Steps Can Be Taken to Enhance the Quality of Audits Involving Small Corporate Returns

September 29, 2011

Reference Number: 2011-30-113

Redaction Legend:
1 = Tax Return/Return Information
2(f) = Risk Circumvention of Agency Regulation or Statute

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

STEPS CAN BE TAKEN TO ENHANCE THE QUALITY OF AUDITS INVOLVING SMALL CORPORATE RETURNS

Highlights

Final Report issued on September 29, 2011

Highlights of Reference Number: 2011-30-113 to the Internal Revenue Service Commissioner for the Small Business/Self-Employed Division.

IMPACT ON TAXPAYERS

Many corporations in the United States are considered closely held because they are owned by one shareholder or a closely knit group of shareholders. As such, the shareholders typically have a significant amount of control over managing and directing the day-to-day operations of the corporation. This, in turn, provides opportunities to improperly structure transactions so they reduce the income taxes owed by the corporation or the shareholders. Corporations and shareholders that take advantage of such opportunities to understate their tax liabilities can create unfair burden on honest taxpayers and diminish the public's respect for the tax system.

WHY TIGTA DID THE AUDIT

The overall objective of this review was to determine whether Small Business/ Self-Employed Division examiners are conducting audits of corporate tax returns in accordance with Internal Revenue Service (IRS) procedures and guidelines. The review is included in our Fiscal Year 2011 Annual Audit Plan and addresses the major management challenge of Tax Compliance Initiatives.

WHAT TIGTA FOUND

IRS management has established many key procedures and guidelines for auditing corporate returns. This has likely contributed to an upward trend in the amount of recommended additional taxes generated from audits of small corporations.

While the IRS has experienced an increase in the amount of recommended additional taxes from small corporate audits in recent years, additional steps can be taken at the examiner and first-line manager levels to improve the quality of corporate examinations.

TIGTA reviewed a nonstatistical sample of 51 closed corporate audits and found potential quality concerns in 19 of the audits reviewed. Many of the quality concerns involved issues between the corporate return and other returns that were or should have been filed by the corporation (e.g., information returns and employment tax returns) or that were related to it (e.g., the shareholder's individual tax return).

WHAT TIGTA RECOMMENDED

TIGTA recommended that the Director, Exam Policy, Small Business/Self-Employed Division, provide additional guidance to first-line managers to improve the feedback provided to field examiners on using the IRS's automated information systems to enhance the quality of their required filing checks during corporate audits.

In their response to the report, IRS officials agreed with the recommendation and plan to issue a memorandum to first-line managers focusing on utilizing automated information systems as a tool to enhance required filing checks. The memorandum will also address feedback provided to field examiners.

TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

September 29, 2011

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED DIVISION

FROM: Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Steps Can Be Taken to Enhance the Quality of Audits Involving Small Corporate Returns (Audit # 201030026)

This report presents the results of our review to determine whether Small Business/Self-Employed Division examiners are conducting audits of corporate tax returns in accordance with Internal Revenue Service (IRS) procedures and guidelines. The review is included in our Fiscal Year 2011 Annual Audit Plan and addresses the major management challenge of Tax Compliance Initiatives.

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

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

Table of Contents

Abbreviations

DIF	Discriminate Index Function
EQRS	Embedded Quality Review System
FY	Fiscal Year
IDRS	Integrated Data Retrieval System
IRS	Internal Revenue Service
LUQ	Large, Unusual, or Questionable
NQRS	National Quality Review System
NRP	National Research Program
SB/SE	Small Business/Self-Employed

Background

Many corporations in the United States are considered closely held because they are owned by one shareholder or a closely knit group of shareholders. As such, the shareholders typically have a significant amount of control over managing and directing the day-to-day operations of the corporation. This, in turn, provides opportunities to improperly structure transactions so they reduce the income taxes owed by the corporation, the shareholders, or both. Corporations and shareholders that take advantage of such opportunities to understate their tax liabilities can create an unfair burden on honest taxpayers and diminish the public's respect for the tax system.

For example, a large dividend could be paid to a shareholder but misclassified as a bonus so the payment can be used to reduce the income taxes owed by the corporation. In other instances, shareholders may mistakenly believe that money can be loaned between themselves and the corporation without any income tax consequences. When a shareholder takes the earnings of a corporation in the form of a loan, the shareholder has tax-free use of corporate funds. Unless a true debtor-creditor relationship exists, the loan can be characterized by the Internal Revenue Service (IRS) as a dividend payment that is taxable to the shareholder. Because of these and numerous other related party issues, it is critical that examiners follow IRS procedures and guidelines when auditing a closely held corporation, and scrutinize all transactions between a corporation and its shareholders.

The IRS uses a variety of sources to select corporate returns for examination. One source is the Discriminate Index Function (DIF), which is an automated system for scoring corporate tax returns according to their audit potential. In general, the higher the DIF score, the greater the chance the audit will result in a material tax change. The IRS also allows returns to be selected through non-DIF sources, such as referrals from State government agencies. Once selected, audits of corporations typically involve a face-to-face audit by an IRS revenue agent (field examiner). In general, field examiners deal with complex tax issues on business returns (e.g., sole proprietors, corporations, partnerships, etc.) and conduct their audits at the taxpayer's place of business. In contrast, IRS tax compliance officers (office examiners) deal with less sophisticated tax issues on individual tax returns and conduct their audits at a local IRS office.

Regardless of whether an audit is conducted in the field or an IRS office, examiners are required to determine whether taxpayers are filing all required tax returns. The initial step in this process is to access internal data sources and verify that required prior and subsequent year tax returns, related tax returns, information returns, and employment tax returns were filed. In addition to verifying that tax returns were filed, filing checks require examiners to evaluate the tax returns for potential areas of noncompliance and expand the audit to include additional tax returns as warranted. Properly executed filing checks 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 Headquarters in New Carrollton, Maryland, during the period August 2010 through May 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

Although overall productivity indicators are trending favorably for audits of small corporations in the SB/SE Division, the number of audits closed as no-change (i.e., without any recommended change to the tax liability reported by the corporation) is a concern. In Fiscal Years (FY) 2006 through 2011 (through March 2011), an average of 32 percent of the corporate returns audited in the SB/SE Division were no-changed.

The Treasury Inspector General for Tax Administration does not know what the no-change rate should be for corporate audits in the SB/SE Division. However, no-changing roughly one out of every three corporate returns audited in the last 5½ fiscal years indicates there may be room for improvement in how returns are identified for audit and/or how examiners are conducting audits.

Overall Productivity Trends Are Favorable for Audits of Corporations in the Small Business/Self-Employed Division

During FY 2010, the SB/SE Division closed examinations of 14,527 corporate returns. This represents about 0.17 percent of corporate returns filed with the SB/SE Division during Calendar Years 2006 through 2009.[1] In most of these audits, the examiners conducted face-to face (fieldwork) audits which resulted in $381 million in additional taxes recommended. Two measures of productivity from these audits are the amount of additional taxes recommended for each return audited and the amount of additional taxes recommended for each hour examiners apply to an audit.

Overall, we found that, while the number of months from the receipt of the tax return to the completion of the examination has remained fairly stable since FY 2006, the amount of additional taxes recommended on both a return and hourly basis has been increasing. As Figure 1 shows, the recommended additional taxes on a return basis increased about 58 percent from $16,576 in FY 2006 to $26,222 in FY 2010, which was the latest full year of audit productivity data available during our review. There may be additional productivity benefits from shareholder or other related party returns for these corporate audits, but IRS management information systems do not have the capability to measure this.

[1] Multiple tax returns for a given taxpayer may be under examination at one time.

Figure 1: Total Cycle Time, Average Additional Taxes Recommended (Per Examined Return and Per Examiner Hour), and No-Change Rates From Corporate Audits for FYs 2006 to FY 2011 (Through March 2011)

FY	***Total Cycle Time*** *(Return receipt date to examination completion date, in months)*	***Additional Taxes Recommended per Examined Return***	***Additional Taxes Recommended per Examiner Hour***	***No-Change Rate***
2006	25	$16,576	$384	37%
2007	25	$20,180	$523	38%
2008	22	$20,784	$552	28%
2009	23	$26,287	$729	32%
2010	24	$26,222	$704	28%
2011	27	$32,477	$843	27%

Source: Our analysis of FYs 2006 through 2011 (through March 2011) audited corporate returns as reflected in the Audit Information Management System.[2]

One factor that may be contributing to the increasing amount of recommended additional taxes in corporate audits is that statistics indicate the SB/SE Division is relying less on the DIF to select corporate returns for audit and more on non-DIF audit sources. This trend would be in line with the IRS's policy and procedures to use non-DIF sources if the audit potential appears to be higher than it would be from using DIF sources. Non-DIF sources are typically used to select returns that have specific issues or characteristics that indicate noncompliance, and were used to initiate 45 percent of the corporate audits closed in FY 2010.

Other factors contributing to the upward trend in recommended additional taxes are the procedures and techniques (management controls) that have been established to assist examiners in performing audits. For example, the SB/SE Division has developed and implemented a number of audit lead sheets for examiners that contain suggested audit techniques and practices, an overview of applicable tax laws, and other information. As shown in Appendix IV, the Civil Penalty Approval Form, which is required to be included in the case files for every audit, solicits answers from examiners to help guide the penalty decision process during audits. It also serves as a review guide for group managers who are responsible for evaluating the accuracy of the penalty decisions made, as well as the quality of work performed by the examiners they supervise. Appendix V contains another example of an audit lead sheet.

[2] A computer system used by the SB/SE Division to control returns, input assessments/adjustments to the Master File, and provide management reports.

While the favorable trend in the amount of recommended additional taxes is noteworthy, the number of corporate audits that are closed as a no-change is an area that could be improved.

Despite the Overall Favorable Trend of Audit Productivity Indicators, the No-Change Percentage of Corporate Audits Is a Concern

In FYs 2006 through 2011 (through March 2011), an average of 32 percent of the corporate returns audited in the SB/SE Division were closed as a no-change (i.e., without any recommended change to the tax liability reported by the corporation). As the IRS reported to Congress in Calendar Year 2003, a high no-change rate means a significant amount of resources are being devoted to unproductive audits and compliant corporations are being unnecessarily burdened by audits. Admittedly, the Treasury Inspector General for Tax Administration does not know how many corporate audits should be closed as a no-change or how many should produce a tax liability. Nevertheless, no-changing roughly one out of every three corporate returns audited in the last 5½ fiscal years suggests there may be room for enhancing the effectiveness of return selection methods and/or the quality of audits.

An upcoming National Research Program (NRP) study could enhance the effectiveness of return selection methods

IRS officials are taking steps to enhance the effectiveness of return selection methods by preparing for an upcoming NRP study that will evaluate the extent to which corporations and their shareholders comply with the tax laws. If effectively planned and implemented, the study should provide the data needed to update DIF formulas so potentially noncompliant corporate returns can be more objectively selected for audit while reducing the number of compliant corporate returns that are audited. DIF formulas for selecting corporate returns for audit were last updated with results from corporate returns processed in Calendar Year 1988 and audited under the Taxpayer Compliance Measurement Program. Consequently, it is no surprise that the passage of time has made using the DIF less useful for identifying and selecting returns for audit, given the tax law and economic changes that have occurred.

Officials anticipate the upcoming study will involve the identification, selection, and examination of approximately 2,500 Tax Year 2010 returns from corporations with assets of less than $250,000. Like prior NRP studies covering other types of tax returns, statistically valid sampling techniques will be used so the results from the examinations can reliably measure the level of compliance in the universe of corporations served by the SB/SE Division. IRS officials will use the results from the sample to generate a new workload identification formula for these taxpayers. Study results should also help IRS officials better understand the effectiveness of their programs devoted to corporations. This, in turn, has the potential to enhance service and promote fairness of the tax system among this segment of taxpayers.

The quality of audits could be enhanced

As the IRS moves forward with the NRP study for corporate audits, it is important to pinpoint and address concerns in the quality of corporate audits, given that each NRP return audited can represent thousands of similar returns in the filing population. Otherwise, errors associated with quality concerns could reduce the reliability of the data collected to measure how well corporations are complying with the tax law and ultimately used to update the DIF. It is just as important to pinpoint and address these concerns to help ensure poor audit quality is not a significant contributing factor to the no-change rate.

We evaluated a nonstatistical sample of 51 corporate audits that were closed as agreed or no-changed by SB/SE Division examiners in FYs 2008 and 2009 and found that examiners documented steps taken to plan their audits, advised corporate representatives of their rights, used a variety of fact-finding techniques to determine the accuracy of return items, and cited applicable sections of the tax law to support tax adjustments. However, while examiners followed many key procedures and guidelines for auditing corporate returns, our review identified potential quality concerns in 19 of the 51 corporate audits. The specific concerns can be categorized into the following three trends:[3]

1. <u>Information/Shareholder Returns Not Adequately Considered (10 cases)</u>. Examiners did not always document the steps taken to investigate significant differences ($40,000 or more) between the amount of labor costs deducted in the corporate return and the amounts reflected on employment tax returns filed with the IRS. In other cases, there was no documentation showing that steps were taken to verify if information returns (Form 1099 series) were required to be filed to report approximately $818,000 in payments for outside services such as contract labor, commissions, or management fees. Although IRS officials informed us that these type of variances are often explained during the course of an examination and do not result in adjustments, we saw no evidence in the case files that examiners took any additional steps to investigate the issues.

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3. <u>Large, Unusual, or Questionable (LUQ) Items Not Adequately Addressed (6 cases)</u>.
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[3] Some sample cases are included in more than one trend and/or example.

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Many of the concerns in our case reviews involved issues between the corporate return and other returns that were or should have been filed by the corporation (e.g., information returns and employment tax returns), or with returns related to the corporate return (e.g., the shareholder's individual tax return). The checking for returns filed portion of an audit is designed to help examiners address these issues; however, National Quality Review System (NQRS) reviewers[4] have consistently identified filing checks as a problem area during their reviews of field audits. In the 5-year period from FY 2006 to FY 2010, the NQRS reported that examiners completed required filing checks in an average of 76 percent of all field examinations reviewed and considered the audit potential of prior and/or subsequent year and related returns in an average of 77 percent of all field examinations. This means that examiners failed to properly complete required filing checks in an average of 24 percent of field examinations reviewed, as well as not considering the audit potential of prior and/or subsequent year and related returns in an average of 23 percent of all field examinations, as shown in Figure 2.

Figure 2: Percent of Field Audits Not Meeting Selected Quality Attributes

NQRS Reporting Period (FY)	***Percent of Field Audits Not Meeting NQRS Quality Attributes***	
	Verifying Compliance With Information and Employment Tax Filing Requirements	*Review of Prior and/or Subsequent Year and Related Returns*
2006	15%	22%
2007	20%	25%
2008	25%	22%
2009	30%	23%
2010	28%	24%

Source: IRS NQRS Quality Attribute Accuracy Reports for FYs 2006 through 2010.

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

Examiners could take better advantage of the IRS's automated information systems to complete required filing checks and improve audit quality

The Internal Revenue Manual requires that examiners use the IRS's automated information systems to complete filing checks during the planning phase of audits. 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 assess the audit potential of the return under audit. At the same time, the sources also reduce the burden audits impose on taxpayers by avoiding the need to request copies of the tax returns that taxpayers have already filed with the IRS.

We used the following 3 command codes to obtain data from the Integrated Data Retrieval System (IDRS)[5] in evaluating each of the 51 audits 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. It can be useful for identifying and verifying whether the taxpayer has filed required employment tax returns and can assist in determining whether wage and salary expenses reported on the income tax return are substantially correct.
- 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. It can be useful for identifying and verifying whether the taxpayer has filed required information returns.
- RTVUE – This provides online access to nationwide tax return data that examiners can use to view, compare, and evaluate specific line items on the individual income tax returns. It can be useful for identifying tax issues on shareholders' tax returns that warrant an audit because they pose a high compliance risk.

In a nonstatistical sample of 97 examiners involved in corporate audits in FYs 2008 and 2009, 34 examiners did not have access to any of the command codes listed above. Although all of the remaining 63 examiners had access to the BMFOL and RTVUE command codes, 26 had not been provided, or did not use, the PMFOL command code.

During discussions with IRS officials on 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 PMFOL, BMFOL, and RTVUE data. Once obtained, the transcripts are provided to examiners for use during the audit. We were also told that, if the transcripts were obtained and provided to examiners, the documentation should be maintained in

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

the audit case files. We checked for documentation of these hard copy transcripts in the 51 sample audit case files discussed in the previous section and found documentation in 8 cases.

To their credit, IRS officials recognized the need to improve the check for return filing portion of audits. On June 1, 2010, the Internal Revenue Manual was revised to require examiners to document case files with the results from assessing related returns and prior and/or subsequent year returns on Multi-Year and Related Returns Lead Sheet (Lead Sheet 130-1).[6] The revisions also indicate that case file documentation should include the internal documents secured (e.g., hard copy IDRS transcripts) and any analysis performed in completing the required filing checks.

Because the Internal Revenue Manual revisions were made after the examiners completed their work in the 51 sample cases, the impact would not be reflected in our case review results. However, results from the NQRS for FY 2010 continue to indicate problems with examiners properly completing required filing checks. As Figure 2 shows, the NQRS reported in FY 2010 that filing checks were not completed in about 28 percent of the cases it reviewed. This raises questions about whether the revisions are having the intended impact and suggests additional steps should be taken to reinforce the importance filing checks have in conducting a quality audit.

Performance feedback mechanisms could be better used to hold examiners more accountable for the quality of their corporate audits

The Treasury Inspector General for Tax Administration[7] and the Government Accountability Office[8] have both 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.

We obtained and evaluated FY 2007 through FY 2010 performance feedback relating to two nonstatistical samples of examiners involved in the audits we reviewed. The feedback included 76 mid-year progress reports, end-of-year appraisals provided to 19 examiners, as well as comments relating to corporate audits recorded by first-line managers in the Embedded Quality Review System (EQRS)[9] for 20 examiners. There were no performance-related comments to review for 28 of the mid-year and end-of-year appraisals. Under union rules, appraisal comments are not required in certain circumstances. However, our review showed that 18 of the

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[6] See Appendix V.
[7] *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).
[8] *IRS Employee Evaluations: Opportunities to Better Balance Customer Service and Compliance Objectives* (GGD-00-1, dated October 1999).
[9] The EQRS allows field managers to provide timely feedback to individual employees through performance case reviews.

19 examiners received written performance feedback from their managers with comments relating to their audit work. This type of managerial involvement and feedback is important because, as the following except 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.

> *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 and how it contributes to the larger mission of the agency.*

Although first-line managers are monitoring and providing feedback to examiners, they could do a better job of citing specific examples of accomplishments and achievements as well as opportunities for improvement in their performance feedback. During our review of the performance feedback provided to the 19 examiners, only 8 of the examiners were given specific feedback about how well transactions between a corporation and its shareholders were scrutinized during an audit or whether issues between a corporate return and other returns were properly handled during the filing check portion of the audits. In addition, only 3 (16 percent) of the examiners were given specific examples for improvement.

Recommendation

Recommendation 1: The Director, Exam Policy, SB/SE Division, should provide additional guidance to first-line managers to improve the feedback provided to field examiners on using the IRS's automated information systems to enhance the quality of their required filing checks during corporate audits.

> ***Management's Response:*** IRS management agreed with this recommendation and will provide a memorandum to first-line managers focusing on utilizing automated information systems as a tool to enhance required filing checks during corporate audits. This memorandum will also address feedback provided to field examiners relating to required filing checks.

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective was to determine whether SB/SE Division examiners are conducting audits of corporate tax returns in accordance with IRS procedures and guidelines. To accomplish this objective, we:

I. Evaluated the adequacy of controls for ensuring that mandatory audit requirements and LUQ items are properly considered and applied in corporate audits conducted by the SB/SE Division. This included documenting the applicable Internal Revenue Code sections, Internal Revenue Manual sections, examiner training materials, and other IRS publications that provide the authority and reasons for considering factors that affect corporate audits.

II. Randomly selected a nonstatistical[1] sample of 51 audits from a population of 6,954 corporate audits closed by SB/SE Division field examiners in FYs 2008 and 2009 as agreed or no-changed.

   A. Reviewed the examination case files and determined if examiners performed the following:[2]

      1. Identified the scope of the audit, beginning with the issues identified by the classifier on the classification check sheet.

      2. Performed a pre-contact analysis including a thorough review of the case file to identify LUQ items beyond those selected on the classification check sheet.

      3. Determined that taxpayers are in compliance with all Federal tax return filing requirements and that all returns reflect the substantially correct tax.

      4. Identified and verified all of the reporting requirements for commissions, labor costs (costs of goods sold), subcontract, royalties, management fees, and consultant fees.

      5. Determined that the income from the related business entity was included on the shareholder/partner's individual return.

[1] We used nonstatistical samples in all instances because we did not intend to project the results of the samples to the entire population.
[2] Without access to taxpayer books and records, we determined exceptions based on possible tax consequences related to available taxpayer data, and IRS officials reviewed the exceptions.

6. Ensured that any loans to or from shareholders were not distributions of earnings, dividend income, or another form of taxable income.
7. Determined the potential for unreported income, which may have indicated that a more in-depth examination of income was warranted. If this was the case, the examiner should have discussed the case with the group manager.
8. Determined if the return had international features and if they meet the mandatory referral criteria.
9. Determined if the case file indicated a decrease in the asset accounts during the year and, if so, verified the resulting gains or losses.
10. Determined if inventory was classified as an issue and, if so, verified that inventories are reported correctly.
11. Determined if a material adjustment was made in the examination and, if so, that the subsequent year was picked up for examination.

B. Interviewed SB/SE Division management and program analysts to identify policy and procedural issues pertaining to the use of audit requirements and LUQ items in corporate audits in the SB/SE Division.

III. Assessed examiner performance feedback and access to the IDRS[3] to identify potential reasons for any problems identified in the case reviews.

A. Randomly selected a nonstatistical sample of 20 examiners from 114 examiners involved in the audits we reviewed. We summarized the feedback given to the examiners by extracting the requisite information recorded in EQRS attribute measures dealing with corporate audits.

B. Randomly selected a nonstatistical sample of 19 examiners from 114 examiners involved in the audits we reviewed. We summarized the feedback dealing with corporate audits included in the FYs 2007 through 2010 mid-year and end-of-year appraisals given to the selected examiners.

C. Reviewed the IDRS profiles of the 97 examiners who closed corporate examinations selected in Step II and verified that each examiner had the IDRS command codes needed to complete filing checks such as BMFOL, PMFOL, and RTVUE.

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

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 examining corporate returns. We evaluated these controls by reviewing source materials, interviewing management, reviewing examination case files, and researching taxpayer accounts.

Appendix II

Major Contributors to This Report

Margaret E. Begg, Assistant Inspector General for Audit (Compliance and Enforcement Operations)
Frank Dunleavy, Director
Robert Jenness, Audit Manager
Ali Vaezazizi, Lead Auditor
Aaron Foote, Senior Auditor
David Hartman, Senior Auditor
Curtis Kirschner, Senior Auditor
Debra Mason, Senior Auditor
Stanley Pinkston, Senior Auditor
William Tran, Senior Auditor

Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Deputy Commissioner for Services and Enforcement SE
Deputy Commissioner, Small Business/Self-Employed Division SE:S
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Audit Liaison: Commissioner, Small Business/Self-Employed Division SE:S

Appendix IV

Civil Penalty Lead Sheet

As illustrated in the following example of an audit lead sheet, audit lead sheets contain techniques, an overview of the applicable procedures, and other information to assist examiners in performing audits.

Taxpayer Name: **Examiner:**
TIN:
Tax Form: **Date:**
Tax Year (s):

CIVIL PENALTY APPROVAL FORM	
Conclusion:	
X appropriate box below	Reason(s) for Non-Assertions of Penalty(s): IRM 4.10.6.7(1)
	No Change or Refund Case
	Deficiency Case (Explanation required when adjustments made and penalties are not asserted. The applicable exceptions to the penalty must be documented)
Reason(s) for Assertions of Penalty(s) IRM 4.10.6.7(1)	
Group Manager Approval to Assess Penalties Identified Above and for Non-Assertion of Substantial Understatement Penalty Where Dollar Criteria for Penalty Has Been Met (IRM 20.1.5.1.6)	
Group Manager Signature: ______________________________	Date: _______________

Workpaper # -1.1

Rev. 3/2011

Source: SB/SE Division Workpaper 300-1, dated March 2011.

Taxpayer Name:
TIN:
Tax Form:
Tax Year (s):

Examiner:

Date:

IRC	Penalty	IRM	Assert Penalty Yes	Assert Penalty No	Reference
Penalties Not Requiring Group Managerial Approval					
6651(a)(1)	Failure to File (Delinquent and non-filed returns) *(Lead Sheet available)*	20.1.2.3			
6651(a)(2)	Failure to Pay	20.1.2.4			
6654	Estimated Tax – Individual	20.1.3.2			
6655	Estimated Tax – Corporate	20.1.3.3			
IRC	**Penalty**	**IRM**	**Assert Penalty Yes**	**Assert Penalty No**	**Reference**
Penalties Requiring Group Manager Approval					
6651(f)	Fraudulent Failure To File, Civil	20.1.2.7			
6662(c)	Negligence *(Lead Sheet available)*	20.1.5.7			
6662(d)	Substantial Understatement *(Lead Sheet available)*	20.1.5.8			
6662(b)	Other Accuracy Related	20.1.5.1.1			
6662(h)	Gross Valuation Misstatement	20.1.5.9.4			
6662A	Accuracy Related Penalty on Understatements with Respect to Reportable Transactions (RT)	20.1.5.13			
6707A	Failure to Include Reportable Transactions Information with Return or Statement *(See MySB/SE Abusive Transactions website)*	20.1.5.13 and 4.32.2			
6663	Fraud *(Lead Sheet available)*	20.1.5.12			
	Alternative Penalty Position	20.1.5.12.2			
Consideration of Preparer/Promoter/Material Advisor Penalties			**Consider Penalty Yes**	**Consider Penalty No**	**Reference**
6694(a)	Preparer Penalties – Understatement Due to Unreasonable Positions *(Lead Sheet available)*	20.1.6.3.7			
6694(b)	Preparer Penalties – Understatement Due to Willful or Reckless Conduct *(Lead Sheet available)*	20.1.6.3.13			
6695	Other Preparer Penalties	20.1.6.4			
6700	Promoting Abusive Tax Shelters	20.1.6.12			
6701	Aiding & Abetting Understatement of Tax Liability	20.1.6.13			
6707	Failure to Furnish Information Regarding RT	20.1.6.15			
6708	Failure to Maintain Lists of Advisees with Respect to RT	20.1.6.16			
6713	Unauthorized Disclosure or Use of Information	20.1.6.6			

Workpaper # -1.2

Rev. 3/2011

Appendix V

Multi-Year and Related Returns Lead Sheet

Taxpayer Name: **Examiner:**
TIN:
Tax Form: **Date:**
Tax Year (s):

Multi-Year and Related Returns Lead Sheet

Multi-year Income Tax Returns (IRM 4.10.5.2 & 4.10.5.3.4) Include Applicable IDRS Research Transcripts	Yes	No	N/A	Reference
Prior/subs year returns filed (*Prepare Comparative Analysis*)				
Adjustments proposed in initial year				
Same pattern(s) of non-compliance exist in prior/subsequent				
Additional LUQs identified on prior/subsequent year returns				
Examination expanded to include prior/subsequent year(s)				
Delinquent multi-year income tax returns secured & processed				
Comments: *(You **MUST** provide a written narrative if (1) adjustment(s) are proposed in initial year, or (2) LUQs identified in prior or subsequent years and audit NOT expanded)*				

Related Income Tax Returns (IRM 4.10.5.4) Include Applicable IDRS Research Transcripts	Yes	No	N/A	Reference
Individual form(s) 1040/1041 (*Prepare Comparative Analysis if applicable*)				
Business Form(s) 1120/1120S/1065 (*Prepare Comparative Analysis if applicable)*				
Adjustments proposed in initial year that affect related returns				
LUQs identified on related returns				
Examination expanded to include related return(s)				
Delinquent related income tax returns secured & processed				
Comments: (*You **MUST** provide a written narrative if (1) adjustment(s) proposed in initial year affect related returns, or (2) LUQs identified and audit NOT expanded)*				

Workpaper # **-1.1**

Rev. 04/2010

Source: SB/SE Division Workpaper 130-1, dated April 2010.

Abbreviations are used for the following terms in this lead sheet: Internal Revenue Manual (IRM), taxpayer (TP), and Specialist Referral System (SRS).

Taxpayer Name: | **Examiner:**
TIN:
Tax Form: | **Date:**
Tax Year (s):

Multi-Year and Related Returns Lead Sheet

All Other Returns/Forms Required To Be Filed (IRM Exhibit 4.10.5.1) Include Applicable IDRS Research Transcripts	Yes	No	N/A	Reference
Employment Tax Forms-940/941/W-2, etc.				
Other(s)- 5500/709/2290, etc.				
Information Returns (1099, etc.)				
Information return penalties applicable				
Forms 8300 required to be filed				
Information Returns Involving Foreign Entities: 926/3520/5471, etc. (IRM 4.60.6 & IRM 21.8.31.5)				
Did the TP have a financial interest in, or signatory authority for, a bank, securities, or other financial account, in a foreign country which, in the aggregate exceeded $10,000 in total value at any time during the calendar year?				
• If "yes" did the TP file the required Report of Foreign Bank and Financial Accounts (TDF 90-22.1)?				
• During 2009, did TP receive a distribution from, or was TP the grantor of, or transferor to, a foreign trust?				
• If "Yes," was a Form 3520 filed?				
Any other delinquent returns secured & processed?				
Comments: (*Note actions taken and decisions made.*)				

Referrals for Specialists (IRM 4.10.2.6.5.2.1) The SRS system **must** be used for referrals (includes questions and informal requests for assistance to the following specialist groups). See IRM for complete list of specialists.	Yes	No	N/A	Reference
International (IRM 4.60.6)				
Employment Tax (IRM 4.23.5)				
Employee Plans (IRM 4.10.5.9(1))				
Excise Tax (IRM 4.10.5.8(3))				
Economist (IRM 4.49.1.2)				
Computer Assisted Audit (IRM 4.47.1)				
Engineer (IRM 4.48.1.5)				
Estate and Gift (IRM 4.25.1)				
Tax Exempt/Governmental Entities				
Comments:				

Workpaper # **-1.2**

Rev. 04/2010

Appendix VI

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
SEP 12 2011

SEP 12 2011

MEMORANDUM FOR MICHAEL R. PHILLIPS
DEPUTY INSPECTOR GENERAL FOR AUDIT

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

SUBJECT: Draft Audit Report – Steps Can Be Taken to Enhance the Quality of Audits Involving Small Corporate Returns (Audit No. 201030026)

Thank you for the opportunity to review your draft audit report, "Steps Can Be Taken to Enhance the Quality of Audits Involving Small Corporate Returns". We appreciate your positive comments regarding our efforts to improve the quality of our examinations.

Specifically, you noted we have developed new lead sheets to assist examiners in documenting their audit steps. In addition, we have updated the Internal Revenue Manual to reflect more comprehensive procedures regarding required filing checks. We believe ensuring compliance with the filing of all related returns is an important audit technique to enhance voluntary compliance and concur with your recommendation.

Attached is a detailed response outlining our corrective actions. If you have any questions, please contact me, or a member of your staff may contact Shenita Hicks, Director, Examination at (859) 669-5526.

Attachment

Attachment

RECOMMENDATION 1:
The Director, Exam Policy, SB/SE Division, should provide additional guidance to first-line managers to improve the feedback provided to field examiners on using IRS's automated information systems to enhance the quality of their required filing checks during corporate audits.

CORRECTIVE ACTION:
We concur with this recommendation. We will provide a memorandum to first line managers focusing on utilizing automated information systems as a tool to enhance required filing checks during corporate audits. This memo will also address feedback provided to field examiners relating to required filing checks.

IMPLEMENTATION DATE:
March 15, 2012

RESPONSIBLE OFFICIAL:
Director, Examination Policy, SB/SE Division

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