



*The Correspondence Audit Selection  
Process Could Be Strengthened*

**August 27, 2013**

**Reference Number: 2013-30-077**

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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## HIGHLIGHTS

### THE CORRESPONDENCE AUDIT SELECTION PROCESS COULD BE STRENGTHENED

## Highlights

### Final Report issued on August 27, 2013

Highlights of Reference Number: 2013-30-077 to the Internal Revenue Service Commissioner for the Small Business/Self-Employed Division.

#### IMPACT ON TAXPAYERS

The IRS relies heavily on the correspondence audit process to address individuals suspected of underreporting their income tax liabilities. Correspondence audits result in significant additional tax assessments and are more economical than other types of audits. IRS statistics show that in Fiscal Year 2012, the IRS conducted 1.1 million correspondence audits and recommended approximately \$9.2 billion in additional taxes.

#### WHY TIGTA DID THE AUDIT

This audit was initiated to determine the effectiveness of filing checks made during the correspondence audit process in the Small Business/Self-Employed Division.

Filing checks are used, in part, to determine whether the same pattern of noncompliance identified on an audited tax return is present on the prior and/or subsequent year tax returns, and if those tax returns warrant an audit. When properly completed, filing checks leverage IRS audit resources by increasing the overall compliance coverage of every audit.

#### WHAT TIGTA FOUND

TIGTA evaluated a statistical sample of 102 of 7,470 single-year correspondence audits in which the taxpayers involved agreed that they understated their tax liabilities by at least \$4,000. Similar tax issues also existed on the prior and/or subsequent year tax returns for 43 of the 102 taxpayers. TIGTA found that 32 of the 43 individuals did not have those tax returns audited and, as a consequence, may have

avoided additional assessments ranging from \$2,343 to \$18,874.

A factor that contributed to the limited number of prior and/or subsequent year tax audits in our sample is the emphasis the IRS places on keeping its audit inventories free of older tax years so there is sufficient time to complete audits and assess any resulting taxes within the three-year assessment statute of limitations. Control issues also exist over how current year audit results are used in deciding whether to audit the prior and/or subsequent year returns.

#### WHAT TIGTA RECOMMENDED

TIGTA recommended that the IRS develop and implement procedures that instruct how current year correspondence audit results are to be used in deciding whether the prior and/or subsequent year tax returns warrant an audit. To ensure that the instructions are followed, the procedures should include instructions for monitoring how well current year correspondence audit results are used in deciding to audit prior and/or subsequent year returns.

The IRS agreed with TIGTA's recommendation and plans to develop an Internal Revenue Manual section to address the case selection and delivery process and the duties and roles of analysts and examiners.



TREASURY INSPECTOR GENERAL  
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C. 20220

August 27, 2013

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

A handwritten signature in blue ink that reads "Michael E. McKenney".

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

**SUBJECT:** Final Audit Report – The Correspondence Audit Selection Process  
Could Be Strengthened (Audit # 201130046)

This report presents the results of our review to determine the effectiveness of filing checks made during the correspondence audit process in the Small Business/Self-Employed Division. The review is part of 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 VI.

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 Augusta R. Cook, Acting Assistant Inspector General for Audit (Compliance and Enforcement Operations).



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*Abbreviations*

AIMS	Audit Information Management System
GAO	Government Accountability Office
IRM	Internal Revenue Manual
IRS	Internal Revenue Service
SB/SE	Small Business/Self-Employed
TIGTA	Treasury Inspector General for Tax Administration



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## *The Correspondence Audit Selection Process Could Be Strengthened*

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### *Background*

The Internal Revenue Service (IRS) has several sources from which to select individual tax returns for audit. One source is the Discriminant Index Function,<sup>1</sup> which is an automated system for scoring individual tax returns according to their audit potential. In general, the higher the Discriminant Index Function score, the greater the chance the audit will result in a material tax change. The IRS's policy also allows tax returns to be selected through non-Discriminant Index Function sources. These non-Discriminant sources include compliance studies and research projects, referrals from other Federal and State Government agencies, and the IRS Revenue Protection Strategy. Under the Revenue Protection Strategy, many audits are initiated automatically based on certain computerized business rules at the time the tax return is processed with little or no examiner involvement and are generally focused on resolving questions about Earned Income Tax Credits.

Except for audits initiated automatically under the Revenue Protection Strategy, tax returns identified for audit are typically subjected to a tax return classification process where they are reviewed by classifiers. These classifiers, who are experienced examiners, play a critical role in the process because they use their experience and judgment to apply guidelines for determining which tax returns will be selected for audit consideration and which can be accepted as filed. If a tax return is not selected by the classifier, it is eliminated from the audit stream and returned to IRS storage files. However, if the tax return is selected, the classifier may determine whether the audit should be conducted through correspondence or by face-to-face contact in the field at either the taxpayer's place of business or an IRS office.

***Correspondence audits are generally less intrusive, more automated, and conducted by examiners who are trained to deal with less complex tax issues.***

In contrast to the more detailed and lengthy face-to-face audits in the field, the correspondence audit process is less intrusive, more automated, and conducted by examiners who are trained to deal with less complex tax issues. Additionally, examiners do not perform required filing checks during correspondence audits. As reflected in the IRS's Internal Revenue Manual (IRM), required filing checks have long been a part of IRS audit policies and procedures that were implemented, in part, to determine whether the same pattern of noncompliance identified on the audited tax return is present on the prior and/or subsequent year tax returns and if those tax returns also warrant auditing. When properly completed, filing checks leverage IRS audit resources by increasing the overall compliance coverage of every audit.

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<sup>1</sup> See Appendix V for a glossary of terms.



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Correspondence audits typically begin with the IRS mailing a computer-generated letter to a taxpayer that outlines the examination process, identifies one or more items on the tax return that are being questioned, and requests supporting information to resolve the questionable items. Once returned, examiners review the information to see whether it resolves the questions. If the questions are sufficiently answered by the information provided, the audit is closed without any tax changes; if not, the taxpayer is sent a letter requesting more information or indicating a recommended tax change. The taxpayer at this point can agree with the examiner, provide the examiner with clarifying information, or appeal the decision to the IRS's Office of Appeals. In instances where the taxpayer does not respond to the IRS's letters, the examiner's recommended tax changes are assessed by default and the taxpayer will generally have to petition the court system to contest the assessment.

This review was performed with information obtained from the Small Business/Self-Employed (SB/SE) Division Headquarters in Washington, D.C., during the period September 2011 through May 2013. 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.



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*Results of Review*

***The Correspondence Audit Process Is a Key Enforcement Tool***

The IRS relies heavily on the correspondence audit process to address individuals suspected of underreporting their income tax liabilities. This reliance will likely continue in the coming years because correspondence audits result in significant additional tax assessments, which helps decrease the Tax Gap and increase compliance. They also are more economical than other types of audits.

IRS statistics show that in Fiscal Years 2008 through 2012 the IRS conducted about 5.7 million correspondence audits and recommended approximately \$40.4 billion in additional taxes. As shown in Figure 1, this represents about 76 percent of all audits the IRS conducted of individual tax returns and 56 percent of the estimated \$72.5 billion in recommended additional taxes from those audits.

***Figure 1: Selected Audit Results for Individual Tax Returns  
Fiscal Years 2008 Through 2012***

	Fiscal Year					Total
	2008	2009	2010	2011	2012	
<b>Total Audits (millions)</b>	1.4	1.4	1.6	1.6	1.5	7.5
<b>Total Correspondence Audits (millions)</b>	1.1	1.1	1.2	1.2	1.1	5.7
<b>Percentage of Correspondence Audits</b>	79%	79%	75%	75%	73%	76%
<b>Recommended Additional Taxes From All Audits (billions)</b>	\$12.5	\$14.9	\$15.1	\$14.7	\$15.3	\$72.5
<b>Recommended Additional Taxes From Correspondence Audits (billions)</b>	\$6.5	\$7.8	\$8.2	\$8.7	\$9.2	\$40.4
<b>Percentage of Recommended Additional Taxes From Correspondence Audits</b>	52%	52%	54%	59%	60%	56%

Source: IRS Data Books, Fiscal Years 2008 through 2012, Publication 55B.



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The correspondence audit process is also a key tool the IRS uses to help address a portion of the underreporting noncompliance that contributes to the Tax Gap. The IRS estimated the Tax Gap for Tax Year 2006 to be \$450 billion. The Tax Gap is considered by the National Taxpayer Advocate,<sup>2</sup> Government Accountability Office (GAO),<sup>3</sup> Treasury Inspector General for Tax Administration (TIGTA),<sup>4</sup> and the IRS Oversight Board,<sup>5</sup> to be one of the most serious problems facing tax administration. The IRS estimates that \$235 billion of the Tax Gap is caused by individuals underreporting their income tax liabilities.

The correspondence audit process is generally more economical to conduct when compared to other types of audits, which is very important given the current constrained fiscal environment. According to a December 2012 GAO report,<sup>6</sup> correspondence audits of individual tax returns are significantly less costly on average than face-to-face audits conducted in the field. The GAO estimated that the average cost (including overhead) of correspondence audits opened in Fiscal Years 2007 and 2008 was \$274, compared to an average of \$2,278 for field audits.

### **The IRS has taken steps to be more responsive to taxpayers and less susceptible to missing areas of noncompliance**

An IRS survey<sup>7</sup> of taxpayers who have had their tax returns audited showed that taxpayers were dissatisfied with the time it was taking to reach the IRS on the telephone for help and the overall length of the audit process. As we reported in August 2012,<sup>8</sup> one of the steps the IRS has taken to help address taxpayers' dissatisfaction with IRS customer service was to implement in Fiscal Year 2010 the Intelligent Contact Management System into the correspondence audit process.

***The Intelligent Contact Management System uses a skill-based call routing system that routes calls to the next available assistor trained to handle the question identified, allowing taxpayers to immediately speak to an assistor who is familiar with their type of audit and reduce the number of repeat contacts.***

The Intelligent Contact Management System is a toll-free telephone system that takes advantage of modern technologies by using a skill-based call routing system to link multiple IRS call centers into a single "virtual" call center. Specifically, one

<sup>2</sup> National Taxpayer Advocate, *2009 Annual Report to Congress*, Volume One, December 31, 2009.

<sup>3</sup> GAO, GAO-13-151, *Tax Gap: IRS Could Significantly Increase Revenues by Better Targeting Enforcement Resources* (Dec. 2012).

<sup>4</sup> TIGTA, *Semiannual Report to Congress, October 1, 2011 – March 31, 2012*.

<sup>5</sup> IRS Oversight Board, *Annual Report to Congress 2011*, May 2012.

<sup>6</sup> GAO, GAO-13-151, *Tax Gap: IRS Could Significantly Increase Revenues by Better Targeting Enforcement Resources* (Dec. 2012).

<sup>7</sup> IRS, *Internal Revenue Service Customer Satisfaction Survey, Correspondence Exam (CCE) SB/SE National Report, Covering January through March 2011, with Annual Results* (Jul. 2011).

<sup>8</sup> TIGTA, Ref. No. 2012-30-093, *Improved Toll-Free Telephone Services Should Make It Easier for Taxpayers to Obtain Assistance During a Correspondence Audit* (Aug. 2012).



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toll-free telephone number routes calls to the next available assistor trained to handle the question identified, regardless of where the assistor and taxpayer are located. The system is expected to provide taxpayers with the ability to immediately speak to an assistor who is familiar with their type of issue and reduce the number of repeat contacts. Providing taxpayers with the ability to speak to an assistor on the first call and reducing call backs has the potential to make the audit process more responsive and less burdensome for taxpayers. Under its old toll-free telephone system, the IRS determined that:

- 70 percent of calls to examiners were answered by voicemail—39 percent of these calls were not returned within 24 hours.
- 62 percent of callers were repeat callers. Of the repeat callers, 28 percent wanted to know if the information they mailed was received and 26 percent wanted to know what information was needed or if the documentation they provided was sufficient.
- 13 percent of callers telephoned more than eight times before their tax issues were resolved.

In February 2010<sup>9</sup> we reported that the IRS needed to better identify and pursue unfiled employment tax and information returns. We determined that approximately \$82.6 million in assessments were at risk because significant tax issues were not addressed during correspondence audits. Deductions were claimed for payment of wages and/or compensation to others, but no records existed with the IRS showing employment tax or information returns were filed.

Unlike procedures for audits conducted in the field, the procedures for correspondence audits do not require examiners to complete minimum checks to detect unfiled employment tax and information returns or unreported income. However, correspondence audit procedures do require the examiners and their managers to consider transferring the audit to the field if there are deductions that cannot be supported by unfiled returns or substantial amounts of income that may not have been reported.

We recommended that the IRS expand controls that provide assurance that examiners are properly performing checks for unfiled employment tax and information returns. Instead, IRS management agreed to refine inventory selection filters to reduce the number of cases with these issues from correspondence examination inventory. Additionally, during quality reviews of correspondence examinations, management will identify inventory where these issues may be present to ensure that appropriate actions have been taken. Feedback from the case reviews will be provided to management and the information may be used to refine inventory selection filters. Our limited testing showed that only about 6,700 (1.4 percent) of approximately 473,800 correspondence audits closed during Fiscal Year 2012 included employee wage and/or contract

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<sup>9</sup> TIGTA, Ref. No. 2010-30-024, *Significant Tax Issues Are Not Often Addressed During Correspondence Audits of Sole Proprietors* (Feb. 2010).



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labor expenses of \$1,000 or more, which may indicate related employment tax or information return filing requirements.

***Actions Are Needed to Ensure That Prior and/or Subsequent Year Tax Returns Are Audited When Substantial Taxes May Be Owed***

We evaluated a statistical sample of 102 of 7,470 single-year correspondence audits of individual tax returns closed between April 1, 2010, and March 31, 2011, in which each of the taxpayers involved agreed that they understated their tax liabilities by at least \$4,000. Similar tax issues also existed for the prior and/or subsequent years tax returns filed by 43 of the 102 taxpayers. Yet, IRS records showed that 32 of the 43 taxpayers' prior and/or subsequent year tax returns were not audited.<sup>10</sup>

- For 16 audits, the taxpayers agreed they owed approximately \$4,100 to \$7,550 in additional taxes after the IRS determined they were not entitled to Earned Income and other credits taken on their tax returns. The 16 audits were initiated through the Revenue Protection Strategy process.
- For 12 audits, the taxpayers agreed they owed approximately \$4,100 to \$14,400 in additional taxes after the IRS determined they overstated itemized deductions on their tax returns. The 12 audits were initiated as a result of the correspondence return classification process.
- For four audits, the taxpayers agreed they owed approximately \$4,450 to \$5,850 in additional taxes after the IRS determined they overstated business expenses on their tax returns. The four audits were initiated as a result of the correspondence return classification process.

Had the prior and/or subsequent tax returns for these 32 taxpayers been audited for similar tax issues, we estimate the potential additional tax, penalty, and interest assessments would range from \$2,343 to \$18,874—totaling \$189,422. When the sample results are projected to the population of 7,470 audits closed between April 1, 2010, and March 31, 2011, we estimate that 2,344 taxpayers may have avoided additional tax, penalty, and interest assessments of \$13.9 million.<sup>11</sup>

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<sup>10</sup> The sampling plan was based on a 95 percent confidence interval,  $\pm$  10 percent precision, and 50 percent expected error rate due to no known rate available. Appendix I contains additional details on the sampling methodology.

<sup>11</sup> The projection is based on a 95 percent confidence level. We expect the number of taxpayers who may have avoided additional assessments to fall between 1,672 and 3,015 and the total taxes, penalties, and interest avoided to range from \$9.1 million to \$18.7 million. Appendix IV contains additional details on the projection.



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### **Strict adherence to audit cycles limits the number of prior year audits**

One factor that contributed to the limited number of prior and/or subsequent year tax audits in our sample, which we determined the IRS should address, is the emphasis the IRS places on keeping its audit inventories free of older tax years so there is sufficient time to complete audits and assess any resulting taxes within the three-year assessment statute of limitations. However, each year thousands of taxpayers consent to provide the IRS additional time to complete the audit and assessment processes by consenting to extend the assessment statute of limitations to either a specific period of time or an unlimited, indefinite period.

For the taxpayer, the additional time can be beneficial in some instances. For example, a taxpayer might want the IRS to consider other issues during the audit that may offset a proposed tax assessment or that may allow for a tax refund. Also, if the remaining time before the statute expires is too short, the IRS might have to prematurely stop the audit process and issue a notice of deficiency. The notice of deficiency serves to ensure that the taxpayer is formally notified of the IRS's intention to assess a tax deficiency and to inform the taxpayer of the opportunity and right to petition the Tax Court to dispute the proposed adjustments.

To minimize the need to request consents to extend the assessment statute of limitations from taxpayers, the IRS established time periods (audit cycles) to follow when making the decision to start an audit. In practice, the audit cycles are strictly adhered to and have resulted in a classification process for correspondence audits that does not consider selecting prior year tax returns for audit. The IRM states that the audit cycle for an individual tax return spans 26 months and begins on the later of the date when the tax return is due or when it is filed. The audit cycle for a business tax return (*e.g.*, corporate, partnerships) is 27 months.

Our analysis of 340,000 single-year correspondence audit closures in Fiscal Year 2012 showed that when about 80,000 (24 percent) of the 340,000 prior year tax returns closed, there were more than six months remaining in the audit cycle and 18 months remaining on the assessment statute of limitations. As such, expanding the scopes of some correspondence audits means more prior year tax returns could be considered, because a single-year correspondence audit averages fewer than seven months.

### **Control issues exist in the correspondence audit process for deciding whether prior and/or subsequent year returns warrant an audit**

Unlike examiners who conduct face-to-face audits, correspondence examiners are not required to consider issues on subsequent year tax returns. Instead, the IRS relies on its audit sources and tax return classification process for correspondence audits to determine if a prior and/or subsequent year tax return should be audited. However, procedures do not exist in the IRM that instruct how current year audit results are to be used in deciding whether a correspondence audit of the prior and/or subsequent year tax return is warranted. Moreover, procedures have not been developed and incorporated into the IRM that describe how the audit sources and tax return classification process are to be monitored through regular management oversight reviews to



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ensure that prior and/or subsequent year tax returns are considered in selecting tax returns for correspondence audit.

Both IRS guidance and the *Standards for Internal Control in the Federal Government*<sup>12</sup> specify that establishing such control techniques as formal procedures and manager oversight reviews help enforce adherence to management policies and directives, maintain records showing that policies and directives are followed, and assure that performance is assessed on an ongoing basis. Because formalized procedures have not been established for how prior and/or subsequent year tax returns are to be considered and monitored, there is an increased risk that opportunities could be missed to address the noncompliance that contributes to the Tax Gap and promote tax system fairness among taxpayers.

### **Similar techniques used for face-to-face audits could be considered to help address the control issues in the correspondence audit process**

In contrast to the correspondence audit classification process, SB/SE Division officials have included procedures in the IRM on the classification process for the office and field audit programs. Specifically, the IRM recommends that the Territory managers over the Office of Planning and Special Programs, or their designees, review a representative sample of tax returns selected for audit and accepted as filed by each classifier.

To supplement the IRM guidance, in Calendar Year 2007, the SB/SE Division developed and implemented a nationwide Classification Handbook that provides detailed instructions and explanations of the administrative and business procedures that are required to be followed during the classification process. The IRM and the Handbook also outline expectations and responsibilities for both classifiers and managers. Included among managers' expectations and responsibilities is a requirement to document the results from reviewing a minimum of 10 percent of the tax returns classified by each classifier. Besides providing assurance that sound judgment is exercised in deciding which tax returns need to be audited and that performance is monitored on an ongoing basis, the reviews help ensure that tax returns are selected for audit in accordance with established procedures and the potential tax change is sufficient to warrant selection.

### ***Recommendation***

**Recommendation 1:** The Director, Campus Compliance Services, SB/SE Division, should develop and implement procedures in the IRM that instruct how current year correspondence audit results are to be used in deciding whether the prior and/or subsequent year tax returns warrant an audit. To ensure that the instructions are properly followed, the procedures should

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<sup>12</sup> GAO (formerly known as the General Accounting Office), GAO/AIMD-00-21.3.1, *Internal Control: Standards for Internal Control in the Federal Government* (Nov. 1999).



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include instructions for monitoring how well current year correspondence audit results are used in deciding to audit prior and/or subsequent year tax returns.

**Management's Response:** IRS management agreed with our recommendation and plans to take appropriate corrective action by developing an IRM section to address the duties and responsibilities of the workload selection analysts; the case selection, delivery, and monitoring processes; and the role of correspondence examiners. The IRS did not agree with TIGTA's estimate of \$69.4 million in additional revenue as a result of increasing the number of prior and/or subsequent year audits. The IRS believes the calculation of this outcome measure did not take into account the impact of procedures to select the next best case for audit while ensuring there is sufficient time remaining on the assessment statute of limitations.

**Office of Audit Comment:** TIGTA acknowledged in Appendix IV of the report that the value of the outcome measure does not include amounts that would partially offset this benefit by directing resources away from other returns to audit prior and/or subsequent year returns. In addition, TIGTA added clarifying language in Appendix IV of the report to highlight the fact that all tax returns included in the calculation had at least 13 months remaining on the assessment statute of limitations. Given that a correspondence audit averages fewer than seven months, TIGTA believes there was sufficient time to complete all the audits and assess any resulting taxes.



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## Appendix I

### *Detailed Objective, Scope, and Methodology*

Our overall objective was to determine the effectiveness of filing checks made during the correspondence audit process in the SB/SE Division. To accomplish this objective, we:

- I. Determined the policies, procedures, and techniques (management controls) the SB/SE Division has in place to ensure that the correspondence audit process is effectively considering and pursuing prior or subsequent year tax returns when warranted.
  - A. Researched applicable IRM sections and employee training materials for management controls used for the correspondence audit process. In addition, we obtained, reviewed, and discussed the desk procedures used to consider the selection of prior and subsequent year tax returns.
  - B. Interviewed a program manager within the correspondence audit process to obtain information about the management controls in place to consider and pursue, when appropriate, a review of prior and subsequent year tax returns with similar issues as identified in the current year audit.
  - C. Reviewed whether the corrective action for TIGTA's prior recommendations to expand correspondence tax examiners' ability to research subsequent year tax returns was implemented.
- II. Analyzed data obtained from the Audit Information Management System (AIMS) and the Individual Return Transaction File for 473,809 correspondence audits closed during Fiscal Year 2012 to determine the effectiveness of the filters used to remove tax returns containing wage expense and/or contract labor expenses on Form 1040, *Individual Income Tax Return*, Schedule C, *Profit or Loss From Business*, from correspondence audit inventory. We validated the audit population by comparing it to correspondence audit closures reported on the AIMS Computer Information System and verified the accuracy of the resulting downloads by comparing the wage expense and contract labor expense data for 15 records to actual tax return data. Based on the data validation, we determined the data to be reliable and appropriate for our analysis.
- III. Determined how well correspondence tax examiners were complying with management controls related to expanding the audit to include the prior and/or subsequent year tax returns.
  - A. Obtained a computer data extract from the AIMS for completed correspondence audits of individual tax returns that were closed between April 1, 2010, and March 31, 2011, and the taxpayer agreed to a tax assessment amount equal to or



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greater than \$4,000. To streamline our testing, we identified single-year correspondence audits by eliminating taxpayers who had multiple audit closures during our testing period and taxpayers who had an audit closure for a prior or subsequent year just before or after our testing period. We also eliminated audits selected for training purposes and those selected for the First-Time Homebuyer Credit because this credit is allowable only one time. The final review population contained 7,470 correspondence audits. We validated the review population by comparing selected key fields from 15 judgmentally selected records with information on the IRS's Individual Master File and determined the data were reliable and appropriate for our analysis.

- B. Reviewed a statistical random sample of 102 audits from the 7,470 individual tax returns closed as taxpayer agreed correspondence audits between April 1, 2010, and March 31, 2011, with a tax assessment amount equal to or greater than \$4,000. See Step III.A. for identification of the population. Our sampling plan, with concurrence from our contract statistician, was based on a 95 percent confidence level,  $\pm 10$  percent precision, and 50 percent expected error rate because no known rate was available. We identified the tax return line items adjusted on the sample cases and then analyzed the prior and subsequent year tax returns to determine if the same issues were also present.
- C. Calculated the potential taxes, penalty, and interest missed because audits were not expanded to include prior and/or subsequent year tax returns. We then projected the sample review results to the population and discussed them with SB/SE Division management.
- D. Analyzed data extracted from the AIMS for 340,186 correspondence audits closed during Fiscal Year 2012 where there was only one audit for a taxpayer. From this data, we determined the average time it takes to complete a single audit and how many of the prior year tax returns for these taxpayers had at least six months remaining on the audit cycle and at least 18 months remaining on the assessment statute of limitations. We validated the initial data extract by comparing it to correspondence audit closures reported on the AIMS Computer Information System and determined the data were reliable and appropriate for our analysis.



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**Internal controls methodology**

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined the following internal controls were relevant to our audit objective: IRS policies, procedures, and practices for determining, during individual tax audits, whether correspondence examiners are examining all prior and subsequent year tax returns, when warranted. We evaluated these controls by reviewing source materials and reviewing a sample of 102 examined closed cases.



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**Appendix II**

*Major Contributors to This Report*

Augusta R. Cook, Acting Assistant Inspector General for Audit (Compliance and Enforcement Operations)  
Frank Dunleavy, Audit Director  
Michelle Philpott, Acting Audit Director  
Alan Lund, Audit Manager  
David Hartman, Lead Auditor  
Aaron Foote, Senior Auditor  
Jean Kao, Senior Auditor  
Brian Hattery, Information Technology Specialist  
Steven Vandigriff, Information Technology Specialist



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**Appendix III**

*Report Distribution List*

Principal Deputy Commissioner  
Office of the Commissioner – Attn: Chief of Staff C  
Office of the 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, Campus Reporting Compliance, Small Business/Self-Employed Division  
SE:S:CCS:CRC  
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 action will have on tax administration. This benefit will be incorporated into our Semiannual Report to Congress.

#### **Type and Value of Outcome Measure:**

- Increased Revenue – Potential; \$13.9 million in additional taxes, penalties, and interest owed by 2,344 taxpayers; approximately \$69.4 million over five years (see page 6). Our calculation assumes that tax issues present on the prior and/or subsequent year tax return would be disallowed at the same rate as the tax issues disallowed on the primary year tax return, and that the trend in audit results would remain the same over a five-year period. The value of the outcome measure does not include amounts (revenue) that would partially offset this benefit as a result of directing examination resources away from other taxpayer returns to audit taxpayers' prior and/or subsequent year tax returns.

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

- We identified a population of 7,470 individual taxpayers with single-year correspondence audits closed between April 1, 2010, and March 31, 2011, who had an agreed assessment of at least \$4,000. See Appendix I for further details.
- We reviewed a statistically valid sample of 102 audits from the population of 7,470 based on a 95 percent confidence level,  $\pm 10$  percent precision, and 50 percent expected error rate because no known rate was available.
- We identified 32 of the 102 taxpayers audited who had prior or subsequent year tax returns with similar tax issues as the original audit that may have warranted expanding the audit to those tax returns. Each of the 32 taxpayers' prior and subsequent year returns had at least 13 months remaining on the assessment statute of limitations when the original audit was completed.
- Based on our sample error rate of 31 percent (32/102), a confidence level of 95 percent, and a  $\pm 8.99$  percent precision, we calculated the number of taxpayers in the population who may have avoided additional taxes, penalties, and interest to be 2,344 taxpayers [7,470 x 31 percent], with a range of 1,672 to 3,015.
- To estimate the potential amount of additional tax, penalty, and interest that may have been assessed for these 32 taxpayers, we computed the additional tax, penalty, and interest



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## *The Correspondence Audit Selection Process Could Be Strengthened*

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liabilities for the prior and/or subsequent year if the tax issues similar to those that resulted in adjustments to the primary year tax return were present. Based on this analysis, we estimated that had the IRS audited the prior and/or subsequent year tax returns for these 32 taxpayers in our sample, an additional \$154,604 in taxes, \$18,632 in penalties, and \$16,186 in interest could have been assessed.

- We calculated the average additional taxes, penalty, and interest for all 102 taxpayers in our sample [ $\$189,422/102 = \$1,857$ ].
- We then multiplied the number of audits in the total population by the average additional taxes, penalty, and interest amounts due from our sample audits to determine the total amount of additional taxes, penalty, and interest the taxpayers in the population of 7,470 may have avoided [ $7,470 \times \$1,857 = \$13,871,790$ ]. Using the computed standard deviation of \$3,346 to compute the  $\pm$  \$645 precision for our sample, we are 95 percent confident that the total amount of taxes, penalties, and interest avoided by the taxpayers in our population will be between \$9,054,390 and \$18,690,382.
- To estimate the amount of additional taxes, penalties, and interest owed that could be assessed over five years if the IRS expanded audits to the prior and/or subsequent year tax returns when similar tax issues are present, we multiplied the total amount of additional taxes, penalties, and interest we estimated is owed for the population of 7,470 examination cases closed between April 1, 2010, and March 31, 2011, by five to obtain the amount of taxes, penalties, and interest that would be owed over five years [ $\$13,871,790 \times 5 = \$69,358,950$ ]. Our calculation assumes that all estimated taxes, penalties, and interest would be owed based upon audits of the taxpayers' books and records and that conditions such as economic factors, tax law, compliance rates, and IRS audit coverage remain the same.



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## Appendix V

### *Glossary of Terms*

**AIMS Computer Information System** – A monitoring and reporting tool that allows its users to generate reports about audit information on the AIMS and related computer systems.

**Assessment Statute of Limitations** – When the IRS audits a tax return and determines that there is an additional tax liability, the additional tax assessment must generally be processed within three years from the date the tax return was due or from the date on which the tax return was actually filed, whichever is later.

**Audit Information Management System** – A computer system used to control tax returns, input assessments/adjustments to the Master File, and provide management reports.

**Classification** – The process used by IRS Examination functions to determine which tax returns should be selected for audit.

**Discriminant Index Function** – An IRS computer-generated score that identifies tax returns with tax change potential.

**Earned Income Tax Credit** – A refundable Federal tax credit for low-income working individuals and families.

**Fiscal Year** – A 12-consecutive-month period ending on the last day of any month. The Federal Government's fiscal year begins on October 1 and ends on September 30.

**Individual Master File** – An IRS database that maintains transactions and records of individual tax accounts.

**Individual Return Transaction File** – An IRS database that maintains data transcribed from initial input of the original individual tax returns during return processing.

**Internal Revenue Manual** – The primary, official source of instructions to staff relating to the organization, administration, and operation of the IRS.

**Master File** – A group of IRS databases that maintain transactions and records of tax accounts. These databases contain data for individuals, businesses, and employee plans and exempt organizations.

**Required Filing Checks** – An analysis of the tax return information and, when warranted, expansion of the examination to include additional tax returns.

**Revenue Protection Strategy** – A set of IRS programs aimed at identifying and resolving tax issues prior to issuing a taxpayer's refund.



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**Tax Gap** – The difference between taxes that are legally owed and taxes that are paid on time.

**Tax Year** – The 12-month period for which tax is calculated. For most individual taxpayers, the tax year is synonymous with the calendar year.



*The Correspondence Audit Selection  
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**Appendix VI**

*Management's Response to the Draft Report*



COMMISSIONER  
SMALL BUSINESS/SELF-EMPLOYED DIVISION

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

JUL 30 2013

MEMORANDUM FOR MICHAEL E. MCKENNEY  
ACTING DEPUTY INSPECTOR GENERAL FOR AUDIT

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

SUBJECT: Draft Audit Report – The Correspondence Audit Selection  
Process Could Be Strengthened (201130046)

Thank you for the opportunity to review your draft report titled: "The Correspondence Audit Process Could Be Strengthened." We agree with your recommendation and appreciate your acknowledgement of our steps already taken to address the subsequent year filing issues as well as the steps we have taken to be more responsive to taxpayers and less susceptible to missing areas of noncompliance.

We agree that, in certain circumstances, it makes sense to audit the prior and/or subsequent year return; however, we need to consider various factors when making that determination. For instance, when deciding whether to select a prior year return, both the burden on the taxpayer and the administrative responsibilities of the IRS must be considered when there is limited time remaining on the statute of limitations. In addition, to best use our limited resources, we select the next best case for examination which may not be the prior or subsequent year of the taxpayer under examination. We will create procedures for selecting prior year returns taking these items into consideration.

The Small Business/Self Employed Division (SB/SE) previously developed and implemented procedures for addressing all subsequent return filings on agreed and default discretionary workloads that are delivered by Campus Reporting Compliance (CRC). We will ensure those procedures are properly documented and monitored. We agree that there may be some measurable benefit derived from your recommendations. However, we believe the outcome measure, as calculated, does not take into account the impact of our model of working the next best case or our procedures to ensure we only work cases with sufficient time on the statute of limitations for assessment.



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Attached is a detailed response outlining our corrective action. If you have any questions, please contact me, or a member of your staff may contact Denice Vaughan, Director, SB/SE Campus Compliance Services at 404-338-9116.

Attachment



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*The Correspondence Audit Selection  
Process Could Be Strengthened*

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Attachment

**RECOMMENDATION 1:**

The Director, Campus Compliance Services, Small Business/Self Employed Division, should develop and implement procedures in the IRM that instruct how current year correspondence audit results are to be used in deciding whether the prior and/or subsequent year tax returns warrant an audit. To ensure that the instructions are properly followed, the procedures should include instructions for monitoring how well current year correspondence audit results are used in deciding to audit prior and/or subsequent year tax returns.

**CORRECTIVE ACTION:**

We will develop an Internal Revenue Manual (IRM) section that will address the duties and responsibilities of the Workload Selection and Delivery Analysts, the case selection and delivery process, and the role of the Correspondence Exam Tax Examiners. The IRM will include the handling of prior and subsequent year returns on Discretionary cases that are delivered by Campus Reporting Compliance and the monitoring actions. Discussions have already taken place cross-functionally within Campus Compliance Services to begin development of this new IRM information.

**IMPLEMENTATION DATE:**

September 15, 2014

**RESPONSIBLE OFFICIAL:**

Director, Campus Reporting Compliance, Small Business/Self-Employed Division

**CORRECTIVE ACTION MONITORING PLAN:**

We will monitor this corrective action as part of our internal management control system.