The Compliance Assurance Process Has Received Favorable Feedback, but Additional Analysis of Its Costs and Benefits Is Needed

February 22, 2013

Reference Number: 2013-30-021

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.

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THE COMPLIANCE ASSURANCE PROCESS HAS RECEIVED FAVORABLE FEEDBACK, BUT ADDITIONAL ANALYSIS OF ITS COSTS AND BENEFITS IS NEEDED

Highlights

Final Report issued on February 22, 2013

Highlights of Reference Number: 2013-30-021 to the Internal Revenue Service Commissioner for the Large Business and International Division.

IMPACT ON TAXPAYERS

Unlike traditional audits, where tax issues are often resolved long after the tax return is filed, taxpayers volunteer to participate in the Compliance Assurance Process (CAP) and strive to resolve potential tax issues before a tax return is filed. The CAP, according to Large Business and International (LB&I) Division statistics, reduces the length of the audit process for both the IRS and large businesses. For taxpayers, achieving tax return certainty can significantly enhance public and investor confidence. While this and other CAP benefits are important, it is equally important for the LB&I Division to ensure that the enforcement resources being devoted to the CAP do not diminish its ability to provide audit coverage over large businesses that do not comply with the tax laws and choose not to volunteer for the CAP.

WHY TIGTA DID THE AUDIT

This audit was initiated to determine the extent to which the planning, implementation, and evaluation for the CAP followed published guidance and whether it is being administered in accordance with IRS policies and procedures. The audit is included in our Fiscal Year 2013 Annual Audit Plan and addresses the major management challenge of Tax Compliance Initiatives.

WHAT TIGTA FOUND

The CAP is being administered in accordance with IRS policies and procedures, and the pilot program followed many key best practices in the design and testing of the process. However, despite the fact that the CAP pilot program ran for six calendar years and the permanent program is in its second calendar year of operation, the LB&I Division has yet to develop and implement a plan to thoroughly evaluate CAP data.

TIGTA's analysis found that the CAP audits are consuming substantially more staff hours than those under the traditional audit process. This makes the hourly revenue rate for the CAP approximately a third of the hourly rate examiners generated from traditional audits, $2,939 versus $8,448, respectively. TIGTA also found that the CAP has not yet been reviewed as a potential new user fee source.

WHAT TIGTA RECOMMENDED

TIGTA recommended that the Commissioner, LB&I Division, develop and implement an evaluation plan that verifies the CAP is delivering sufficient benefits in relation to the costs being incurred. In addition, the Commissioner, LB&I Division, should ensure that the CAP is assessed as a potential new user fee source once the IRS-wide user fee guidelines are revised and implemented.

In their response to the report, IRS management agreed with the recommendations and plans to take appropriate corrective actions.

TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

February 22, 2012

MEMORANDUM FOR COMMISSIONER, LARGE BUSINESS AND INTERNATIONAL DIVISION

FROM: Michael E. McKenney
Acting Deputy Inspector General for Audit

SUBJECT: Final Audit Report – The Compliance Assurance Process Has Received Favorable Feedback, but Additional Analysis of Its Costs and Benefits Is Needed (Audit # 201130045)

This report presents the results of our review to determine the extent to which the planning, implementation, and evaluation for the Compliance Assurance Process followed published guidance and whether it is being administered in accordance with Internal Revenue Service (IRS) policies and procedures. This audit is included in our Fiscal Year 2013 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 V.

Copies of this report are also being sent to the IRS managers affected by the report recommendations. If you have any questions, please contact me or Carl Aley, Acting Assistant Inspector General for Audit (Compliance and Enforcement Operations).

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Abbreviations

CAP	Compliance Assurance Process
FY	Fiscal Year
GAO	Government Accountability Office
IDR	Information Document Request
I.R.C.	Internal Revenue Code
IRM	Internal Revenue Manual
IRS	Internal Revenue Service
LB&I	Large Business and International
OMB	Office of Management and Budget
PFA	Pre-Filing Agreement
TIGTA	Treasury Inspector General for Tax Administration
TY	Tax Year

Background

Increasing voluntary taxpayer compliance and reducing taxpayer burden have been the focus of many Internal Revenue Service (IRS) initiatives. The IRS's Large Business and International (LB&I) Division, formerly the Large and Mid-Size Business Division,[1] has developed initiatives through its issue management strategy to consider new ways of reducing cycle time, improving currency, lessening taxpayer burden, and improving efficiency. Examples of initiatives that became LB&I Division programs include the Pre-Filing Agreement (PFA),[2] the Limited Issue Focused Examination,[3] and Fast Track Appeals.[4]

During December 2003 and January 2004, the LB&I Division conducted a business process review for its issue management strategy that included participation from external stakeholders to represent taxpayers' and practitioners' perspectives. The business process review evaluated opportunities to leverage previous examination reengineering efforts, as well as the increased corporate governance requirements brought about by the Sarbanes-Oxley Act of 2002.[5] As part of the business process review, a working group of LB&I Division officials and external stakeholders created an alternative compliance concept. The concept was discussed by external stakeholders (*e.g.*, taxpayers, Tax Executives Institute, Securities and Exchange Commission), internal stakeholders (*e.g.*, IRS Commissioner, Counsel, National Treasury Employees Union), and LB&I Division officials, and ultimately the Compliance Assurance Process (CAP) was created.

The CAP is a cooperative effort between the IRS and taxpayers to conduct real-time audits of businesses with assets of $10 million or more, with a goal of determining the correct tax treatment of material activity prior to the filing of the tax return. Once the tax return is filed, there is a postfiling audit to determine if the tax return is consistent with the agreements made during the prefiling process and whether there are any additional issues not identified that would require additional examination activity. Figure 1 is a flowchart of the CAP as initially designed.

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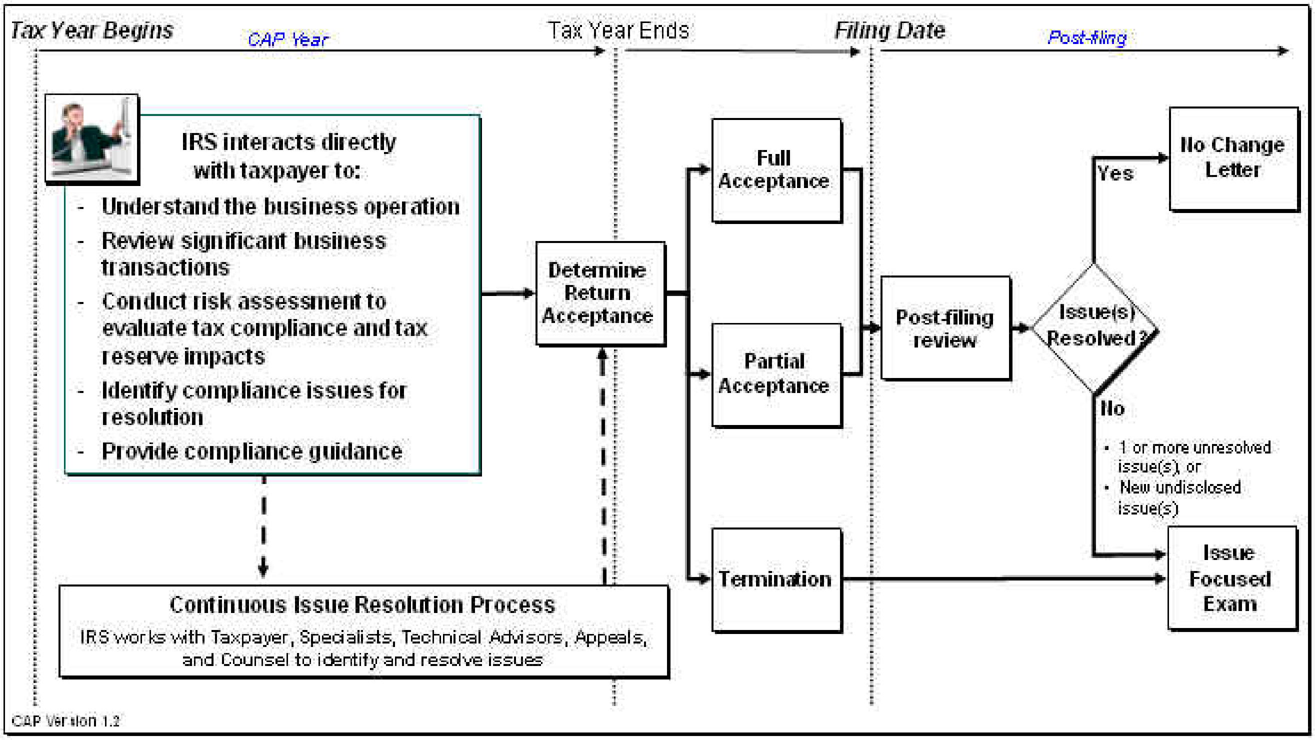
[1] The IRS realigned and renamed the Large and Mid-Size Business Division to the LB&I Division effective October 1, 2010. When the term "LB&I Division" is used in this report related to activities before the date of the transition, it is referring to the Large and Mid-Size Business Division.
[2] Revenue Procedure 2005-12.
[3] IRS News Release 2002-133 (Dec. 4, 2002).
[4] Revenue Procedure 2003-40.
[5] Pub. L. No. 107-204.

Figure 1: CAP Flowchart



Source: The LB&I Division, September 2004.

In March 2005, the IRS initiated a CAP pilot program, which involved 17 volunteer participants that were selected based on factors such as industry leadership, industry diversity, working relationship with the IRS, lack of aggressive tax positions, no major litigation, and resource availability. In December 2005, the IRS officially announced[6] the initiation of the CAP pilot and stated that upon conclusion it would evaluate the program, consider adjustments, and determine whether to make the program permanent. The CAP pilot ran from Tax Year (TY)[7] 2005 through TY 2011 and ultimately included 161 different business taxpayers.

On March 31, 2011, the LB&I Division announced[8] that it had decided to make the CAP a permanent program starting in TY 2012. The permanent CAP program also established three levels of participation: 1) Pre-CAP, in which the IRS and taxpayer cooperatively work in the traditional postfiling examination process to close current audits with the goal of meeting selection criteria and progressing to the next level; 2) CAP, in which the IRS and taxpayer

[6] Announcement 2005-87.
[7] 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.
[8] IRS News Release 2011-32 (Mar. 31, 2011).

cooperatively work in the prefiling and postfiling examination process to resolve material tax activity; and 3) Compliance Maintenance, in which there is an adjusted level of IRS examination based on factors such as the IRS's experience with the taxpayer during CAP activity as well as history of compliance risk.

The business taxpayer must meet the following basic eligibility requirements to participate in the Pre-CAP level:

- Assets of $10 million or more.
- Publicly held entity with a legal requirement to prepare and submit disclosure forms to the Securities and Exchange Commission or equivalent regulatory body or, if privately held, agree to provide certified, audited financial statements or equivalent documentation on a quarterly basis.
- Must not be under investigation by, or in litigation with, the IRS or other Federal or State agency that would limit the IRS's access to current corporate tax records.

To be eligible for the CAP participation level, in addition to the above criteria, taxpayers currently under audit cannot have more than one filed return under examination and one unfiled return for the most recently ended tax year. Acceptance into the Compliance Maintenance level is at the discretion of the Director, Field Operations, and, as noted previously, the acceptance is based on factors such as the taxpayer's transparency and cooperation, internal controls, and history of risky and controversial transactions while in the CAP.

This review was performed at the LB&I Division Headquarters in Washington, D.C., and LB&I Division field offices in Jacksonville, Florida; Chicago, Illinois; New York City, New York; Dallas, Texas; and Salt Lake City, Utah, during the period August 2011 through September 2012. 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.

Results of Review

The CAP is being administered in accordance with IRS policies and procedures, and the pilot program followed many key best practices in the design and testing of the process. However, the LB&I Division needs to develop and implement a plan to thoroughly evaluate CAP data. By developing and implementing an evaluation plan that includes objective measures and standards for defining success, the LB&I Division could enhance the credibility and transparency of the results while helping avoid any perception of bias. Careful assessment of the CAP may also lead to the identification of necessary revisions to further enhance the process as well as permit stakeholders to adequately assess whether the CAP is generating sufficient benefits in relation to its costs. The CAP also needs to be included in an upcoming review of potential new user fee sources.

The Compliance Assurance Process Is Administered in Accordance With Internal Revenue Service Policies and Procedures

The procedures for all LB&I Division audits are contained in the LB&I Division Guide for Quality Examinations (Guide) that is formalized in the Internal Revenue Manual (IRM). Specific procedures for the CAP were established during the pilot program by means of a user guide that was last updated in July 2012. When the CAP became a permanent program in March 2011, the procedures were placed into a draft IRM, which was formalized in June 2012. This IRM establishes process controls for how the CAP should be administered, along with applicable general policies and procedures for audit activity. Our review found that the CAP IRM procedures are consistent with the policies and procedures in the Guide. A comparison of the two is shown in Figure 2.

Figure 2: Comparison of Selected CAP Procedures to the LB&I Division Guide for Quality Examinations

Policies and Procedures per LB&I Division's Guide for Quality Examinations (IRM 4.46)	CAP Procedures (IRM 4.51.8)
PLANNING	
"Currency is a priority for [the] LB&I [Division] and Agents should explore options to improve currency during the planning process."	*"[The CAP] fosters compliance by helping the IRS achieve its goal of reducing overall examination cycle time and increasing currency for participating taxpayers while enhancing the accurate, efficient, and timely resolution of complex tax issues."*
"Quality Examination guidelines emphasize the importance of ongoing dialogue between the exam team and taxpayer throughout execution of the exam plan."	*"The IRS and the taxpayer will jointly determine the scope of the CAP review, including materiality thresholds. However, the ultimate decision of identifying transactions, items, and issues for compliance review remains within the discretion of the IRS."*
INSPECTION AND FACT FINDING	
"[The Information Document Request (IDR) Management Process] encourages collaboration between the taxpayer and IRS personnel to agree on and provide information needed to support an examination."	*"The scope of any necessary IDRs should be discussed in an open and honest manner and the parties should reach mutually agreed upon due dates for the responses."*
"[The team coordinator or revenue agent] should follow up with the taxpayer when the IDR is 15 calendar days delinquent. Problems that exist and reasons for the delay should be discussed and resolved if possible."	*"If for any reason the taxpayer is unable to comply with the due date of an IDR, the taxpayer should notify the IRS immediately, explain the circumstances for the delay, and a revised due date should be considered."*
"Upon receipt of the response to the request for information, the requester will timely review the records received for completeness."	*"The IRS will promptly evaluate the IDR responses for completeness and, after a thorough analysis of the responses, will discuss the results of the review with the taxpayer."*
ISSUE DEVELOPMENT AND RESOLUTION	
"An important objective of the [IRS] is to resolve tax differences at the lowest level without sacrificing the quality and integrity of those determinations."	*"Under the CAP, the IRS and taxpayers work together on a contemporaneous basis toward the goal of achieving an acceptable level of tax compliance prior to the filing of the tax return."*
"Ensure there are open communications with the taxpayer and that the taxpayer is actively involved in the examination planning process."	*"The [CAP] Program focuses on issue identification and resolution through transparent and cooperative interaction between taxpayers and the IRS."*
"The team manager should periodically meet with appropriate levels of company management to discuss the progress of the examination and to resolve any developing problems."	*"The IRS and taxpayers should work together during the CAP to identify and resolve issues. The IRS and taxpayers should regularly engage in discussions for the purpose of resolving factual or technical differences."*

Source: LB&I Division Guide for Quality Examinations (IRM 4.46) and CAP procedures (IRM 4.51.8).

To gain an understanding of the process and determine the effectiveness of management controls, we reviewed and discussed with LB&I Division officials the key CAP management controls that covered the application and acceptance process; contact between CAP teams and taxpayers; training/orientation provided to CAP teams and taxpayers; the responsibilities of CAP Account Coordinators; and the identification, development, and resolution of tax issues. We judgmentally selected a sample of 10 audits[9] from the 101 taxpayers that participated in the CAP during TY 2009.[10] During our sample audit review, we conducted on-site visitations with the CAP teams to discuss activity and obtain supporting documentation. Although we found some variations and minor exceptions, in general we found the CAP cases were being administered in accordance with IRS policies and procedures.

The results of our sample review are consistent with the findings from LB&I Division's quality reviews, which are conducted in the fiscal year[11] following the tax return due dates. As shown in Figure 3, the overall quality scores for the pilot program years indicate that the CAP audits generally followed the policies and procedures initially established for the program.

[9] Our review of CAP audits included all IRS activity, both before and after the filing of the taxpayer's return.
[10] A judgmental sample is a nonstatistical sample, the results of which cannot be used to project to the population. A judgmental sample was used because of limited auditing resources and time. Selection criteria included a mix of taxpayers' asset levels, industry types, years of CAP experience, case status, and geographic location. CAP TY 2009 was used because it was the most current period and included taxpayers that completed the prefiling review (and a majority had also completed the postfiling review).
[11] A 12-consecutive-month period ending on the last day of any month, except December. The Federal Government's fiscal year begins on October 1 and ends on September 30.

Figure 3: Summary of CAP Quality Review Audits and Scores

CAP Tax Year	Number of Audits in the CAP	Number of Audits Quality Reviewed	Percentage of Audits Quality Reviewed	Overall Quality Score	Quality Review Fiscal Year	Sampling Methodology
2005	17	17	100%	Not Applicable	2007	Review process established and tested; 100 percent sample.
2006	35	35	100%	91.8%	2008	100 percent sample.
2007	72	27	37.5%	93.8%	2009	Random sample.
2008	95	30	31.6%	95.3%	2010	Random sample.
2009	101	18	17.8%	98.0%	2011	Judgmental sample for taxpayers not previously reviewed.
2010	112	17	15.2%	In Process	2012	Judgmental sample for taxpayers not previously reviewed.
2011	140	To Be Determined			2013	The IRS plans to select a random sample with additional stratification for taxpayers not previously reviewed.
2012	178	To Be Determined			2014	The IRS plans to select a random sample.

Source: Treasury Inspector General for Tax Administration's (TIGTA) summary of the IRS's CAP quality analysis reports for TYs 2005–2010 and explanatory data provided by the IRS.

However, our review noted several issues in the administration of the quality reviews for CAP audits. Specifically, although the quality review process has been performed for six fiscal years and the overall quality review scores have been consistently high, the IRS has yet to establish a target goal for the quality score. Also, the quality review sample size has steadily declined as a percentage of the CAP audits and the sample selection methodologies differed from year to year. While these issues do not invalidate the results of the quality reviews, a more consistent approach would have made the results more comparable between years of the pilot as well as between the pilot and the future results for the permanent program. LB&I Division officials informed us that a standardized random sampling methodology will be used starting in Fiscal Year (FY) 2014, when the first CAP permanent program year (TY 2012) is reviewed.

Many Key Issues Were Addressed in Planning and Implementing the Compliance Assurance Process

Among the recommended practices for developing and implementing new business processes, or for improving existing ones, is to establish an overall framework with detailed steps for carrying out the various phases of a project. The Government Accountability Office (GAO), with input from discussions with managers in private industry and in other Federal agencies, developed a best practice framework that involves 20 steps and is based on its *Business Process Reengineering Assessment Guide.*[12] As discussed in Appendix IV, the framework is designed to help ensure that potential obstacles are considered, problems are pinpointed and addressed, costs and benefits are analyzed, and results are accurately evaluated.

We used the GAO's 20-step best practice framework as criteria to assess how closely IRS personnel considered the recommended steps in planning, implementing, and evaluating the CAP. In using the GAO's approach, it is important to recognize that although the IRS established a similar framework in April 2009, it was not in place when IRS personnel planned and began implementing the CAP as a pilot program in March 2005. We believe it is equally important to recognize that, according to the GAO, a degree of discretion is involved in making judgments about each of the steps, and some steps are not appropriate for every project. Consequently, we followed steps outlined in the GAO's framework and used IRS statistics, results from discussions with IRS personnel, data analyses, the IRM, sample case reviews, and IRS strategic planning documents for our assessment. As shown in Figure 4, except for the areas involving productivity measures and evaluation, IRS personnel successfully met, or partially met, 16 of the 19 applicable steps during planning and implementing of the CAP.

[12] GAO, GAO/AIMD-10.1.15, *Business Process Reengineering Assessment Guide* (May 1997).

Figure 4: Assessment of the CAP Pilot Program Using GAO Best Practices

Best Practices Advocated by the GAO	Included in Pilot	Comments or Explanations
Identify productivity baseline.	***Y***	
Include complexity and quality in productivity measures.	***P***	Satisfaction survey results were used along with results of reviews over the technical accuracy and thoroughness of the activity. However, other productivity measures, such as the amount of additional taxes recommended, were not used to capture results from the CAP prefiling activities.
Map current process.	***Y***	
Compare current productivity to internal and external benchmarks.	***P***	Data available and used to compare the length of the CAP to the length of traditional audits. However, some productivity measures such as the amount of additional taxes recommended were not captured for the CAP prefiling activities.
Identify causes of weak performance.	***Y***	
Measure gap between current and desired productivity.	***N***	To date, there has not been any analysis to measure the gap between current and desired productivity.
Understand the best practices of others.	N/A	
Analyze alternatives.	***Y***	
Design new process to close productivity gap.	***N***	Desired level of performance is not quantitatively defined.
Obtain executive support.	***Y***	
Assess barriers to implementing changed process.	***Y***	
Assess resource needs and availability.	***Y***	
Conduct pilot tests.	***Y***	
Adjust target process based on pilot results.	***Y***	
Define roles and responsibilities.	***Y***	
Establish employee expectations for new process.	***Y***	
Develop plans to monitor and evaluate new process.	***N***	In addition to lacking an evaluation plan, there were no predefined criteria to determine what would constitute a success.
Establish a change management strategy.	***Y***	
Establish a transition team.	***Y***	
Develop workforce training plans.	***Y***	
Y - Yes N - No P - Partial		

Source: TIGTA's evaluation of the CAP pilot program using the GAO 20-step framework and data provided by the IRS.

By considering most of the steps in planning and implementing the CAP, the LB&I Division positioned itself to implement the CAP smoothly and according to plan. For example, the IRS has long used key productivity measures that include the total additional taxes recommended during an audit to show that its examiners annually identify billions of dollars in additional taxes that may be owed by our Nation's largest corporations. Other IRS productivity measures, such as cycle time, have shown that the audits of large corporations typically started months or even years after tax returns were filed and then took several more years to complete. As reflected in publications and public notices, IRS personnel used this baseline data along with other information in deciding a change was needed in how it approached audits of large corporations to ensure that they complied with the tax law. Specifically, the IRS concluded its current process was far too lengthy and burdensome on both IRS resources and those of large corporations.

IRS personnel also developed and implemented a CAP pilot program that lasted from March 2005 through March 2011. This was designed to provide an opportunity for the IRS and large corporations to test how the CAP would work in actual practice and address problem areas detected in the process. During the pilot program, IRS personnel developed and refined detailed procedures that were ultimately incorporated into the IRM and are currently being used to provide needed guidance and direction to IRS personnel and taxpayers involved in the CAP permanent program. Notably, the procedures include a requirement that both the IRS and the taxpayers execute a Memorandum of Understanding early in the CAP. Among other things, the Memorandum of Understanding describes the steps that will be followed and establishes accountability by specifying the roles and responsibilities for both parties, including communication and disclosure responsibilities.

Importantly, LB&I Division personnel also applied some lessons learned from an earlier initiative to address potential barriers that could hamper the implementation of the CAP. In October 2003, the Commissioner, LB&I Division, announced the Currency and Cycle Time Improvement Initiative (currency initiative) to "realize significant gains in cycle time, currency, return closures, rates, and audit coverage performance" by identifying opportunities to close aged inventory and replace it with more current work. While the initiative was well intentioned, some employees expressed resistance to the changes introduced by the initiative. As TIGTA previously reported,[13] this generated adverse publicity for the initiative, including concerns that significant tax issues might have been overlooked because audits were closed prematurely to meet the initiative's deadlines.

In contrast to the currency initiative, which was largely communicated in a downward fashion from the top of the LB&I Division, senior managers used a variety of communication channels to reach out to employees, taxpayers, union representatives, and other stakeholders for ideas,

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[13] TIGTA, Ref. No. 2008-30-181, *Although the Large and Mid-Size Business Division's Currency Initiative Was Considered a Success, Improvements Could Be Made in Future Initiatives* (Sept. 2008).

suggestions, and support for the CAP. The various communication channels, such as e-mail, face-to-face meetings, large and small group meetings, intranet websites, surveys, and town hall meetings, facilitated a two-way exchange that allowed for input from employees, taxpayers, and other stakeholders. For example, the CAP articles written by the Commissioner, LB&I Division, were published in at least two popular tax administration journals and provided stakeholders and interested readers with a consistent message on how the CAP worked, the rationale for its implementation along with details on its goals and expected benefits, origin and evolution, and implementation process. These articles also provided details on the progress being made to implement the CAP and employee and taxpayer experiences with the process.

A Well-Defined Evaluation Plan Needs to Be Developed and Implemented

Despite the fact that the CAP pilot program ran for six calendar years and the permanent program is in its second calendar year of operation, the LB&I Division has yet to develop and implement a plan to thoroughly evaluate CAP data. By developing and implementing an evaluation plan that includes objective measures for defining success, the LB&I Division could enhance the credibility and transparency of the results the CAP is generating while helping avoid any perception of bias. Careful assessment of the CAP may also lead to the identification of necessary revisions to further enhance the process as well as permit LB&I Division officials, the Congress, and other stakeholders to adequately assess whether the CAP is generating sufficient benefits in relation to its costs. According to the GAO's best practice framework, a sound evaluation plan should contain key elements such as clearly stated objectives that measure success against well-defined standards and detailed steps for verifying that sufficient benefits are being realized in relation to the costs being incurred.

Objectives that are clear and measureable can help ensure that the appropriate data are collected and measured against the standards that define success

In announcing the CAP pilot program, the IRS articulated that the objectives and approach for the program would be to:

- Reduce taxpayer burden and uncertainty while assuring the IRS of the accuracy of tax returns prior to filing, thereby reducing or eliminating the need for postfiling examinations.
- Reduce taxpayer burden through the contemporaneous exchange of information about completed events and transactions that affect tax liability rather than through the traditional examination process.
- Foster compliance by helping the IRS achieve its goal of shortening examination cycles and increasing currency for taxpayers while enhancing the accurate, efficient, and timely final resolution of increasingly complex corporate tax issues.

- Assist in increasing audit coverage by providing a more efficient use of resources.
- Allow taxpayers to better manage tax reserves and ensure more precise reporting of earnings on financial statements.

The Commissioner, LB&I Division, described the CAP as a strategy to benefit taxpayers in terms of the possibility of achieving tax certainty sooner and with less administrative burden and to benefit the IRS in terms of reduced resource burdens and the ability to identify emerging taxpayer issues and compliance risks more readily. The IRS Commissioner similarly alluded to the CAP in prepared remarks to the American Institute of Certified Public Accountants in November 2011 as an innovative strategy for issue resolution that is less time and resource intensive for both the IRS and taxpayers.

In June 2012, the LB&I Division added objectives to the CAP IRM that were similar to those announced at the start of the pilot program. Although the IRS has articulated the objectives for the CAP, they are not as clear as they could be due in part to the absence of standards that would enable determining if and when the objectives are achieved. For instance, one of the objectives states that the CAP will foster "*compliance by helping the IRS achieve its goal of reducing overall examination cycle time and increasing currency for participating taxpayers while enhancing the accurate, efficient, and timely resolution of complex tax issues*," but it does not explain what complex tax issues will be involved or how many would need to be resolved accurately, timely, and efficiently to foster compliance. Nor are the objectives measurable. For example, one of the objectives states that taxpayers "*are able to achieve tax certainty sooner and with less administrative burden than in the traditional postfiling examination program*" and the CAP "*assists in increasing audit coverage by providing a more efficient use of audit resources*," but it does not specify how much of a reduction in burden or increased coverage would indicate success.

Accurately measuring costs and benefits, including any savings generated, can help ensure that sufficient benefits are realized in relation to the costs incurred

Recognizing the importance of assessing the costs and benefits of new business processes, the Office of Management and Budget (OMB) developed guidance that recommends agencies conduct a sound cost-benefit analysis before initiating any long-term project that extends three or more years into the future.[14] The guidelines are intended to promote efficient resource allocation through well-informed decision making and include, among other things, a detailed plan to verify results.

The LB&I Division has developed information for the CAP through formal assessments of taxpayer and employee satisfaction surveys that overall shows taxpayers and examiners are

[14] OMB, Circular A-94, *Guidelines and Discount Rates for Benefit-Cost Analysis of Federal Programs* (Oct. 1992).

satisfied with their CAP experiences. For example, the results of surveys conducted during the CAP pilot found that most taxpayers described the IRS's commitment to the CAP as strong and commented positively on their interactions with the CAP teams regarding information requests. The majority of the survey respondents indicated they would like to see the CAP continue as a way of doing business with the IRS, and most expressed a desire to continue participating in the program.

As shown in Figure 5, we compared[15] productivity statistics for the CAP audits of corporations with assets of more than $250 million to traditional audits of similar size corporations over a five-year period (FYs 2007 through 2011) and found that the CAP audits were completed sooner overall and achieved tax certainty earlier. Specifically, the cycle time for the CAP audits was an average of almost 24 months with tax certainty reached at an average of eight and a half months after the return was filed. By comparison, traditional audits were concluded an average of about 40 months after the return was filed, which is a year and a third longer than the CAP audits overall and more than two and a half years longer from when returns are filed.

[15] At the time of our review, the LB&I Division had not yet compared the performance statistics of the CAP audits to traditional audits of taxpayers that are similar to taxpayers involved in the CAP.

Figure 5: LB&I Division Productivity Statistics for Corporations With Assets More Than $250 Million[16]

Productivity Statistic	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011	Five-Year Averages[17]
CAP CLOSURE RESULTS						
Corporate Returns Closed	7	31	61	77	97	
Total FY 2007–2011 Corporate Returns Closed					273	**55**
Average Cycle Time in Months	24.0	24.9	23.9	22.5	24.8	**23.9**
Prefiling Average	*18.3*	*15.1*	*15.7*	*14.3*	*16.0*	***15.4***
Postfiling Average	*5.7*	*9.8*	*8.2*	*8.2*	*8.8*	***8.5***
Average Staff Hours per Return[18]	4,348.0	4,054.1	3,216.8	2,659.4	2,449.8	**2,911.1**
Prefiling Average	*3,905.9*	*3,389.0*	*2,565.8*	*1,909.5*	*1,802.0*	***2,237.2***
Postfiling Average	*442.1*	*665.0*	*651.0*	*749.9*	*647.8*	***674.0***
Average Tax Increase per Return	$6,674,067	$5,406,303	$10,316,927	$10,842,279	$6,776,404	**$8,556,092**
Average Tax Increase per Staff Hour	$1,535	$1,334	$3,207	$4,077	$2,766	**$2,939**
TRADITIONAL AUDIT CLOSURE RESULTS						
Corporate Returns Closed	3,230	3,509	3,632	3,275	3,568	
Total FY 2007–2011 Corporate Returns Closed					17,214	**3,443**
Average Cycle Time in Months	45.7	39.9	37.8	35.9	38.2	**39.4**
Average Staff Hours per Return	975.9	868.0	838.3	876.3	727.6	**854.5**
Average Tax Increase per Return	$7,392,459	$6,916,557	$7,861,111	$7,244,912	$6,678,483	**$7,218,271**
Average Tax Increase per Staff Hour	$7,575	$7,969	$9,377	$8,267	$9,178	**$8,448**

Source: LB&I Division Table 37, computer extract data from the Audit Information Management System, and CAP data provided by the IRS.

However, our analysis also found that the CAP audits are consuming substantially more staff hours than those under the traditional audit process. The large difference between the five-year average staff hours spent on the CAP audits and traditional audits (2,911 compared to 855 staff hours per return or almost three and a half times more staff hours) raises a number of issues that

[16] We also conducted additional detailed analyses that considered fiscal year and five-year average results by asset levels, industry case types, and audit selection sources in which the results of the analyses showed similar patterns as those displayed here.

[17] The five-year averages are based on the totals (not averages) for the 273 CAP and 17,214 traditional closures during each of the five fiscal years and divided by five. The totals for each fiscal year are not shown in Figure 5.

[18] Due to rounding, the prefiling average plus the postfiling average may not always equal the sum average.

underscores the importance of including a sound cost-benefit analysis in an overall evaluation of the CAP.

One issue involves determining the effect the staff hours spent on the CAP is having on the LB&I Division's ability to increase audit coverage, which is a key benefit envisioned under the CAP. For the CAP to assist in increasing audit coverage, it must demonstrate a savings of resources that can be applied toward additional audits by either using fewer resources in its process or providing benefits to other audits. As noted in Figure 5, CAP audits are using fewer staff hours than in the past (2,450 in FY 2011 versus 4,348 staff hours in FY 2007) but are still consuming more than three times more hours than the traditional audit process. Therefore, the CAP has yet to show that it will increase audit coverage by using fewer resources. The LB&I Division provided examples of emerging issues identified from the CAP audits that included domestic production deduction[19] and repatriation,[20] which implies increased audit coverage, but without a cost-benefit analysis it is not known if this justifies the additional staff hours used in the CAP. Determining the effect of staff hours spent on the CAP is equally important for the LB&I Division to ensure that the enforcement resources being devoted to the CAP do not diminish its ability to provide audit coverage over the large businesses that do not comply with the tax laws and choose not to volunteer for the CAP.

The second issue involves determining the effect the CAP is having on revenue in terms of the amount of additional taxes examiners are identifying and recommending that taxpayers may owe. As shown in Figure 5, examiners generated a larger five-year average of additional recommended taxes for each CAP return audited ($8.5 million) compared to traditional audited returns ($7.2 million). These additional recommended taxes during the CAP generally stemmed from issues that could not be resolved before the return was filed. However, as noted previously, examiners used far more staff hours on CAP returns than traditional returns, which in turn makes the hourly rate for the CAP approximately a third of the hourly rate examiners generated from traditional audits, $2,939 versus $8,448, respectively. The vast majority of CAP staff hours (77 percent) were consumed in the prefiling stage reviewing taxpayer-provided data and information collected from a variety of third-party sources, such as Securities and Exchange Commission filings, in an effort to identify and resolve potential issues relating to each CAP tax return before it was filed. Neither we nor the IRS know the effect the hours are having on revenue because a method to reliably measure this prefiling activity has yet to be developed and implemented by the LB&I Division.

The third issue involves assessing the effect the LB&I Division's lack of prior experience with potential new CAP taxpayers will have on resources. During the pilot program, almost all

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[19] Internal Revenue Code (I.R.C.) Section (§) 199 provides for domestic manufacturers to receive a deduction for the net income resulting from the domestic production of products.
[20] To send money that has been earned or invested abroad back to its owner's country of origin.

taxpayers that participated in the CAP were corporations, and all had assets of $250 million or more. In addition, taxpayers were selected to participate in part due to previous audit history. Now that the CAP is a permanent program, almost all LB&I Division taxpayers are eligible to participate. Consequently, there is a risk that as the CAP expands to include a broader population of taxpayers with lower asset levels that have not been audited extensively, the lack of familiarity with a taxpayer's financial statements, books, records, and other data may require additional staff hours to ensure that the returns are prepared and filed in a manner that is substantially compliant with the tax laws.

During the conclusion of our fieldwork, we were informed that the IRS's Office of Research, Analysis, and Statistics recently started coordinating with the LB&I Division to research and develop innovative ways to determine the indirect benefits of the permanent CAP program. This new initiative was in response to a February 2011 IRS Commissioner's request. However, the IRS has not yet started to develop an evaluation plan to assess CAP performance to address the issues we identified during our review.

Recommendation

Recommendation 1: The Commissioner, LB&I Division, should ensure that an evaluation plan is developed and implemented to thoroughly assess the CAP. At a minimum, the evaluation plan should include clearly stated objectives that measure success against well-defined standards and detailed steps for verifying that sufficient benefits are being realized in relation to the costs being incurred.

> ***Management's Response:*** IRS management agreed with this recommendation and will continue to develop and implement an evaluation plan for the CAP, including performance indicators and cost-benefit analyses.
>
> ***Office of Audit Comment:*** Although the Commissioner, LB&I Division, agreed with our recommendations, she also commented that showing the difference in hours spent on CAP audits from the hours spent on traditional audits does not draw a meaningful comparison. She appears to base this on the view that the traditional examination statistics cited were not comparable based on average taxpayer size and variance in the type of examinations. We do not agree with this view. As discussed in this report, almost all taxpayers that were audited under the CAP were corporations with assets of $250 million or more and these audits consumed more than three times the examiner hours of traditional audits of corporations with assets of $250 million or more. Further, the report notes that the variance in the type of audits was incorporated into additional detailed analyses and the results showed a similar pattern in CAP consuming more hours.
>
> Moreover, such comparisons are important to allow the LB&I Division to ensure that the enforcement resources being devoted to the CAP do not diminish its ability to provide audit coverage over the large businesses that do not comply with the tax laws and choose

not to volunteer for a CAP audit. This is especially important now that the CAP is a permanent program and almost all LB&I Division taxpayers are eligible to participate.

The Compliance Assurance Process Needs to Be Included in Upcoming Reviews of Potential New User Fee Sources

Much like the fees paid to drive on toll roads or to airlines for additional luggage, Federal Government user fees are intended to cover the costs an agency incurs to provide goods or services that are beyond what is provided to the general public. Such fees are based on the principle that those who receive special benefit from a Federal Government program or activity should bear the cost of receiving such benefit.

User fees were initially authorized by Congress under the Independent Offices Appropriations Act of 1952[21] and are currently governed by OMB Circular A-25.[22] As noted in a 2008 GAO report,[23] there has been a noticeable increase in the amount of user fee collections. Specifically, the report cited figures from data compiled by the OMB that showed total user fee collections increased 69 percent from $138 billion in FY 1999 to $233 billion in FY 2007. A number of factors are likely contributing to increasing popularity of the fees as the following excerpt from the GAO report illustrates.

> *As the nation continues to change in fundamental ways, a wide range of needs and demands have emerged, for example, evolving defense and homeland security programs, increasing global interdependence, and advances in science and technology. At the same time, our current long-term simulations of the federal budget show ever-larger deficits. As funds become increasingly scarce and new priorities emerge, policymakers have demonstrated interest in user fees as a means of financing new and existing services.*

In the IRS, user fees are imposed on a variety of services that range from helping taxpayers satisfy outstanding tax liabilities and resolving tax issues before filing a tax return to clarifying areas of the tax law and registering tax return preparers. Although user fee collections are expected to reach $309 million in FY 2012, the IRS has not always adhered to established guidelines for administering user fees. For example, TIGTA reported in September 2005[24] that the salary and benefit costs the IRS was incurring for PFAs with large businesses were far outpacing what was being recovered in user fees. To address this issue, IRS officials agreed to evaluate its compliance with OMB Circular A-25 and determine the appropriate user fee to

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[21] 31 U.S.C. 9701.
[22] OMB, Circular A-25, *Transmittal Memorandum No. 1, User Charges* (July 1993).
[23] GAO, GAO-08-386SP, *Federal User Fees: A Design Guide*, p. 1 (May 2008).
[24] TIGTA, Ref. No. 2005-30-151, *The Pre-Filing Agreement Program for Large Businesses Has Yielded Modest Results* (Sept. 2005).

charge for PFAs. Subsequently, the IRS changed PFA user fees for large businesses from a three-tier structure that had a maximum fee of $10,000 to a single fee of $50,000. In addition, in May 2008, TIGTA reported[25] that installment agreement user fee cost estimates were based on incorrect assumptions and contained calculation errors and unsupported costs. To address these issues, the IRS (1) developed and published instructions in the IRM for calculating the full cost of the services provided and (2) validated the cost estimate used for setting installment agreement user fees.

More recently, the GAO reported in November 2011[26] that the IRS conducts a review of its user fees every two years as required and is improving how it estimates its costs of providing user fee services. However, the GAO also reported that the IRS omitted fees from its review process, did not clearly document assumptions to be used in some cost estimates, and lacked documentation of factors considered in setting some fees. In addition, the GAO found the IRS did not fully document final decisions made on fee rates as a result of its review and may not be taking full advantage of its process for identifying new user fees. IRS officials agreed with the findings and responded that they plan to incorporate corrective actions into their FY 2013 review of user fees.

As the IRS moves forward with plans to implement corrective actions in response to the GAO's findings, it would be worthwhile for LB&I Division officials to ensure that the CAP is included in their next review of potential new user fee sources. Although LB&I Division officials acknowledged that the decision about CAP user fees was not documented, they stated that fees should not be imposed on CAP participants because the CAP is part of the LB&I Division's core responsibility to audit tax returns. LB&I Division officials also stated that the CAP should not be funded by the participants because it provides tax administration benefits that include enhancing the IRS's ability to better identify emerging issues, establish needed guidance, and allocate compliance resources.

We recognize that auditing tax returns is a responsibility of the LB&I Division and that the CAP has tax administration benefits. Nevertheless, there are a number of important reasons to review the CAP as a potential new user fee source along with documenting the factors considered during the review. First, the review and related documentation would be consistent with the expectations of OMB[27] and GAO[28] standards for internal control in the Federal Government. According to these control standards, reviews should be documented to help maintain the continuing usefulness of the results for making and supporting decisions and for providing assurances that policies and procedures are being carried out as directed.

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[25] TIGTA, Ref. No. 2008-40-113, *Installment Agreement User Fees Were Not Properly Calculated or Always Collected* (May 2008).
[26] GAO, GAO-12-193, *User Fees: Additional Guidance and Documentation Could Further Strengthen IRS's Biennial Review of Fees* (Nov. 2011).
[27] OMB, Circular A-123, *Management's Responsibility for Internal Control* (Dec. 2004).
[28] GAO, GAO/AIMD-00-21.3.1, *Standards for Internal Control in the Federal Government* (Nov. 1999).

The second reason for evaluating the CAP as a potential new user fee source is to ensure that the IRS is complying with Federal Government policy reflected in OMB Circular A-25. According to OMB Circular A-25, a user fee is required to be collected from recipients who receive special benefits from a Federal activity. For the purposes of OMB Circular A-25, special benefits are considered ones that (1) enable the recipient to obtain more immediate or substantial gains or values than those available to the general public, (2) provide business stability or contribute to public confidence in the business activity of the recipient, or (3) are performed at the request of the recipient and is beyond the services regularly received by other members of the same industry or group or by the general public. Besides being a taxpayer-initiated process that is limited to companies that fall under the jurisdiction of the LB&I Division, the CAP provides a participating company with the certainty that its income tax returns are compliant with tax laws. Achieving tax return certainty can, in turn, significantly enhance public and investor confidence in the integrity of the company's financial statements because it eliminates or reduces the need to (1) maintain tax reserves in the statements for uncertain tax positions and (2) make additional disclosures about uncertain tax positions. For example, Financial Accounting Standards Board Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, requires disclosures in the financial statements that show the total amount of unrecognized tax benefits that, if recognized, would affect the tax rate used to determine the company's profits, the total interest and penalties related to the unrecognized tax benefits that may be owed, and a description of the tax years that may be audited by the IRS.

Third, the review and documentation could provide explanation and support for charging a $50,000 user fee for participating in the LB&I Division's PFA program and no user fee for participating in the CAP notwithstanding the similarities of the two processes. As outlined in Figure 6, both processes are initiated by a large business taxpayer to cooperatively resolve tax issues before a return is filed to provide tax certainty while reducing costs and burden.

Figure 6: Comparison of Processes for the PFA and the CAP

Process Topic	Description for the PFA	Description for the CAP
Overview	A taxpayer-initiated process with an objective to resolve, before returns are filed, issues that are likely to be disputed in postfiling audits. The taxpayer and the IRS work in a cooperative environment to resolve issues.	A taxpayer-initiated process structured to conduct real-time compliance reviews to establish the correct tax treatment of tax return positions prior to a taxpayer filing its Federal income tax return. The CAP focuses on issue identification and resolution through transparent and cooperative interaction between the taxpayers and the IRS.
Eligibility	Taxpayers under the jurisdiction of the LB&I Division are eligible to apply for a PFA. Both Coordinated Industry and Industry cases[29] are eligible.	Taxpayers under the jurisdiction of the LB&I Division that are publicly held entities with a legal requirement to prepare and submit disclosure forms to the Securities and Exchange Commission or, if privately held, agree to provide to the IRS certified, audited financial statements and not be under investigation or in litigation that would limit the IRS's access to current tax records.
Scope	The process does not determine the tax treatment of prospective or future transactions or events, but only completed transactions or events whose tax treatment has not yet been reported on a return. The IRS will consider issues that require a determination of facts, the application of established legal principles to known facts, or a methodology used to determine the amounts for an item of income, allowance, deduction, or credit. A user fee will be assessed for each separate and distinct issue.	The CAP does not provide taxpayers with guidance on, or resolution of, prospective or incomplete transactions outside of existing procedures. Taxpayers are expected to make open, comprehensive, and contemporaneous disclosures of their completed business transactions that could have a material effect on their Federal income tax liability. Further, taxpayers must disclose their proposed tax positions with regard to these disclosures. The IRS and the taxpayer will jointly determine the scope of the CAP review, including materiality thresholds. However, the ultimate decision of identifying transactions, items, and issues for compliance review remains within the discretion of the IRS.
Conclusion	If agreement is reached, the determination will be recorded in a PFA and be a closing agreement under I.R.C. § 7121 for the current taxable year; however, the PFA is a nonstatutory binding agreement if the determination involves a future taxable year. The IRS will review the subsequently filed return to insure compliance with the terms of the PFA.	An Issue Resolution Agreement is prepared for each item or issue that is resolved in the CAP. At the end of the CAP year, and as deemed appropriate by the IRS, the completed Issue Resolution Agreement(s) is incorporated into a closing agreement(s). If a taxpayer has fully complied with the terms of the CAP at the conclusion of the prefiling stage, the IRS will provide the taxpayer with an Acceptance Letter that constitutes written confirmation that, subject to the completion of a postfiling review of the return, the IRS will accept the taxpayer's return as it relates to the resolved items and issues if the return is filed consistent with the agreement(s).

[29] The LB&I Division serves corporations, subchapter S corporations, and partnerships with assets more than $10 million and divides these taxpayers into two category case types called Coordinated Industry and Industry. Coordinated Industry cases generally involve the Nation's largest taxpayers and are usually audited by teams of examiners. Industry cases are generally assigned to one examiner.

Process Topic	Description for the PFA	Description for the CAP
Benefits	Taxpayers and the IRS often resolve issues more effectively and efficiently through a prefiling examination than a postfiling examination because the taxpayer and the IRS have more timely access to the records and personnel that are relevant to the issues. A prefiling examination also provides the taxpayer with certainty regarding the examined issue at an earlier point than a postfiling examination. These procedures benefit both taxpayers and the IRS by improving the quality of tax compliance while reducing costs, burdens, and delays.	Taxpayers are able to achieve tax certainty sooner and with less administrative burden during the CAP than in the traditional postfiling examination program. This allows taxpayers to better manage tax reserves and ensure more precise reporting of earnings on financial statements. The CAP fosters compliance by helping the IRS achieve its goal of reducing overall examination cycle time and increasing currency for participating taxpayers while enhancing the accurate, efficient, and timely resolution of complex tax issues. In addition, the CAP assists in increasing audit coverage by providing a more efficient use of resources.
Legal Protection	All information provided to and agreements reached with the IRS are considered return information protected from disclosure by the confidentiality provisions of I.R.C. § 6103. The taxpayer agrees that the review of records and information under the PFA procedures does not constitute an inspection within the meaning of I.R.C. § 7605(b) and will not preclude or impede the IRS from later examining any return or inspecting any records.	All information provided to the IRS in connection with the CAP is return information protected from disclosure by the confidentiality provisions of I.R.C. § 6103. The IRS's participation in the prefiling review during the CAP does not constitute an examination or inspection of the taxpayer's books of account for purposes of I.R.C. § 7605(b).

Source: TIGTA's analysis of IRS Revenue Procedure 2009-17 PFA program (IRM 4.30.1), and CAP procedures (IRM 4.51.8).

The fourth reason for evaluating the CAP as a potential new user fee source is the amount of revenue at stake for the Federal Government. The potential amount of user fees for the first CAP permanent program year (TY 2012) would have been $8.9 million if the 178 participating taxpayers were required to submit a user fee similar to the PFA user fee of $50,000. In FY 2011, the IRS calculated the actual average cost of a PFA to be $134,600. Therefore, the potential user fee revenue for the CAP could be substantially higher if the actual costs of the CAP exceeded $50,000 and the potential CAP user fee is set closer to actual costs.

Recommendation

Recommendation 2: Once revised IRS-wide user fee guidelines are implemented, the Commissioner, LB&I Division, should ensure that the guidelines are used to evaluate the CAP as a potential new user fee source.

Management's Response: IRS management agreed with this recommendation and once the IRS-wide user fee guidelines are implemented, they will evaluate the CAP program to determine if it is an appropriate program for a user fee.

Appendix I

Detailed Objectives, Scope, and Methodology

The objectives of this review were to determine the extent to which the planning, implementation, and evaluation for the CAP followed published guidance and whether it is being administered in accordance with IRS policies and procedures. To accomplish our objectives, we:

I. Determined if the steps used to plan, implement, and evaluate the CAP were consistent with the GAO 20-step business process reengineering approach (see Appendix IV) by interviewing LB&I Division officials and obtaining supporting documentation.

II. Developed a profile of the CAP taxpayer population and determined if taxpayer segments within the LB&I Division customer base that generally meet current CAP eligibility requirements were adequately considered during the CAP testing. Specifically, we compared statistics for the 161 taxpayers that participated during the CAP pilot (TYs[1] 2005 through 2011) to LB&I Division tax return statistic tables for traditional examinations conducted during Processing Years[2] 2007 through 2011 to determine if applicable taxpayer segments were included in the CAP.

III. Assessed if taxpayers should pay a user fee to participate in the CAP program. Specifically, we conducted research to determine when the IRS should apply user fees, interviewed LB&I Division officials to determine if user fees were considered for the CAP, compared and contrasted the CAP with the LB&I Division's PFA program[3] to determine if user fees are being equitably applied, and calculated the amount of user fees that could have been collected during the pilot and future CAP activity.

IV. Determined the effectiveness of CAP management controls by reviewing sample cases. To gain an understanding of the process, we reviewed and discussed with LB&I Division officials the CAP management controls that covered the application and acceptance process; contact between CAP teams and taxpayers; training/orientation provided to CAP teams and taxpayers; the responsibilities of Account Coordinators and management; the identification, development, and resolution of tax issues; and examination job rotation. We judgmentally selected[4] 10 of the 101 CAP TY 2009 cases based on availability of auditing resources and case locations, and to obtain a mix of cases that considers asset

[1] 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.
[2] The calendar year in which the tax return or document is processed by the IRS.
[3] Revenue Procedure 2005-12.
[4] A judgmental sample is a nonstatistical sample, the results of which cannot be used to project to the population.

levels, industry types, and years of experience with the CAP program. The sample cases were reviewed by conducting on-site visitations with the CAP teams to discuss case activity and obtain supporting documentation for management controls. The results were compared to the findings of the LB&I Division quality review process.

V. Assessed the CAP potential to achieve selected benefits as stated by the IRS (*e.g.*, reduce cycle time, save staff resources, reduce taxpayer burden). We discussed with LB&I Division officials and obtained supporting documentation for their efforts to measure and report on the CAP accomplishments. In addition, we obtained the raw computer data used for LB&I Division management reports of closed corporation examination results during FYs 2007 through 2011. A review of the data including comparison of summary totals to LB&I Division management reports determined these data are sufficiently reliable for our testing needs. Using the computer data, summary results including average cycle time, staff resources, and tax increases for just the CAP and similar LB&I Division closed corporation cases were determined and compared.

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: guidance from the GAO for business process changes; guidance from the OMB for user fees; and IRS policies, procedures, and practices for resolving examinations. We evaluated these controls by reviewing source material, interviewing management, reviewing sample cases, and evaluating summary program results including quality review results.

Appendix II

Major Contributors to This Report

Margaret E. Begg, Assistant Inspector General for Audit (Compliance and Enforcement Operations)
Carl Aley, Acting Assistant Inspector General for Audit (Compliance and Enforcement Operations)
Frank Dunleavy, Director
Michelle Philpott, Acting Director
Robert Jenness, Audit Manager
Aaron Foote, Lead Auditor
Carole Connolly, Senior Auditor
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Appendix III

Report Distribution List

Commissioner C
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Deputy Commissioner for Services and Enforcement SE
Deputy Commissioner, Large Business and International Division SE:LB
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Director, Office of Program Evaluation and Risk Analysis RAS:O
Office of Internal Control OS:CFO:CPIC:IC
Audit Liaison: Large Business and International Division SE:LB

Appendix IV

Recommended Approach for Business Process Changes

The three figures in this appendix present summary information on the criteria the GAO developed for use when considering, planning, and implementing new business processes or improving existing business processes. The GAO developed the approach based on its *Business Process Reengineering Assessment Guide* and discussions with top-level managers in private industry as well as in other Federal agencies.

Figure 1: Recommended Steps in Considering a Potential Process Change

Steps	Description
Map current process	Similar to flowcharting, process mapping is a graphical representation of the various activities, procedures, roles, and responsibilities within one or more business processes. Its purpose is to help present a clear picture of the current processes to help identify the root causes for under performance and achieve the desired level of improvement.
Identify productivity baselines	Baseline data are needed to provide measures from the current processes to use in comparing the level of improvement achieved by the new process.
Identify causes of poor performance	This step involves identifying the factors or combination of factors that are causing the poor performance in the current process. Examples could include a lack of resources and/or regulatory requirements.
Include complexity and quality in productivity measures	Productivity measures the efficiency with which a process uses resources to produce a product or service, such as the number of audits an IRS examiner completes in a month. To be accurate, a combination of measures is generally needed and consideration is given to the level of difficulty involved.
Measure gap between current and desired productivity	Ideally, the level of performance improvement desired should be achievable and based on empirical data that define where a particular performance level is and where the level of improvement is sought.
Compare current productivity to internal and external benchmarks	Benchmarks are measures from which performance improvement can be quantified. They provide reference points that can be used to help identify and close performance gaps between processes used in other organizations and/or in different functions within the same organization.

Source: TIGTA's summary of the GAO's 20 steps for process improvement.

Figure 2: Recommended Steps for Planning a Process

Steps	Description
Use best practices	Identifying and using best practices is a form of benchmarking that involves adapting practices of others to reach new improvement levels. It is especially recommended that Government agencies use business organizations in private industry for this purpose.
Design process to close productivity gap	Quantitative data are needed to support changing to a new process that shows the change will narrow the gap between current performance and the desired level of performance. To add credibility and avoid any perception of bias in making the change, the desired level of performance sought should be specified.
Analyze alternatives	Alternative process changes that may produce the same level of improvement should be explored in terms of their relative costs and benefits. Such exploration can be done through limited testing and may identify a more cost-effective approach to achieving the same or similar results.
Obtain executive support	Executive support and oversight throughout a process change is important for a number of reasons that include ensuring resources are available, securing support from internal and external stakeholders, and approving proposed recommendations for implementation.
Assess barriers to implementing changes	Identifying and assessing the costs of overcoming potential barriers to implementing a change is important because it may ultimately prove to be too great a burden. Examples of barriers could include laws, regulations, employee union agreements, lack of resources, current political environment, and/or lack of executive support.
Assess resource needs and availability	Before initiating a process improvement project, it is important to ensure that the resources are available to design, plan, and implement the change. Otherwise, there is a risk the new change will be only partially implemented.

Source: TIGTA's summary of the GAO's 20 steps for process improvement.

Figure 3: Recommended Steps for Implementing a Process Change

Steps	Description
Conduct pilot tests	In short, pilot testing is designed to show intended benefits from a change that can in fact be realized. It involves evaluating how well the process change works in practice, pinpointing and correcting problems, and refining performance measures. Importantly, it can also strengthen executive and other stakeholder support for moving from testing to full-scale operation.
Adjust process based on pilot	This step is designed to incorporate and test needed changes to the new process based upon lessons learned in earlier pilot testing.
Define roles and responsibilities	To ensure accountability, it is vital to designate the specific personnel who will be responsible for making the process improvement.
Establish employee expectations	Developing and issuing new performance expectations needs to be considered and developed if the new process causes traditional roles, responsibilities, and expectations to change for employees.
Monitor and evaluate the new process	An evaluation plan is one of the first steps needed for evaluating the success of process change and needs to include a combination of performance measures for weighing the costs of the new process against expected benefits, determining whether the process is achieving desired results, and assessing if further improvements are needed. To enhance credibility and avoid potential bias, the criteria about what would constitute a success needs to be defined.
Establish a change management strategy	Change management is a structured approach for how best to address the transitional issues associated with moving to a new process. These issues, among others, include addressing resistance to a new way of conducting business that may be encountered within an organization or work unit. The approach should be designed to build support and positive attitudes for the change.
Establish a transition team	Typically, a transition team is responsible for managing the implementation of a new process. As such, the team should develop a plan that communicates the various aspects of the new process, its goals, and how it will be implemented.
Develop workforce training plans	In general, employee training plans need to be considered and developed if the change is going to significantly alter traditional roles and responsibilities. For example, employees may need training to learn new technical or communication skill sets if they are going to successfully take on new responsibilities or be expected to work more independently under the new process.

Source: TIGTA's summary of the GAO's 20 steps for process improvement.

Appendix V

Management's Response to the Draft Report

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, DC 20224

COMMISSIONER
LARGE BUSINESS AND
INTERNATIONAL DIVISION

JAN 28 2013

MEMORANDUM FOR ACTING ASSISTANT INSPECTOR GENERAL FOR AUDIT (COMPLIANCE AND ENFORCEMENT OPERATIONS)

FROM: for Heather C. Maloy
Commissioner, Large Business and International Division

SUBJECT: Draft Audit Report – The Compliance Assurance Process Has Been Well-Received, but Additional Analysis of Its Costs and Benefits Is Needed (Audit # 201130045)

Thank you for providing the subject draft audit report for our review and comments. We appreciate the considerable time the Audit Team spent assessing our planning, implementation, and evaluation of the Compliance Assurance Process (CAP) Program to determine whether we followed published guidance and established IRS policies and procedures. Your findings indicate that the CAP is being administered according to established policies and procedures and that the pilot program followed best practices in the design and testing of the CAP process.

Because the CAP was an innovative compliance strategy, its implementation involved major, unique efforts and many internal and external stakeholders. As your report indicates, the IRS used different approaches to reach out to many employees, taxpayers, and stakeholders for suggestions and support of the pilot program. Based on positive feedback from employees and taxpayers participating in the CAP pilot, the IRS made the CAP a permanent program effective March 31, 2012.

The Large Business and International (LB&I) Division has a full set of balanced measures for the CAP, which provides a framework for measuring the success of the program. These measures have been in place since the inception of the CAP pilot. In addition to using our in-place balanced measures, we will continue to develop strategic indicators to enhance our measures and ensure that the CAP does not erode compliance efforts. We will continue to collaborate with the Research, Analysis, and Statistics organization on developing innovative methods for gaining insights into the benefits of the CAP to taxpayers and IRS administration.

The draft audit report states, "CAP audits are consuming substantially more staff hours than those under the traditional audit process" (see Figure 5 and pg. 14 of the draft audit report). While this statement is accurate, we do not believe it draws a meaningful comparison. As we pointed out during the course of the audit, examinations under the CAP consist of a limited population of our largest taxpayers. In contrast, examinations in our traditional examination process consist of examinations of all sizes of corporations in our filing population and also include other types of examinations; for example, claim examinations, reconsiderations of examinations and carryback claim examinations from all taxpayers in our filing population. As a result, as we have stated previously, we do not believe that comparing the hours spent in the CAP to the hours spent in the traditional examination process yields any meaningful result.

Attached is our actions plan addressing the audit recommendations. If you have any questions, please contact Sunita Lough, Director, Pre-Filing and Technical Guidance at (202) 283-8463.

Attachment

3

Attachment

RECOMMENDATION 1:

The Commissioner, LB&I Division, should ensure that an evaluation plan is developed and implemented to thoroughly assess the CAP. At a minimum, the evaluation plan should include clearly stated objectives that measure success against well-defined standards and detailed steps for verifying that sufficient benefits are being realized in relation to the costs being incurred.

CORRECTIVE ACTIONS:

We agree with this recommendation. We will continue to develop and implement an evaluation plan for the CAP, including performance indicators and cost-benefit analyses.

IMPLEMENTATION DATE:

March 31, 2014

RESPONSIBLE OFFICIAL(S):

Director, Pre-Filing and Technical Guidance

RECOMMENDATION 2:

Once the revised IRS-wide user fee guidelines are implemented, the Commissioner, LB&I Division, should ensure the guidelines are used to evaluate the CAP program as a potential new source of user fee.

CORRECTIVE ACTIONS:

Once the IRS-wide user fee guidelines are implemented, we will evaluate the CAP program to determine if it is an appropriate program for user fee.

IMPLEMENTATION DATE:

March 31, 2014

RESPONSIBLE OFFICIAL(S):

Director, Pre-Filing and Technical Guidance

CORRECTIVE ACTION(S) MONITORING PLAN:

4

The LB&I Internal Control Coordinator will track the implementation date for the corrective actions through the Joint Audit Management Enterprise System that tracks implementation of corrective actions addressing audit recommendations.