



*Actions Can Be Taken to Reinforce the
Importance of Recognizing and Investigating
Fraud Indicators During Office Audits*

March 13, 2013

Reference Number: 2013-30-020

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

Redaction Legend:

1 = Tax Return/Return Information

Phone Number | 202-622-6500

E-mail Address | TIGTACommunications@tigta.treas.gov

Website | <http://www.treasury.gov/tigta>



HIGHLIGHTS

ACTIONS CAN BE TAKEN TO REINFORCE THE IMPORTANCE OF RECOGNIZING AND INVESTIGATING FRAUD INDICATORS DURING OFFICE AUDITS

Highlights

Final Report issued on March 13, 2013

Highlights of Reference Number: 2013-30-020 to the Internal Revenue Service Commissioner for the Small Business/Self-Employed Division.

IMPACT ON TAXPAYERS

Penalties, such as for civil fraud, are designed to promote voluntary compliance by imposing an economic cost on taxpayers who choose not to comply with the tax law. Because indicators of fraud are not always recognized and properly investigated, the IRS may be missing opportunities to further promote voluntary compliance and enhance revenue for the Department of the Treasury.

WHY TIGTA DID THE AUDIT

This audit was initiated to determine whether fraud is recognized and pursued during office audits of individual tax returns in accordance with IRS procedures and guidelines. The review is part of our Fiscal Year 2013 Annual Audit Plan and addresses the major management challenge of Tax Compliance Initiatives.

WHAT TIGTA FOUND

TIGTA reviewed a statistical sample of 100 office audits, closed between October 2009 and September 2010, that involved high-income and sole proprietor taxpayers agreeing they owed additional taxes of at least \$10,000. The review identified 26 audits with fraud indicators that were not recognized and investigated in accordance with some key IRS procedures and guidelines. When the sample results are projected to the population of 3,674 closed office audits meeting the above characteristics, TIGTA estimates that fraud indicators were not recognized and investigated in approximately 939 office audits during Fiscal Year 2010.

TIGTA estimates that additional assessments totaling approximately \$5.8 million in civil fraud penalties may have been avoided by taxpayers.

TIGTA's evaluation indicates that a combination of factors caused the quality problems and that actions can be taken at the examiner and first-line manager levels to better ensure that fraud indicators are recognized and properly investigated.

WHAT TIGTA RECOMMENDED

TIGTA recommended that the Director, Exam Policy, Small Business/Self-Employed Division: 1) standardize the process for office audit examiners' documentation of fraud consideration by developing and implementing a specific job aid that requires examiners to acknowledge which indicators, if any, were considered during the audit and 2) develop additional criteria and guidance for when a discussion should be held between the examiner and first-line manager about the potential fraudulent activity of the taxpayer to cover instances other than omissions of income.

IRS management partially agreed with both recommendations. For the first recommendation, the IRS plans to review existing guidelines and make revisions to standardize the process for documenting the consideration of fraud. TIGTA believes this planned corrective action is responsive to the recommendation.

For the second recommendation, the IRS plans to provide a guidance memorandum to emphasize when a discussion should be held between the examiner and first-line manager about potential fraudulent activity. However, it did not agree to provide additional criteria related to overstated deductions. As such, it is unlikely that the corrective action will be effective. Overstated deductions can be just as egregious as omissions of income and result in the same tax loss to the Government. Moreover, the IRS agreed that the recommendations have the potential to increase revenue by \$29 million over five years. Therefore, TIGTA continues to believe the IRS should expand the requirement for examiners and first-line managers to discuss potential fraudulent behavior beyond unreported income.



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

March 13, 2013

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED
DIVISION

FROM:

Michael E. McKenney
Acting Deputy Inspector General for Audit

SUBJECT:

Final Audit Report – Actions Can Be Taken to Reinforce the
Importance of Recognizing and Investigating Fraud Indicators During
Office Audits (Audit # 201130022)

This report presents the results of our review to determine whether fraud is recognized and pursued during office audits of individual tax returns in accordance with Internal Revenue Service (IRS) procedures and guidelines. The review is part of our Fiscal Year 2013 Annual Audit Plan and addresses the major management challenge area of Tax Compliance Initiatives.

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

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

BSA	Bank Secrecy Act
FTA	Fraud Technical Advisor
FY	Fiscal Year
IRM	Internal Revenue Manual
IRS	Internal Revenue Service
NQRS	National Quality Review System
SB/SE	Small Business/Self-Employed
TIGTA	Treasury Inspector General for Tax Administration



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Background

Tax fraud is a deliberate and purposeful violation of Internal Revenue laws by those who do not file and properly report their income and expenses. Tax fraud requires both an underpayment and fraudulent intent, and it can be considered one of the most egregious forms of noncompliance.

According to the Internal Revenue Manual (IRM), the discovery and development of fraud is the result of effective investigative techniques. The investigative techniques employed by examiners are designed to disclose not only errors in accounting and application of tax law but also irregularities that indicate the possibility of fraud. At a minimum, the IRM indicates that examiners should exercise sound judgment and follow up on all fraud indicators by performing necessary investigative techniques, such as interviewing the taxpayer or substantiating information obtained from the taxpayer with third parties. The IRM emphasizes that fraud will not ordinarily be discovered when examiners readily accept the completeness and accuracy of the records presented and the explanation offered by the taxpayer. It is necessary for examiners to explore records and to probe beneath the surface to validate information provided and statements made in order to evaluate the credibility of evidence and testimony provided by the taxpayer.

During audits, Internal Revenue Service (IRS) examiners are largely focused on determining whether the correct tax liability has been reported. However, if an examiner suspects there are indications that a taxpayer may have committed tax fraud,¹ the examiner should first discuss the audit with their first-line manager.² If the first-line manager determines that there are indicators of fraud warranting development, then he/she would advise the examiner to contact an IRS Fraud Technical Advisor (FTA)³ to help determine whether to pursue imposing a civil fraud penalty or whether the audit file should be referred to IRS Criminal Investigation for possible criminal prosecution. If imposed, the civil fraud penalty is equal to 75 percent of the tax owed that is attributable to fraud, plus interest on the penalty amount. Although civil and criminal tax fraud involves significant dollars in penalties and fines annually, criminal tax fraud is considerably more serious because it can involve prosecution costs and jail time.

To pursue the civil fraud penalty, Small Business/Self-Employed (SB/SE) Division office examiners need to coordinate with their first-line managers and FTAs to complete a Form 11661, *Fraud Development Recommendation – Examination*. Form 11661 is used to document the

¹ Tax fraud consists of both civil and criminal tax fraud.

² See Appendix VII for a glossary of terms.

³ The FTA serves as a resource person and liaison to compliance employees in all IRS operating divisions. The FTA is available to assist in fraud investigations and offer advice on matters concerning tax fraud.



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FTA's involvement and place an audit in fraud development status. Once an office audit is placed in fraud development status, a plan of action is usually developed jointly with the examiner, first-line manager, and FTA to establish affirmative acts (proof) of fraud and guide the investigation to its appropriate conclusion in a timely manner. Although the investigation plan of action is jointly developed, the ultimate decision to both further investigate suspected fraudulent behavior and seek the assistance of an FTA rests with the experience and judgment of each of the many first-line managers. For Fiscal Years (FY) 2008 through 2011, SB/SE Office Examination placed, on average, 172 audits into fraud development status (Forms 11661 were completed) out of the approximately 127,100 office audits closed each year. Of the 172 audits placed into fraud development status, SB/SE Office Examination recommended that 96⁴ audits result in taxpayers being assessed a civil fraud penalty.

This review was performed at the SB/SE Division Examination function in New Carrollton, Maryland, and the IRS National Headquarters in Washington, D.C., during the period July 2011 through July 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 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.

⁴ The Fraud/Bank Secrecy Act function provided data from the National Fraud Program database system, from which we determined the average number of taxpayer accounts placed into fraud development status and the number of times that one or more civil fraud penalties were recommended. Subsequent to our closing meetings, the SB/SE Division Examination function provided an analysis performed by the Office of Servicewide Penalties of data from the Enforcement Revenue Information System, which showed that, on average, 123 civil fraud penalties were assessed annually during FYs 2008 through 2011. Given the receipt date of this assessment information, we did not attempt to validate the number of civil fraud penalties assessed. According to IRS officials, the reason for the difference between the number of civil fraud penalties recommended and assessed is due to the Fraud/BSA and the Office of Servicewide Penalties' tracking methods. For example, a taxpayer could be assessed more than one civil fraud penalty if fraud is identified on more than one return during a multiple tax period examination. Regardless of the number of civil fraud penalties recommended for the taxpayer with an account placed into fraud development status, Fraud/BSA would record one recommendation per taxpayer, whereas the Office of Servicewide Penalties would record the total number of penalties assessed.



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Results of Review

The Treasury Inspector General for Tax Administration (TIGTA) reviewed a statistical sample of 100 closed office audits of high-income and sole proprietor taxpayers with additional agreed tax assessments of \$10,000 or more. This review found 26 audits with fraud indicators that were not recognized and investigated in accordance with some key IRS procedures and guidelines. As a result, opportunities may have been missed to further promote voluntary compliance and enhance revenue for the Department of the Treasury. The TIGTA's evaluation indicates that a combination of factors caused the quality problems and that actions can be taken at the examiner and first-line manager levels to better ensure that fraud indicators are recognized and properly investigated.

Numerous Management Controls Have Been Developed to Help Ensure That Fraud Is Emphasized and Considered During Audits

The IRS relies on its examiners and their first-line managers to ensure that the civil fraud penalty is adequately considered. To assist examiners and first-line managers in meeting this responsibility, the IRS has developed and implemented a number of policies, procedures, and techniques (management controls). At the agency level, broad policy statements provide guidance nationwide to IRS personnel. Of the 184 IRS Policy Statements, 36 cover examination issues, such as taxpayer rights and examiner responsibilities.

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

At the first-line manager level, the performance management system requires that, at the beginning of each fiscal year, first-line managers coordinate with their respective territory managers to set forth commitments in their individual performance plans. The commitments are intended to provide the basis for linking the first-line managers' critical job responsibilities with the IRS's balanced measures and strategic goals and holding them accountable for their individual and team performances. To realize these benefits, the commitments are to be related



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to at least one critical job responsibility. They should also, according to the IRS,⁵ specifically describe the actions to be taken, include a deadline, indicate an expected result, and include some means of verifying whether the commitment was met. Our review of the FY 2009 through December 2011 performance agreements for a judgmental sample⁶ of 20 first-line managers found that all 20 managers received clear and specific commitments related to fraud consideration. We found, for example, commitments that stated:

- *I will improve the quality, effectiveness and efficiency of income probes and fraud development. I will deliver tools and training to examiners supporting income examination techniques. I will consult with the National Fraud Program on a quarterly basis to review fraud performance, identify best practices and collaborate on potential areas of improvement. I will create an environment conducive to recognition of fraud indicators and development of cases that meet the quality attributes. Measure: Success will be measured by supporting an improvement in overall Area case quality scores; and delivering improvement in National Quality Attribute 300 (Income Determination) by providing tools and training through Income Determination Workshops and discussions at the group level.*
- *I will support the development of quality fraud referrals by coordinating with the FTA, communicating effective audit techniques to my employees, and by conducting timely, productive four-way meetings with the IRS's Criminal Investigations Division. I will conduct a fraud awareness group meeting jointly with the National Fraud Program by June 30, 2010. Through managerial engagement in case activities, I will ensure correct and timely actions are taken in cases with indicators of fraud, as required by the Embedded Quality attributes. Success will be measured based on timeliness in conducting a fraud awareness group meeting, timeliness in conducting four-way conferences and documentation of managerial engagement activities.*

As noted in the examples above, managers were required to complete certain actions related to fraud within a specific time period. We believe that territory managers should be able to use these types of commitments to hold first-line managers responsible for meeting expectations, including fraud consideration.

At the group level, first-line managers are also an important control component because they are responsible for the quality of work performed by the examiners they supervise. A variety of techniques are used to ensure that examiners follow applicable standards and procedures when they identify fraud indicators. These techniques include performance observations, discussions with examiners, and reviews of audit file documentation during audits and after they are closed. Through these observations, discussions, and reviews, first-line managers attempt to identify

⁵ See, for example, the IRS Human Capital Office guide entitled, *Writing Performance Commitments "A Reference Guide for Managers and Management Officials"* (Oct. 2011).

⁶ A judgmental sample is a nonstatistical sample, the results of which cannot be used to project to the population.



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problems so examiners can take prompt corrective actions. Our review of the FY 2009 through December 2011 performance appraisals and the Embedded Quality Review System for a judgmental sample of 20 examiners found that 19 of the 20 examiners received feedback related to fraud consideration.

The IRM is another important control component because it contains the official compilation of detailed instructions and explanations of fraud consideration for examiners to follow during audits. Throughout the IRM, examiners are instructed to properly document, in audit case files, all aspects of their work during the planning, initiating, conducting, and closing phases of audits. Audit case file documentation is important because it provides the principal evidence that procedures were followed as well as the foundation for other control processes such as managerial reviews and the quality measurement reviews. The importance of examiner documentation is further emphasized in management directives, examiner training materials, and the quality measurement standards.

In addition to the above controls, SB/SE Division management has continued to implement various approaches to emphasize the expectation that examiners identify, pursue, and develop fraud indicators. Specifically, following TIGTA reports issued in FY 2007⁷ and FY 2012,⁸ the Examination and Fraud/Bank Secrecy Act (BSA) functions took or plan to take the following actions:

- Issued a December 2007 memorandum to examiners reinforcing managerial and FTA involvement and the documentation of actions in the development of fraud cases.
- Implemented a case management tool that assists the FTAs in tracking the cases referred by examiners for further fraud development. This tool also facilitates cases to be reconciled to the Fraud/BSA function's internal database and allows management to monitor FTA staffing needs.
- Highlighted the importance of the required discussion with the first-line manager to consider the potential for fraudulent activity when the examiner identifies an understatement of taxable income⁹ greater than \$10,000 (a fraud indicator) in the August 2010 issue of *Fraud Digest*, a quarterly publication by SB/SE Division's Technical Services.
- Developed a checklist¹⁰ that lists the fraud indicators and fraud penalty considerations. The checklist is an optional tool that may be used by examiners during audits.

⁷ TIGTA, Ref. No. 2007-30-179, *Management Has Emphasized the Fraud Program, but Opportunities Exist to Further Improve It* (Sept. 2007).

⁸ TIGTA, Ref. No. 2012-30-030, *Actions Can Be Taken to Reinforce the Importance of Recognizing and Investigating Fraud Indicators During Field Audits* (Mar. 2012).

⁹ Taxable income is all income received minus allowable IRS deductions.

¹⁰ See Appendix V for an example of the Fraud Checklist.



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- Provided examples of case studies illustrating proper development of fraud indicators for consideration of the civil fraud penalty in each quarterly issue of the *Fraud Digest* since November 2007.
- Enhanced the *Fraud Development Lead Sheet*¹¹ in March 2011 to include IRM references and guidelines related to fraud development and the indicators of fraud.
- Developed and implemented additional fraud training during FY 2012 that provided examiners with tips on effective interviewing techniques as well as stressed the importance of expanding audits to include prior and subsequent tax returns when similar tax issues exist.
- Provided guidance to first-line managers during FY 2012 to improve the effectiveness and quality of performance feedback given to examiners as it related to the expansion of audits.
- By April 2013, issue a joint memorandum from the Directors of Examination Policy and Fraud/BSA to all Examination compliance employees highlighting fraud awareness expectations, responsibilities, and proper involvement of FTAs.

Although there are layers of management controls in place to guide examiners through the consideration of fraud, our results indicate that additional steps are needed to ensure that potential fraud is adequately considered and investigated during office audits.

Opportunities May Have Been Missed to Enhance the Contribution Fraud Penalties Make to Compliance

As noted earlier, IRS records show that the civil fraud penalty is rarely recommended for office audits. Specifically, during FYs 2008 through 2011, SB/SE Division office examiners recommended, on average, that 96 taxpayers be assessed a civil fraud penalty out of the approximately 127,100 office audits closed each year. According to the IRS, penalties, such as for civil fraud, promote voluntary compliance by imposing an economic cost on taxpayers who choose not to comply with the tax law. Consequently, when penalties are not properly considered and assessed, opportunities can be missed to provide economic disincentives for noncompliance, promote future compliance, and enhance revenue for the Department of the Treasury.

We evaluated a statistical sample of 100 office audits of high-income and sole proprietor taxpayers with additional agreed tax assessments of \$10,000 or more that were closed between

¹¹ See Appendix VI for the Fraud Development Lead Sheet.



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October 2009 and September 2010. This review identified 26 (26 percent)¹² office audits for which fraud indicators were not recognized and investigated in accordance with IRS procedures and guidelines. For example, in 14 of the 26 office audits, the audit case files lacked adequate documentation to support that the taxpayers were questioned as to the reasons why income was understated and/or deductions were overstated. *****]*****
*****]*****
*****]. In addition, we found no evidence that the taxpayers involved in all 14 of these audits were questioned about the overstated deductions, which ranged from approximately \$35,000 to \$288,000.¹³ Furthermore, according to the information included in the audit case files in 10 of the 26 office audits, third parties were not contacted to validate taxpayers' assertions about who was responsible for omitting income and/or overstating deductions. We found several instances, for example, where the taxpayers stated that return preparers caused the errors. However, we found no evidence indicating that the return preparers were contacted by the examiners to confirm the taxpayers' statements. We also found that in four of the 26 audits, the audits were not expanded to include the taxpayers' subsequent year returns despite the fact that similar tax issues existed on those returns. According to Fraud/BSA officials, a multiyear pattern of noncompliance is a strong indicator of potential fraud.

There was no evidence of FTA involvement despite the presence of fraud indicators

Although the behaviors included large amounts of understated income, substantial overstatement of business expenses, and failure to keep adequate books and records, we found no evidence of FTA involvement in any of the 26 office audits, even though all had at least two fraud indicators and resulted in an additional tax assessment of at least \$10,000. The IRM specifies that when there are fraud indicators to investigate, a discussion should be initiated with the first-line manager. If the first-line manager concurs that there are indicators of fraud warranting fraud development, the examiner should contact an FTA to help evaluate the risk posed and, if warranted, develop an investigative action plan. The FTAs are generally selected from the ranks of experienced IRS examiners, and the IRS considers the FTAs subject matter experts because they are specifically trained to assist other examiners on the complexities of applying laws, regulations, and procedures governing the development of criminal and civil tax fraud cases.

The first-line manager is the primary control to ensure FTA involvement in an audit when fraud indicators are detected. However, neither the IRM nor supplemental IRS guidance provides specific criteria or examples where first-line managers are strongly encouraged to involve an FTA in an office audit. Instead, the ultimate decision to both further investigate suspected

¹² Amount is rounded to the nearest percent and represents the weighted average exception rate of 25.55 percent with a 95 percent confidence level (± 8.87 percent precision). See Appendix IV for the calculation.

¹³ For these 14 audits, the total overstated deductions which the taxpayers were not questioned about amounted to nearly \$1.4 million.



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fraudulent behavior and seek the assistance of an FTA rests with the experience and judgment of each of the many first-line managers. As a result, the technical and procedural expertise the FTAs possess is not always taken advantage of when warranted.

In response to TIGTA's FY 2012 report that addressed fraud consideration during field audits, the IRS agreed to issue a memorandum to all Examination function compliance employees emphasizing the importance of involving an FTA in audits when there are indicators of fraud, along with highlighting fraud awareness expectations and responsibilities and proper involvement of FTAs. Although the IRS's planned alternative corrective action is responsive to recommendations in the report, we continue to believe it will be important for the IRS to go beyond merely reiterating existing IRM procedures in their memorandum and provide additional instructions and guidance that clarify when the assistance of an FTA should be sought in an audit rather than leaving the decision largely to the experience and judgment of the first-line manager. Such clarification is important given the compliance implications and the potential revenue at stake.

The IRS agreed with our conclusions that fraud was not adequately considered and investigated in all 26 of our exception audits. When the sample results are projected to the population of 3,674 closed office audits, we estimate that fraud indicators were not recognized and investigated in approximately 939 office audits during FY 2010. The projection is based on a 95 percent confidence level. We expect the number of office audits where fraud was not adequately considered to fall between 613 and 1,265. We estimate that additional assessments totaling approximately \$5.8 million¹⁴ in civil fraud penalties may have been avoided by taxpayers.

IRS quality reviews have also identified problems with fraud consideration

Recent reports issued by the SB/SE Division's National Quality Review System (NQRS) staff have also noted problems with the quality of fraud consideration performed by examiners. For example, for FY 2011, the NQRS staff reported that examiners did not meet the standard for determining if fraud indicators were pursued and developed in 50 percent of the office audits reviewed for which fraud consideration was applicable. The primary issue that the NQRS staff identified was that the required manager discussion was not held when the examiner identified an understatement of income greater than \$10,000.¹⁵ Additionally, in a small percentage of office audits, the NQRS staff found other issues, such as a failure to consider potential fraud as a result

¹⁴ Our calculation assumes that the civil fraud penalty could have been assessed on 56 percent of the audits that we determined were exceptions and is based on our analysis of readily available IRS data. We are unable to quantify the degree of uncertainty associated with the estimated \$5.8 million in additional assessments because of the variability in the dollars assessed for the population of exception audits and the uncertainty as to which of the individual exception audits could have resulted in a civil fraud penalty assessment. See Appendix IV for more details.

¹⁵ The IRS methodology used income instead of taxable income in determining when first-line manager involvement would be appropriate. Taxable income factors both income and any IRS deductions.



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of overstated expenses and a failure to document the content of a first-line manager discussion and resulting decision to not pursue fraud when fraud should have been pursued.

Although we did not audit the accuracy of results reported by the SB/SE Division's quality measurement staff, one reason that could account for the difference between our results (26 percent) and those reported by the SB/SE Division's quality measurement staff (50 percent) was the methodology used to evaluate the office audits. For example, the SB/SE Division's methodology considers an audit an exception if there is an understatement of income greater than \$10,000 and the examiner did not discuss the understated income with the first-line manager. For our review, we considered whether investigative techniques were properly performed given the fraud indicators present in the audit case file. Therefore, our methodology would not take exception with an audit when the investigative techniques were properly performed even when a discussion with the first-line manager had not occurred.

To address the concerns identified by the NQRS staff for FY 2011, the SB/SE Division Examination function reemphasized the importance of fraud consideration to examiners and their managers using the Division's *Technical Digest* newsletter. The SB/SE Division Examination function also placed an emphasis upon improving overall quality performance with Area Directors' commitments linked to quality performance. For the third quarter of FY 2012, the NQRS staff reported that examiners continued to not meet the standard relating to pursuing and developing fraud indicators in 37 percent of the office audits reviewed for which fraud consideration was applicable. The fact that NQRS results show that about one out of every three audits in which fraud consideration was applicable is not meeting standards for considering fraud suggests there may be room to better ensure that fraud indicators are recognized and properly investigated.

Audit case files showed that fraud indicators were not always recognized

Among the initial steps examiners need to take when investigating taxpayers that may be involved in fraudulent activities is to recognize and document audit case files with indicators of such behavior. To assist examiners with recognizing fraudulent behavior, the IRM lists the following six categories of fraud indicators: income, expenses or deductions, books and records, conduct of taxpayer, methods of concealment, and income allocation. Each category, in turn, contains specific examples of supporting behavior that range from omitting income, substantially overstating expenses, failing to keep adequate records to attempt to hinder the audit, making false statements, and failing to disclose relevant facts to an accountant.¹⁶

Office audit examiners have several tools available to assist them with fraud consideration, such as the *Fraud Checklist* that lists the IRM fraud indicators and fraud penalty considerations and the *Fraud Development Lead Sheet*, which contains specific directions to follow in considering,

¹⁶ These categories are not all inclusive and only indicate the types of actions taxpayers may take to deceive or defraud.



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developing, and pursuing a civil fraud penalty or, if warranted, a referral to IRS's Criminal Investigation. However, office audit examiners are not required to use the *Fraud Checklist* or *Fraud Development Lead Sheet*. Instead, IRS officials stated that although office audit examiners are required to document the consideration of fraud along with identifying fraud indicators, the decision of where to include such documentation in case files is left up to the discretion of each examiner.¹⁷ Our review of the information included in the audit case files found that not all fraud indicators were recognized and documented in the 26 audit case files where we determined fraud was not adequately considered. Our analysis of these conditions, along with a prior audit's results,¹⁸ indicate that it would be beneficial to designate a specific job aid, such as one similar to the *Fraud Development Lead Sheet* used by field audit examiners, to be completed and included in office audit examiners' audit case files. The job aid could list fraud indicators and require examiners to acknowledge which indicators, if any, were considered during the audit. Standardizing the process and providing guidance on the form would likely involve minimal costs since a similar job aid already exists and the fraud indicators have already been identified and are listed in the IRM and on the optional *Fraud Checklist*. If well-designed, the job aid could provide an effective tool to reinforce the importance of examiners ensuring that fraud indicators are recognized, investigated, and documented during audits. The job aid could also help facilitate managerial reviews after examiners submit the audit case file for closing actions and be used in third-party reviews, such as NQRS reviews, as a quality control and measurement instrument.

The first-line managers could have a greater role in the decision process to investigate fraud indicators

At the time the examiners completed the audits in our sample, the IRM required that examiners discuss the audit with their first-line manager when there was an understatement of taxable income greater than \$10,000 so important decisions could be made about whether the audit scope, depth, or techniques should be changed to investigate the potential for fraudulent activity. In all 26 office audits where fraud was not adequately considered, we found evidence in the audit file of first-line manager involvement; however, we did not find adequate documentation in the audit case files to indicate that a discussion was held about the potential fraudulent activity of the taxpayer.

During discussions with IRS officials, we learned that the IRM requirement was later revised¹⁹ in May 2011 to indicate that the first-line manager discussion requirement only applied when there was an understatement of income greater than \$10,000. As a result, examiners are no longer

¹⁷ There is no standardized process for documenting fraud consideration; however, there are several places where the examiner could document fraud consideration such as on the activity record in the case file.

¹⁸ TIGTA, Ref. No. 2012-30-030, *Actions Can Be Taken to Reinforce the Importance of Recognizing and Investigating Fraud Indicators During Field Audits* (Mar. 2012).

¹⁹ According to the IRS, the May 2011 revision is a correction to the prior version of the IRM.



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required to have a discussion with their first-line manager regarding fraud consideration for understatements of taxable income greater than \$10,000 resulting from only overstated deductions. Although we agree that understatements of income by more than \$10,000 is egregious and would warrant involvement of the first-line manager, overstated deductions can be equally egregious and would often warrant the same scrutiny by the first-line manager to better ensure that fraud indicators are adequately considered and investigated. For instance, our review found that 22 of the 26 exception audits²⁰ in our sample had adjustments solely due to overstated deductions. Since these 22 audits only involved overstated deductions, the examiner would no longer be required to discuss with his/her first-line manager the potential fraudulent activity of the taxpayer relating to those overstated deductions that ranged from approximately \$33,000 to \$288,000 and resulted in additional tax assessments of about \$10,000 to \$70,000 per audit.²¹

This finding, combined with the NQRS staff's finding that overstated deductions were not always considered for potential fraud during office audits, indicates that the requirements for discussing the potential fraudulent activity of the taxpayer with a first-line manager could be enhanced. Specifically, the outcome of the managerial reviews and decisions to pursue and investigate civil fraud may have been different had the examiners held discussions with their first-line manager about the potential of fraudulent activity of the taxpayer relating to the understated income and/or overstated deductions that met specific criteria and/or a minimum dollar threshold. During this audit, we also met with IRS Criminal Investigation officials, who agreed that overstated deductions can be equally egregious as omissions of income and result in a tax loss to the Government.

Recommendations

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

Recommendation 1: Standardize the process for office audit examiners' documentation of fraud consideration by developing and implementing a specific job aid that requires examiners to acknowledge which indicators, if any, were considered during the audit.

Management's Response: IRS management partially agreed with this recommendation. Specifically, IRS management will review the IRM and lead sheets 205, *Fraud Development Lead Sheet*, and 300, *Civil Penalty Approval form*, and make necessary revisions to standardize the process for office audit examiners' documentation of fraud consideration.

²⁰ The remaining four of the 26 audits had understated income by at least \$10,000, which would have required a discussion with the first-line manager. We did not find evidence in the audit case file to support that a discussion was held between the examiner and the first-line manager.

²¹ For the 22 audits, the total additional tax assessment was approximately \$497,000.



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Office of Audit Comment: We considered the planned corrective action and concluded that it is responsive to our recommendation. However, we encourage IRS management to ensure that the revisions they decide to make to standardize the process for office audit examiners' documentation of fraud consideration include a requirement that examiners specifically acknowledge which indicators, if any, were considered during the audit.

Recommendation 2: Develop additional criteria and guidance for when a discussion should be held between the examiner and first-line manager about the potential fraudulent activity of the taxpayer to cover instances other than omissions of income.

Management's Response: IRS management partially agreed with the recommendation. Specifically, IRS management will provide additional guidance emphasizing when a discussion should be held between the examiner and first-line manager about potential fraudulent activity of the taxpayer by issuing a memorandum to compliance employees highlighting fraud awareness, responsibilities, and proper involvement of managers and FTAs. However, IRS management does not believe it is appropriate to provide additional specific criteria for when a discussion must be held between the examiner and first-line manager.

Office of Audit Comment: TIGTA believes that the planned corrective action is not adequate because it does not address the additional criteria that we recommended. As such, it is unlikely that the IRS's corrective action will be effective.

As noted in the report, the IRS Criminal Investigation officials we spoke with agreed that overstated deductions can be equally egregious as omissions of income and result in the same tax loss to the Government. In addition, IRS management agreed with our conclusions that fraud was not adequately considered and investigated in all 26 of our exception audits, of which 22 involved only overstated deductions. Further, as noted in their response, IRS management agreed that the recommendations have the potential to increase revenue by an estimated \$5.8 million a year (\$29 million over five years). Therefore, TIGTA continues to believe the IRS should expand the requirement for examiners and first-line managers to discuss potential fraudulent behavior beyond unreported income.



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Appendix I

Detailed Objective, Scope, and Methodology

The objective of this review was to determine whether fraud is recognized and pursued during office audits¹ of individual tax returns in accordance with IRS procedures and guidelines.

To accomplish this objective, we:

- I. Evaluated the adequacy of controls for ensuring fraud penalties are adequately considered and applied during office audits.
 - A. Documented the applicable Internal Revenue Code sections, Treasury Regulations, IRM sections, management directives, examiner training materials, and IRS public announcements and notices that provide the authority and reasons for assessing the penalty.
 - B. Interviewed IRS officials to obtain an understanding of all policies, procedures, and techniques (management controls).
 - C. Obtained quality review results related to fraud consideration in office audits from the NQRS and the Embedded Quality Review System to determine any areas identified for improvement and the actions taken by management to address weaknesses in the areas identified.
- II. Determined whether examiners followed procedures and guidelines during consideration of the civil fraud penalty and the potential tax effect of noncompliance.
 - A. Obtained an extract from the Audit Information Management System of office audits closed by office examiners (Employee Group Codes 2000 through 2999) between October 1, 2009, and September 30, 2010, for sole proprietor Form 1040² returns (Activity Codes 274 through 277) and high-income taxpayers (total positive income³ over \$200,000) (Activity Codes 279 through 281) that had an agreed assessment equal to or greater than \$10,000. From this extract, only those records with a Fraud Condition Indicator Code of 00 or blank were selected. Any records for which the civil fraud penalty was applied were removed from the population. This was performed by matching the remaining records against the Individual Master File and eliminating any records with a dollar amount in Transaction Code 320 (Fraud

¹ See Appendix VII for a glossary of terms.

² Form 1040, *U.S. Individual Income Tax Return*.

³ Total positive income is sum of the total positive values from the following income fields (losses are treated as a zero): wages, interest, dividends, other income, distributions, Schedule-C Net Profits, and Schedule-F Net Profits.



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- Penalty) and Transaction Code 240 with Penalty Reference Number 686 (Accuracy-Related Penalty for Fraudulent Failure to File).
- B. Validated the data by comparing the data to the Integrated Data Retrieval System and the IRS's Statistics of Income Table 37, which proved the data were sufficiently reliable for the purposes of this report.
 - C. Stratified the population of office audits identified in Step II.A into three strata based on the amount of additional tax assessed. See Figure 1 of Appendix IV for details regarding each of the three strata. We then selected a statistical sample of 100 closed office audits using a 95 percent confidence level, ± 10.19 percent precision rate, and 50 percent occurrence rate as discussed with TIGTA's contracted independent statistician. A statistical sample was taken because we wanted to estimate the number of audits and amount of dollars associated with not properly considering the fraud penalty for a population of 3,674 office audits. We shared our sampling and outcome measure methodologies with an outside statistical expert who confirmed the accuracy of our methodology and projection.
 - D. Determined whether examiners are complying with the procedures and guidelines required for considering the fraud penalty.
 - E. Assessed whether examiners adequately considered the fraud penalty during office audits and whether there may be opportunities to enhance revenue. For revenue enhancements, we calculated the potential penalty amount by multiplying the 75 percent civil fraud penalty rate by the agreed assessment amount and subtracting any amounts previously assessed for accuracy-related penalties.
- III. Assessed the emphasis placed on recognizing, considering, and developing fraud in the performance feedback provided to examiners and first-line managers.
- A. Summarized the performance feedback given to a judgmental sample⁴ of 20 examiners included in our audit reviews during FY 2009 through December 2011 by extracting the requisite information recorded in the Embedded Quality Review System attribute dealing with recognizing, considering, and developing fraud (*i.e.*, Attribute 407). We used judgmental sampling to select the examiners because we did not plan to project our results.
 - B. Reviewed the FY 2009 through December 2011 midyear and annual appraisals and summarized feedback related to recognizing, considering, and developing fraud that was given to the judgmental sample of 20 examiners identified in Step III.A.
 - C. Identified the first-line manager for each of the 20 examiners identified in Step III.A and evaluated the FY 2009 through December 2011 performance expectations for the

⁴ A judgmental sample is a nonstatistical sample, the results of which cannot be used to project to the population.



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first-line managers to determine if there were any commitments or expectations relating to asserting the fraud penalty. We used judgmental sampling to select the first-line managers because we did not plan to project our results.

Internal controls methodology

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined the following internal controls were relevant to our audit objective: IRS policies, procedures, and practices for determining whether examiners are recognizing and pursuing fraud indicators during office audits. We evaluated these controls by reviewing source materials, interviewing management, and reviewing a statistical sample of 100 examined closed office audits.



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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, Acting Assistant Inspector General for Audit (Compliance and Enforcement Operations)

Michelle Philpott, Acting Director

Alberto Garza, Acting Audit Manager

Tina Fitzsimmons, Lead Auditor

Malissa Livingston, Lead Auditor

Donna Saranchak, Lead Auditor

Jean Kao, Senior Auditor

Levi Dickson, Auditor



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Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Deputy Commissioner for Services and Enforcement SE
Deputy Commissioner, Small Business/Self-Employed Division SE:S
Director, Campus Compliance Services, Small Business/Self-Employed Division SE:S:CCS
Director, Communications, Liaison, and Disclosure, Small Business/Self-Employed Division
SE:S:CSO
Director, Examination, Small Business/Self-Employed Division SE:S:E
Director, Campus Reporting Compliance, Small Business/Self-Employed Division
SE:S:CCS:CRC
Director, Exam Policy, Small Business/Self-Employed Division SE:S:E:EP
Director, Exam Planning and Delivery, Small Business/Self-Employed Division SE:S:E:EPD
Chief Counsel CC
National Taxpayer Advocate TA
Director, Office of Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis RAS:O
Office of Internal Control OS:CFO:CPIC:IC
Audit Liaison: Commissioner, Small Business/Self-Employed Division SE:S



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Appendix IV

Outcome Measure

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

Type and Value of Outcome Measure:

- Increased Revenue – Potential; \$5.8 million from additional penalties assessed for 939 office audits;¹ \$29 million over five years (see page 8).

Our calculation assumes that the civil fraud penalty would have been recommended, assessed, and sustained upon any taxpayer appeal, on the entire amount of additional taxes owed for 56 percent of the office audits that we determined were exceptions if the examiners adequately considered and investigated the potential fraudulent activity of the taxpayer during the audit.

We limited our penalty calculation to 56 percent of the audits based on analyzing readily available IRS data that suggest more than half² of the office audits placed in fraud development status result in a civil fraud penalty recommendation. Specifically, IRS data showed that in FYs 2008 through 2011, an average of 172 taxpayer accounts were placed into fraud development status (Forms 11661, *Fraud Development Recommendation – Examination*, were completed) annually during office audits in the SB/SE Division. IRS data also showed that in FYs 2008 through 2011 a civil fraud penalty was recommended for an average of 96 taxpayers annually during SB/SE Division office audits. Therefore, we calculated the 56 percent by dividing the 96 taxpayers for whom a civil fraud penalty was recommended by the 172 taxpayers who had accounts placed into fraud development status [$96 / 172 = 56$ percent].

Additionally, this calculation is net of any accuracy-related penalties that were previously assessed during the office audits. Further, the value of the outcome measure does not include

¹ See Appendix VII for a glossary of terms.

² The approximate percentage was calculated by taking the number of civil fraud penalty recommendations and dividing by the number of Forms 11661 completed over the four-year period. We did not analyze the data to determine whether the civil fraud penalty was recommended within the same year that the taxpayer account was placed into fraud development status. Therefore, the approximate percentage for the four-year period may differ as it may include completion of a Form 11661 in a different year than when the civil fraud penalty was recommended. A four-year average is provided to account for the potential overlap between fiscal years.



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amounts (revenue) that would partially offset this benefit as a result of directing examination resources away from other taxpayer returns in order to pursue the civil fraud penalty cases.

Methodology Used to Measure the Reported Benefit:

To estimate the potential additional revenue associated with the difference between the number of civil fraud penalties assessed and the number that should be assessed in sole proprietor and high-income taxpayer office audits, we reviewed a statistically valid stratified sample, as shown in Figure 1, of 100 office audits from a population of 3,674 office audits of sole proprietors and high-income taxpayers that were closed between October 1, 2009, and September 30, 2010, with an agreed assessment equal to or greater than \$10,000.

Figure 1: Statistical Sampling Data

Strata	Universe Size per Stratum	Sample Size per Stratum
Stratum 1: Tax assessment of \$250,000 or greater	2	2
Stratum 2: Tax assessment between \$50,000 and \$249,999	93	11
Stratum 3: Tax assessment between \$10,000 and \$49,999	3,579	87
Totals	3,674	100

Source: TIGTA analysis of: 1) an extract from the Audit Information Management System of office audits closed between October 2009 and September 2010 for sole proprietor and high-income taxpayers with an agreed assessment equal to or greater than \$10,000 and for which fraud penalties were not applied and 2) TIGTA's sampling plan.

- Calculated the weighted average error rate for our sample, which was required due to our stratified sampling methodology.
 - Prior to determining our overall weighted average error rate for our sample, we first had to determine the weight of each stratum in our universe. To do so, we divided the number of office audits in each stratum by the total office audits in the universe, as shown in Figure 2.



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Figure 2: Weight of Strata in Universe

Strata	Universe Size per Stratum	Weight of Each Stratum in Universe (Stratum Universe Size / Total Universe Size) ³
Stratum 1: Tax assessment of \$250,000 or greater	2	0.06%
Stratum 2: Tax assessment between \$50,000 and \$249,999	93	2.53%
Stratum 3: Tax assessment between \$10,000 and \$49,999	3,579	97.41%
Totals	3,674	100.00%

Source: TIGTA analysis of an extract from the Audit Information Management System of office audits closed between October 2009 and September 2010 for sole proprietor and high-income taxpayers with an agreed assessment equal to or greater than \$10,000 and for which fraud penalties were not applied.

- Next, we calculated the error rate per stratum, as shown in Figure 3, by dividing the number of errors in each stratum by the sample size for each stratum and multiplying by 100.

Figure 3: Error Rate per Stratum

Strata	Number of Errors per Stratum	Sample Size per Stratum	Error Rate per Stratum
Stratum 1: Tax assessment of \$250,000 or greater	0	2	0.00%
Stratum 2: Tax assessment between \$50,000 and \$249,999	4	11	36.36%
Stratum 3: Tax assessment between \$10,000 and \$49,999	22	87	25.29%
Totals	26	100	

Source: TIGTA sampling plan and audit file analysis.

- We then calculated the weighted average error rate for our sample, as shown in Figure 4, by multiplying the error rate for each stratum by the percentage of each respective stratum represented in our universe (*i.e.*, “Weight of Stratum in Universe”) and summing the results.

³ Percentages are rounded.



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Figure 4: Weighted Average Error Rate Calculation for Stratified Sample

Strata	Error Rate per Stratum	Weight of Each Stratum in Universe	Weight of Error Rate per Stratum
Stratum 1: Tax assessment of \$250,000 or greater	0.00%	0.06%	0.00%
Stratum 2: Tax assessment between \$50,000 and \$249,999	36.36%	2.53%	0.92%
Stratum 3: Tax assessment between \$10,000 and \$49,999	25.29%	97.41%	24.63%
Weighted Average Error Rate for Sample			25.55%

Source: TIGTA analysis of: 1) an extract from the Audit Information Management System of office audits closed between October 2009 and September 2010 for sole proprietor and high-income taxpayers with an agreed assessment equal to or greater than \$10,000 and for which fraud penalties were not applied and 2) results of audit file testing.

- Based on our sample error rate of 25.55 percent and a confidence level of 95 percent (± 8.87 percent precision), we calculated the number of office audits where fraud was not adequately recognized and pursued to be approximately 939 audits ($3,674 \times 25.55$ percent), with a range of 613 to 1,265.
- To estimate the potential amount of additional civil fraud penalties that may have been assessed for these 26 office audits, we computed the additional penalty assessment by multiplying the agreed assessment for each audit by the 75 percent civil fraud penalty rate and subtracting any amounts previously assessed for accuracy-related penalties. Based on this analysis, we estimated that, had potential fraud been adequately considered and investigated for these 26 office audits, approximately \$362,000 in additional penalties could have been assessed.⁴
 - However, as discussed previously, our analysis of available data suggests that there is a 56 percent probability a civil fraud penalty will be recommended when a Form 11661 is completed. Based on this probability, we reduced the above amount by 44 percent, from approximately \$362,000 to \$203,000.

⁴ Amounts are rounded to the nearest dollar.



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- To determine the total amount of potential additional penalties owed for the office audits in our universe that may have avoided a civil fraud penalty that otherwise should have been assessed:
 - We calculated the weighted average additional penalties for all 100 office audits in our sample. To calculate the weighted average additional penalties, we calculated the average additional penalties for each stratum and then multiplied it by the weight of the stratum in our universe. We summed the results for each stratum to arrive at the weighted average additional penalties for our sample. See Figure 5 for details of our calculation.

Figure 5: Weighted Average Penalty Dollar Calculation⁵

Strata	Average Additional Penalties ⁶ per Stratum	Weight of Each Stratum in Universe	Weight of Additional Penalties ⁷ per Stratum
Stratum 1: Tax assessment of \$250,000 or greater	\$0	0.06%	\$0
Stratum 2: Tax assessment between \$50,000 and \$249,999	\$12,356	2.53%	\$313
Stratum 3: Tax assessment between \$10,000 and \$49,999	\$2,595	97.41%	\$2,528
Weighted Average Additional Penalties for Sample			\$2,841

Source: TIGTA analysis of: 1) an extract from the Audit Information Management System of office audits closed between October 2009 and September 2010 for sole proprietor and high-income taxpayers with an agreed assessment equal to or greater than \$10,000 and for which fraud penalties were not applied and 2) results of audit file testing.

- We then multiplied the number of office audits in the universe by the weighted average additional penalties for our sample office audits (3,674 x \$2,841 = \$10.4 million). The \$10.4 million represents the point estimate for the total potential additional penalties for a one-year period. Based on a 95 percent confidence interval, the total potential additional penalties range from approximately \$6.7 million to \$14.2 million.
 - However, as discussed previously, our analysis of available data suggests that there is a 56 percent probability that a civil fraud penalty will be recommended when a Form 11661 is completed. Based on this probability, we reduced the above additional penalty amount of \$10.4 million by 44 percent. Therefore, we estimate that sole proprietors and high-income taxpayers in our universe may have avoided additional

⁵ Amounts in Figure 5 are calculated using the estimate for \$362,000 in additional penalty assessments.

⁶ Amounts are rounded to the nearest dollar.

⁷ Amounts are rounded to the nearest dollar.



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penalties totaling about \$5.8 million.⁸ This adjustment is not based on our sampling and does not have a confidence interval. Our calculation assumes that for 56 percent of the office audits that we determined were exceptions, the civil fraud penalty would have been recommended, assessed, and sustained upon taxpayer appeal, on the entire amount of additional taxes owed had the examiners adequately considered and investigated the potential fraudulent activity of the taxpayer during the audit.

- To calculate the potential amount of additional penalties owed by sole proprietors and high-income taxpayers in our universe that we estimate may have avoided a civil fraud penalty that otherwise should have been assessed over five years if the IRS does not change its procedures, we multiplied the estimated total amount of additional penalties owed for the office audits closed between October 2009 and September 2010 by five to obtain the amount of taxes [\$5,800,000 x five = \$29,000,000]. Our calculation assumes that all estimated penalties would be owed based upon the development of fraud and that conditions such as economic factors, tax law, compliance rates, and IRS audit coverage remain the same.

We shared our sampling and outcome measure methodologies with an outside statistical expert who confirmed the accuracy of our methodology and projection.

⁸ We are unable to quantify the degree of uncertainty associated with the estimated \$5.8 million in additional assessments because of the variability in the dollars assessed for the population of exception audits and the uncertainty as to which of the individual exception audits could have resulted in a civil fraud penalty assessment.



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Appendix V

Fraud Checklist (2010)¹

Fraud Indicators—Income

- Omissions of specific items where similar items are included.
- Omissions of entire sources of income.
- Unexplained failure to report substantial amounts of income.
- Unexplained sources substantially exceeding reported income.
- Substantial excess of personal expenditures over available resources.
 - Material acquisitions suggest living beyond reported income.
- Bank deposits substantially exceed reported income.
- Checks cashed that never hit taxpayer's bank accounts.
- Concealment of bank accounts, brokerage accounts, and other property.
- Inadequate explanation for dealing in large sums of currency.
- Consistent concealment of unexplained currency, especially in a business not calling for large amounts of cash.
- Failure to deposit receipts to business account.
- Failure to file a return, especially for a period of several years, although substantial amounts of taxable income were received.
- Cashing checks at check-cashing services and banks other than taxpayer's banks.
- Covering up sources of receipts by false description of source of disclosed income or nontaxable receipts.
- Loan applications that state a higher income than shown on the returns.
- Other indicator _____.

Fraud Indicators—Allocations of Income

- Distribution of profits to fictitious partners.
- Inclusion of income or deductions on return of a related taxpayer.
- Other indicator _____.

¹ Source: SB/SE Fraud/BSA Function Management.



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Fraud Indicators—Deductions

- Substantial overstatement of deductions.
- Substantial amounts of personal expenditures deducted as business expenses.
- Claiming fictitious deductions.
- Multiple deductions end in zeroes or amounts overuse a particular digit.
- Dependency exemption claimed for nonexistent, deceased, or self-supporting people.
- Loans of trust funds disguised as purchases or deductions.
- Other indicator _____.

Fraud Indicators—Books & Records

- Keeping two sets of books or no books.
- False entries or alterations made on books and records, backdated or post-dated documents, and false invoices, applications, statements, or other documents.
- Invoices are irregularly numbered, unnumbered, or altered.
- Checks made payable to third parties are endorsed back to taxpayer.
- Failure to keep adequate records, concealment of records, or refusal to make certain records available.
- Variances between amounts or inconsistent treatment of questionable items on return and in books.
- Intentional under-footing or over-footing of columns in journal or ledger.
- Amounts posted to ledger accounts not in agreement with source books.
- Recording income items in suspense or asset accounts.
- False receipts to donors by exempt organizations.
- Other indicator _____.

Fraud Indicators—Conduct of Taxpayer

- False statement about a material fact during examination.
- Attempts to hinder examination (e.g., failure to cooperate or answer pertinent questions, repeated cancellation of appointments, refusal to provide records, threatening or assaulting potential witnesses or the agent).
- Failure to follow advice of accountant or attorney.
- Failure to make full disclosure of relevant facts to accountant or return preparer.
- Taxpayer's knowledge of taxes and business practices.
- Testimony of employees concerning irregular business practices by taxpayer.
- Destruction of books and records.



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- Transfer of assets for purposes of concealment or diversion of funds and assets.
- Consistent failure over several years to fully report income.
- Return incorrect to such an extent and in respect to items to compel conclusion that falsity was known and deliberate.
- Payment of improper expenses by or for officials or trustees.
- Willful and intentional failure to execute pension plan amendments.
- Backdating of applications and related documents.
- Conduct or transactions contrary to normal business practices
- Use of false Social Security Numbers.
- Submission of false forms (e.g., Forms W-2² or W-4³).
- Submitting false affidavits or documents.
- Attempts to bribe the agent.
- Other indicator _____.

Fraud Indicators—Methods of Concealment

- Insolvency of transferor.
- Assets placed in another's name.
- Transfer of all or nearly all of taxpayer's property.
- Close relationship between parties to transfer of property.
- Transfer made in anticipation of tax assessment or after examination began.
- Reserves or retains an interest in the property transferred.
- Transaction not in the usual course of business.
- Transaction surrounded by secrecy.
- False entries in books of transferor or transferee.
- Unusual/*de minimis* consideration received for the property.
- Use of secret bank accounts or accounts in nominee names.
- Conduct business transactions in false names.
- Other indicator _____.

Fraud Penalties—Additional Considerations

- Workpapers should be indexed, and should include an accurate record of contacts and conversations and an explanation of evidence to support fraud.
- Recognized and consistent method of determining underpayment of tax (e.g., specific items, bank deposits, or net worth).
- Files should include all source documents, including bank records.

² Form W-2, *Wage and Tax Statement*.

³ Form W-4, *Employee's Withholding Allowance Certificate*.



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- Affidavits and statements/letters from witnesses should be included in file.
- Pattern of years of under-reporting income or inflating expenses.
- The indicia necessary to support fraudulent conduct may be based on the amount of deficiency; the smaller the deficiency, the greater need for strong, overt badges of fraudulent conduct.
- Multiple badges exist apart from frivolous arguments or noncooperation.
- Allegations show taxable source of unreported income or negate that income came from a nontaxable source.
- If joint return, either intent separately established for each spouse or fraud asserted on one spouse only. Section (§) 6663(c).
- Taxpayer and third-party interviews conducted, especially of preparer.
 - Who prepared the information used on return?
 - Who approved and classified expense items?
 - Who deposited business receipts?
 - How were business gross receipts stated on return determined?
 - Who controlled the accounts (signature authority)?
- Taxpayer's explanation obtained.
 - Off-setting cash expenses that were not deducted.
 - Nontaxable source of income.
 - Reasonable, good-faith reliance on advisor, who caused noncompliance.
 - No unreasonable assumptions. § 1.6664-4(c)(1)(ii).
- If period of limitations open, accuracy-related penalty for negligence or substantial understatement imposed in the alternative. § 6662(a).
- Period of limitations also held open by fraudulent intent of third party (e.g., preparer). Allen, 128 T.C.37, 42 (2007).
- Protect period of limitations if open; exception or additional period may apply under § 6501 (e.g., six years for substantial omission under § 6501(e)).
- Respondent has the burden of proving by clear and convincing evidence that some part of the underpayment of tax was due to civil fraud. T.C. Rule 142(b).
- All fraud Notices of Deficiency should be coordinated with the Fraud Technical Advisor ("FTA") prior to being sent to Counsel.
- If Counsel has doubt about whether to approve, ask agent to explain position.
- If not approved and further development required, Counsel must recommend that agent coordinate with FTA. SB-2009-04.
- Counsel should copy FTA manager whenever written advice provided to Exam, regardless of whether you are approving the fraud. SB-2009-04.
- If CI recommended criminal prosecution and civil fraud or fraudulent failure to file penalty is not approved, Area Counsel must provide written advice. IRM 25.1.7.8(7).
- Other indicator _____..



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Additional Indicators for Fraudulent Failure to File—§ 6651(f)

- History of nonfiling.
- History of criminal tax prosecutions.
- Repeated contacts by the IRS.
- Indications that the nonfiler had knowledge of filing requirements (e.g., advanced education, works directly in tax field, or previously filed).
- Experienced in tax matters (e.g., law professor, CPA, or tax attorney).
- Attempted to conceal or transfer assets to evade collection of tax later assessed.
- Furnished false W-4 to employer.
- The use of dummy business entities or bank accounts under assumed names, or false SSNs in an attempt to conceal the identity of true owner or income earner.
- Submitted copies of nonfiled returns to third parties (e.g., lending institutions when taxpayer intends to secure loans).
- Large number of cash transactions.
- Indications of significant income (e.g., interest and dividends earned, investments in IRA accounts, stock and bond transactions, or mortgage interest paid).
- Substantial tax liability after withholding credits and estimated tax payments.
- Other indicator _____.

Resources

- IRM 4.10.6--Penalty Considerations
- IRM 25.1--Fraud Handbook
- Fraud Office
- FTA program Counsel contacts, National Fraud Program--SB-2009-04

Abbreviations are used for the following terms in this fraud checklist: Tax Court (T.C.), Fraud Technical Advisor (FTA), Criminal Investigation (CI), Certified Public Accountant (CPA), Social Security Number (SSN), and Individual Retirement Arrangement (IRA).



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Appendix VI

Fraud Development Lead Sheet

Taxpayer Name: TIN: Tax Form: Tax Year (s):	Examiner: Date:		
Fraud Development Lead Sheet			
Tax Period	Code Section	Penalty Amount	Reference
Conclusion: <i>(Reflects action on the issue.)</i>			
<input type="checkbox"/> No Fraud [Comment required if there are adjustment(s) and fraud had been considered] <input type="checkbox"/> Indications of fraud [Explain]; Date of discussion with manager: <input style="width: 100px;" type="text"/>			
<p>The following items are not intended to be all-inclusive nor are they mandatory steps to be followed. Judgment should be used in pursuing the items that apply to each taxpayer. Refer to IRM 25.1, <i>Fraud Handbook</i> and the Fraud Website at http://sbseservice.wide.web.irs.gov/Fraud/default.aspx and contact your local Fraud Technical Advisor (FTA) when indicators of fraud are present.</p>			
Guidelines			
IRM 25.1.1.1(6) The FTA plays a vital role in the development of a potential fraud case. The FTA will be consulted in all cases involving potential fraud after discussing the case with the group manager.			
IRM 25.1.1.2(2) defines tax fraud. Tax fraud is often defined as an intentional wrongdoing on the part of a taxpayer, with the specific purpose of evading a tax known or believed to be owing. Tax fraud requires both an underpayment of tax due and fraudulent intent.			
IRM 25.1.2.3, <i>Indicators of Fraud</i> lists examples of fraud indicators. Fraud cannot be established unless affirmative acts of fraud are present.			
IRM 25.1.1, <i>Overview/Definitions</i> ; IRM 25.1.2, <i>Recognizing and Developing Fraud</i> ; and IRM 25.1.7, <i>Failure to File</i> provide specific guidance on fraud indicators and the development of fraud for filed and/or non-filed returns.			
IRM 20.1.5.3, <i>Examination Penalty Assertion</i> and IRM 20.1.2.7, <i>Fraudulent Failure to File — IRC section 6651(f)</i> , provide specific procedures for assertion of the civil fraud and fraudulent failure to file penalties.			
In cases where fraud was considered and the civil fraud penalty is not being recommended, the examiner will explain the reasons why the penalty was not asserted. Document the explanation in the "Conclusion" section above or at Lead Sheet 300, <i>Civil Penalty Approval Form</i> .			
Key Items			
Fraud Development (IRM 25.1.2.2 & IRM 25.1.7.4) and Indicators of Fraud (IRM 25.1.2.3 & IRM 25.1.7.2):			
<ol style="list-style-type: none"> 1. Document discussion with group manager in the Conclusion section above. 2. Discuss with FTA and prepare Form 11661 electronically if there is an agreement that potential for fraud exists and forward to group manager. If a disagreement exists on whether a case should or should not be in fraud development status, the ultimate decision rests with the group manager. 3. Upon receipt of approved Form 11661 with Plan of Action, update the case to Status Code 17. 4. Timely actions and periodic meetings with FTA are required. 5. If no fraud potential, Form 11661 will be updated by the FTA and the case returned to status 12. 			
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Source: SB/SE Division Workpaper 205-1, dated March 2011.

Abbreviations are used for the following terms in this lead sheet: Internal Revenue Code (IRC) and Audit Information Management System (AIMS).



*Actions Can Be Taken to Reinforce the
Importance of Recognizing and Investigating
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Taxpayer Name: _____ **Examiner:** _____
TIN: _____
Tax Form: _____ **Date:** _____
Tax Year (s): _____

Fraud Development Lead Sheet

Affirmative Acts (firm indicators) of Fraud warranting criminal consideration (IRM 25.1.3):

1. If affirmative acts of fraud are established, suspend all activity.
2. When affirmative acts (firm indications) of fraud/willfulness exist and criminal criteria are met, refer the case to Criminal Investigation (CI) via Form 2797, *Referral Report of Potential Criminal Fraud Cases*. The FTA is available to assist in determining if firm indications of fraud/willfulness are present, criminal criteria has been met, etc.
3. No actions should be taken until Criminal Investigation accepts or declines referral.
4. If accepted, cases should be updated to Status 18.
5. If not accepted by CI, civil fraud consideration should be pursued.
6. If assigned a case as Cooperating Agent (Form 6544), review and follow guidelines set out in IRM 25.1.4, *Administrative Joint Investigation* and/or IRM 25.1.5, *Grand Jury Investigations*.

Civil Fraud Developed (IRM 25.1.6)

1. A civil fraud penalty including the fraudulent failure to file may be developed based on the civil examination and/or result from a criminal investigation (CI) initiated case.
2. Discuss the case with group manager and the FTA. If agreement can not be reached regarding assertion of the civil fraud penalty, the decision will rest with the group manager.
3. Complete a write up including the facts, applicable law, argument, and conclusion (IRM 4.10.8.11.2, *Explanation of Items*).
4. Cases being developed for civil fraud will be updated on AIMS to status code 17 (Fraud Development), via Form 11661, *Fraud Development Recommendation - Examination*.
5. Examiners should be aware of Collateral Estoppel on cases criminally prosecuted. Refer to IRM 25.1.6.4, IRM 25.1.7.8(5) and IRM 20.1.2.7(9). A taxpayer or nonfiler convicted of IRC 7201, *Attempt to Evade or Defeat Tax*, is collaterally estopped from denying liability for the civil fraud or fraudulent failure to file penalty.

Facts: (Document the relevant facts.)

Law: (Tax Law, Regulations, court cases, and other authorities. If Unagreed, add Argument)

IRC Section:

Specific Citations:

Taxpayer Position: (If applicable) Summarize defenses given by the Taxpayer / Filer, Representative, or Preparer for acts of fraud.

Additional Items:	Workpaper Reference
Form 11661 - Fraud Development Recommendation - Examination	
Form 2797 - Referral Report of Potential Criminal Fraud Cases	
Form 10498A - Joint Investigations Intent to Commence Civil Action	
Form 10498B - Joint Investigations Intent to Solicit Consent to Extend Statute	Attach to back of tax return
Form 6544 - Request for Cooperating Examiner	
Form 13308 - Criminal Investigation Closing Report (Tax and Tax Related Only)	

Rev. 03/2011

Workpaper #

-1.2



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Appendix VII

Glossary of Terms

Activity Codes – A code that identifies the type and condition of returns selected for audit.

Attributes – Concise statements of SB/SE Division’s expectations for quality audits. Attributes are guidelines to assist examiners in fulfilling their professional responsibilities.

Audit Information Management System – A computer system used to control returns, input assessments/adjustments to the Integrated Data Retrieval System, and provide management reports.

Embedded Quality Review System – The Embedded Quality Review System allows field managers to provide timely feedback to individual employees through performance reviews of audits.

Enforcement Revenue Information System – A computer system that tracks enforcement activity and enforcement revenue.

First-Line Manager – A group manager in the Examination function responsible for supervision of IRS examiners.

Fiscal Year – 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.

Fraud/Bank Secrecy Act Function – Within the IRS, the SB/SE Division Fraud/BSA function provides oversight and direction for fraud policy and operations Servicewide and examines for compliance with BSA requirements.

Fraud Condition Indicator Code – A code that identifies for audited returns the following conditions: no fraud, civil fraud, criminal fraud, both civil and criminal fraud, or blank.

Fraud Technical Advisor – An FTA is a specialized revenue agent who provides guidance to other examiners who have identified fraud indicators. Among their various responsibilities, the FTAs provide technical and procedural fraud advice to examiners to help identify and develop potential civil fraud penalty cases and criminal fraud referrals. The FTAs are qualified to provide such guidance because they are required to have specialized knowledge of the laws, regulations, and procedures governing criminal and civil tax fraud cases as well as extensive fraud development experience.

Individual Master File – The IRS database that maintains transactions or records of individual tax accounts.



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Integrated Data Retrieval System – IRS computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer’s account records.

National Fraud Program Database – A computer system that is used by FTAs when there is a taxpayer account placed into fraud development status or recommended for a fraud penalty.

National Quality Review System – The NQRS allows national reviewers to evaluate audit case files to determine whether examiners complied with quality attributes established by the IRS.

Office Audit – An office audit is an audit of a tax return that is typically conducted by an office examiner. An office examiner conducts audits of individual taxpayers through interviews at IRS field offices.

Penalty Reference Number – Penalty reference numbers are used to assess and abate miscellaneous civil penalties.

Territory Manager – Territory managers are responsible for planning, organizing, coordinating, monitoring, and directing their respective programs through subordinate managers who are geographically dispersed throughout the assigned territory.

Transaction Code – A three-digit code used to identify actions being taken on a taxpayer’s account.



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Appendix VIII

Management's Response to the Draft Report

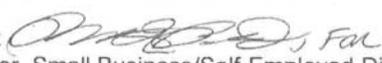


COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

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

JAN 31 2013

MEMORANDUM FOR MICHAEL R. PHILLIPS
DEPUTY INSPECTOR GENERAL FOR AUDIT

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

SUBJECT: Draft Audit Report – Actions Can Be Taken to Reinforce
the Importance of Recognizing and Investigating Fraud
Indicators During Office Audits (Audit # 201130022)

Thank you for the opportunity to review your draft report titled, "Actions Can Be Taken to Reinforce the Importance of Recognizing and Investigating Fraud Indicators During Office Audits." We appreciate your recognition that we have developed and implemented a number of policies, procedures, and techniques (management controls) to help ensure fraud is emphasized and considered during audits, including providing managers with clear and specific commitments related to fraud consideration. We are also pleased your review found that we have continued to emphasize the expectation that examiners identify, pursue, and develop fraud indicators, and that we provide examiners with feedback related to fraud consideration.

Based on your recommendations, we will standardize the process for office audit examiners' documentation of fraud consideration. We will also issue additional guidance emphasizing the importance of and when a discussion should be held between the examiner and first-line manager about potential fraudulent activity of the taxpayer.

Office audit examiners currently have several tools available to assist them with fraud consideration including: the Internal Revenue Manual (IRM) that provides specific guidance on fraud indicators and the development of fraud; the *Fraud Checklist* that lists the IRM fraud indicators and fraud penalty considerations; and the *Fraud Development Lead Sheet* that was significantly enhanced in March 2011 and now provides specific IRM references and guidelines, including those related to fraud development and indicators of fraud. The IRM also provides examiners with guidance regarding proper documentation of workpapers to include the procedures applied, tests performed, information obtained, and the conclusions reached in the examination. We believe these tools are sufficient to help our examiners identify, address and document the



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fraud potential of their examinations. Therefore, we do not believe it is necessary to develop an additional job aid requiring examiners to acknowledge which indicators were considered during the audit.

In addition, due to the factual nature of tax fraud cases, we do not believe it is appropriate to provide additional specific criteria for when a discussion must be held between the examiner and front-line manager. The IRM already requires management discussions when there is an understatement of income greater than \$10,000 or when a compliance employee first suspects indicators of fraud.

We agree with the proposed outcome measure based on the assumptions outlined in your report. Attached is a detailed response outlining our corrective actions addressing your recommendations.

If you have any questions, please contact me, or a member of your staff may contact Shenita Hicks, Director, Examination, SB/SE at 859-669-5526.

Attachment



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Attachment

RECOMMENDATION 1:

Standardize the process for office audit examiners' documentation of fraud consideration by developing and implementing a specific job aid that requires examiners to acknowledge which indicators, if any, were considered during the audit.

CORRECTIVE ACTION:

We will review the IRM and lead sheets 205, *Fraud Development Lead Sheet*, and 300, *Civil Penalty Approval Form*, and make necessary revisions to standardize the process for office audit examiners' documentation of fraud consideration. Since a significant amount of guidance already exists, we do not believe it is necessary to develop an additional job aid.

IMPLEMENTATION DATE:

September 15, 2014

RESPONSIBLE OFFICIAL(S):

Director, Examination Policy, SB/SE Division

CORRECTIVE ACTION MONITORING PLAN:

IRS will monitor this corrective action as part of our internal management system of controls.

RECOMMENDATION 2:

Develop additional criteria and guidance for when a discussion should be held between the examiner and first-line manager about the potential fraudulent activity of the taxpayer to cover instances other than omissions of income.

CORRECTIVE ACTION:

We will provide additional guidance emphasizing when a discussion should be held between the examiner and first-line manager about potential fraudulent activity of the taxpayer by issuing a joint memorandum from the Directors, Examination Policy and Fraud/Bank Secrecy Act (BSA) to all Examination compliance employees highlighting fraud awareness, responsibilities, and proper involvement of managers and fraud technical advisors. However, due to the factual nature of tax fraud cases, we do not believe it is appropriate to provide additional specific criteria for when a discussion must be held between the examiner and front-line manager.

IMPLEMENTATION DATE:

March 15, 2014



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RESPONSIBLE OFFICIAL(S):

Director, Examination Policy, SB/SE Division

CORRECTIVE ACTION MONITORING PLAN:

IRS will monitor this corrective action as part of our internal management system of controls.