality Reviewers</b>
Planning	Information Document Requests	Did the examiner prepare appropriate information document requests?
	Prior, Subsequent Year, and Related Returns	Did the examiner consider the prior, subsequent, and related tax returns in the audit when warranted?
Income Determination	Exam Income Determination	Did the examiner use appropriate techniques to determine income and properly consider the applicable tax law?
Investigative and Audit Techniques	Audit Compliance Interview	Did interviews with taxpayers, representatives, and third parties provide a clear understanding of the taxpayer and his/her income-producing activities?
	Interpreted and Applied Tax Law Correctly	Did the examiner interpret and apply the tax law correctly?
	Civil Penalty Determination	Did the examiner appropriately consider and compute applicable civil penalties?
Timeliness	Time Spent on Examination	Was the time spent on the examination appropriate considering the complexity of the issues?
Customer Relations and Professionalism	Taxpayer Rights	Did the examiner advise the taxpayer or representative on all rights?
Documentation and Reports	Workpapers Support Conclusion	Did the examination workpapers support the conclusion?
	Report Writing	Were report writing procedures followed?

*Source: Internal Revenue Manual and discussions with IRS SB/SE Division Examination function officials.*