



*Improvements Are Needed in
Documentation and Data Accuracy
for the Employment Tax Study*

May 8, 2014

Reference Number: 2014-10-031

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

Redaction Legend:

1 = Tax Return/Return Information

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HIGHLIGHTS

IMPROVEMENTS ARE NEEDED IN DOCUMENTATION AND DATA ACCURACY FOR THE EMPLOYMENT TAX STUDY

Highlights

Final Report issued on May 8, 2014

Highlights of Reference Number: 2014-10-031 to the Internal Revenue Service Deputy Commissioner for Services and Enforcement and Director, Office of Research, Analysis, and Statistics.

IMPACT ON TAXPAYERS

The National Research Program (NRP) Employment Tax Study is designed to collect examination data to allow the IRS to understand the compliance characteristics of taxpayers and use the information to improve employment tax compliance. If complete and accurate data are not collected as part of the NRP Employment Tax Study, study results may not allow the IRS to focus its limited resources on productive areas, reduce burden on compliant taxpayers, or better educate taxpayers on employment tax issues.

WHY TIGTA DID THE AUDIT

The overall objective of this review was to determine whether the examinations conducted as part of the NRP Employment Tax Study considered mandatory (issues specific to a particular IRS business unit), required (issues common among all IRS business units), and worker classification employment tax issues and whether examiners properly documented examination work and appropriately recorded examination results.

WHAT TIGTA FOUND

TIGTA determined that examiners generally completed required forms for the NRP Employment Tax Study to document that they considered mandatory, required, and worker classification issues. However, various supporting documents were not included in the electronic case files. For example, examiners

generally noted that they performed payroll reconciliations on the required forms for a statistical sample of cases TIGTA reviewed. However, in 32 percent of the cases reviewed, examiners did not document steps taken to perform the payroll reconciliations. For instance, examiners noted that they reconciled the Employer's Quarterly Federal Tax Return to Wage and Tax Statements, but there was no documentation in some electronic case files to verify these reconciliations were completed. Required managerial reviews were not effective in identifying the issues TIGTA found.

TIGTA also found inaccuracies on the NRP Employment Tax databases. From a statistical sample of 95 closed cases, TIGTA determined that 1,037 of 3,065 data elements related to examination workpapers and 44 of 1,683 data elements related to examination reports were not accurately reflected on the NRP Employment Tax databases.

WHAT TIGTA RECOMMENDED

TIGTA recommended that the Commissioner, Small Business/Self-Employed Division, and Commissioner, Tax Exempt and Government Entities Division, remind managers and examiners of the importance of adequately documenting case files and document lessons learned to improve future quality of employment tax examinations. In addition, TIGTA recommended that the Director, Office of Research, improve the quality of the data compiled as part of the NRP Employment Tax Study.

In their response to the report, IRS officials agreed with TIGTA's recommendations and plan to or have taken corrective actions. The IRS stated it plans to discuss better documentation of case files with staff and managers and inform all examiners about best practices and techniques to improve employment tax audit quality overall. Also, the IRS stated it plans to employ a data perfection process to identify and correct data problems.



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

May 8, 2014

MEMORANDUM FOR DEPUTY COMMISSIONER FOR SERVICES AND
ENFORCEMENT
DIRECTOR, OFFICE OF RESEARCH, ANALYSIS, AND
STATISTICS

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

SUBJECT: Final Audit Report – Improvements Are Needed in Documentation and
Data Accuracy for the Employment Tax Study (Audit # 201310023)

This report presents the results of our review to determine whether the examinations conducted as part of the National Research Program Employment Tax Study considered mandatory, required, and worker classification employment tax issues¹ and whether examiners properly documented examination work and appropriately recorded examination results. This review is included in our Fiscal Year 2014 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 VIII.

Copies of this report are also being sent to the Internal Revenue Service managers affected by the report recommendations. If you have any questions, please contact me or Gregory D. Kutz, Assistant Inspector General for Audit (Management Services and Exempt Organizations).

¹ Mandatory issues are specific to a particular Internal Revenue Service business unit, while required issues refer to issues common among all Internal Revenue Service business units.



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Abbreviations

DCI	Data Capture Instrument
FSLG	Federal, State, and Local Governments
IRAS	Information Return Analysis System
IRS	Internal Revenue Service
LB&I	Large Business and International
NRP	National Research Program
SB/SE	Small Business/Self-Employed
TE/GE	Tax Exempt and Government Entities
TY	Tax Year



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Background

In Fiscal Year¹ 2000, the Internal Revenue Service (IRS) established the National Research Program (NRP) as part of its efforts to develop and monitor strategic measures of taxpayer compliance. The IRS believes data and compliance measures resulting from the NRP will help it detect noncompliance, reduce taxpayer burden, and support the strategic planning and budget process. According to the IRS, the Tax Gap increased from \$345 billion in Tax Year (TY) 2001 to \$450 billion in TY 2006, the most recent year for which the necessary statistics were available. The IRS estimates that employment tax underreporting constitutes almost \$72 billion of the Tax Gap, including \$14 billion in underreported Social Security and Medicare taxes.

According to the IRS, the data collected from the NRP Employment Tax Study will be used to measure employment tax reporting compliance, better target limited IRS resources, and improve taxpayer education efforts.

The Office of Research, within the IRS's Office of Research, Analysis, and Statistics, is responsible for identifying and selecting tax returns for examination as part of the NRP. Various IRS business operating divisions are responsible for examining the tax returns using NRP guidelines and transmitting the results back to the Office of Research for compilation and analysis.

In February 2010, the IRS initiated an NRP Employment Tax Study focusing on employment tax reporting compliance. The IRS had not conducted a comprehensive study of business taxpayers' compliance with employment taxes since 1984. According to the IRS, the current NRP Employment Tax Study is designed to measure compliance, determine compliance characteristics so the IRS can focus on the employment tax areas with the most significant problems, update return selection criteria, assist the IRS with updating the Tax Gap compliance estimates, identify pre-filing activities that will help taxpayers comply with the tax law, and help ensure fairness of the tax system. However, in a previous audit,² we concluded that the examination results for the sampled taxpayers in the NRP Employment Tax Study may not enable IRS management to fully estimate compliance levels for business taxpayers. Available resources limited the overall sample size, and the sample design excluded some larger employers from the study. In response to that audit, IRS management indicated that they may use the results of ongoing audits to assist in estimating compliance levels for these taxpayers.

¹ See Appendix VII for a glossary of terms.

² Treasury Inspector General for Tax Administration, Ref. No. 2011-10-034, *Limitations in the Sample Size for the Internal Revenue Service's Employment Tax Study May Impact the Ability to Determine Compliance Levels* (May 2011).



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The NRP Employment Tax Study focuses on examinations of Forms 941,³ *Employer's Quarterly Federal Tax Return*, covering TYs 2008, 2009, and 2010. The NRP Employment Tax Study includes Forms 941 selected for the 1) Small Business/Self-Employed (SB/SE) Division, 2) Exempt Organizations function within the Tax Exempt and Government Entities (TE/GE) Division, 3) Federal, State, and Local Governments (FSLG) office within the TE/GE Division, and 4) Large Business and International (LB&I) Division.⁴ As shown in Figure 1, a total of 6,840 cases were randomly selected for the NRP Employment Tax Study. According to IRS management, NRP Employment Tax Study examinations will be substantially completed by the end of Fiscal Year 2014.

Figure 1: Sample Size of the NRP Employment Tax Study by Functional Area

Functional Area	TY 2008	TY 2009	TY 2010	Totals
SB/SE Division	1,514	1,378	1,465	4,357
Exempt Organizations Function	543	770	533	1,846
FSLG Office	89	181	220	490
LB&I Division	49	45	53	147
Totals	2,195	2,374	2,271	6,840

Source: Inventory of the NRP Employment Tax Study as of September 30, 2012.

Examiners within each business operating division receive tax returns assigned to them on their respective inventory and case management system.⁵ The Office of Research has provided examiners with tools developed for the NRP Employment Tax Study to enhance the examination process and capture the data for each of the sampled cases. These include:

- Data Capture Instruments (DCI). Two DCIs were used to electronically organize and collect examination workpapers and results and generate reports for each year of the

³ See Appendix V for a description of tax forms referred to in this report.

⁴ The IRS merged its SB/SE Division and LB&I Division employment tax groups on October 1, 2012.

⁵ The Exempt Organizations function and FSLG office used the Reporting Compliance Case Management System to manage their inventory and work assigned cases, while the SB/SE and LB&I Divisions used the Report Generation Software to manage and work assigned cases. According to the IRS, the Report Generation Software was a completely new program for SB/SE Division and LB&I Division employment tax examiners and managers.



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study.⁶ The first DCI, referred to as DCI-1, contains identifying data, an issue summary, and the lead sheets (workpapers) to be completed during the examination. The case file includes different categories of lead sheets the examiner has available to develop the employment tax case. Mandatory lead sheets address issues specific to a particular business unit within the IRS, while required lead sheets refer to common issues among the business units. The second DCI, referred to as DCI-2, is used by the examiners to create examination reports that are provided to taxpayers. According to the Office of Research, data captured from the DCIs and other IRS computer systems will be used to analyze the results of the NRP Employment Tax Study.

- The Information Return Analysis System (IRAS). Examiners were provided a Microsoft Access[®] program and a data file with Form 1099, *U.S. Information Return*, series of returns and Form W-2, *Wage and Tax Statement*, information that the examiners were required to use to perform payroll tests. This IRAS tool generated reports that enabled the examiner to isolate potential compliance reporting issues. For example, the IRAS generates a report referred to as “An Invalid SSN⁷ Test.” This test may indicate an internal control problem with the preparation of Forms W-2 or Forms 1099 and potential for information return penalties.

Mandatory and required lead sheets (hereafter referred to as required forms) must be completed during the examination, along with additional forms when needed. For example, there are five additional forms associated with worker classification issues that would need to be completed only if the examiner identifies worker classification as a potential issue in the examination. All of the required forms are used to complete examination steps and to document what the examiner did and found during the course of the examination. During the course of this audit, we focused on the following required forms:⁸

- Multi-Year and Related Returns.
- Payroll Reconciliation.
- Form 1099 Filing Checks.
- Fringe Benefits for Executives and Non-Executives.
- Backup Withholding.
- Worker Classification.

⁶ Each DCI had to be extensively reconstructed for each tax year due to tax law changes, tax rate changes, and enhancements identified in the prior year study.

⁷ SSN – Social Security Number.

⁸ See Appendix VI for a description of the required forms we reviewed.



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Once the examination is completed, the examiner uploads case information to the respective inventory management systems, completes the NRP Examiner Case Closing Check Sheet, and transmits the case information and results to the NRP databases. Office of Research analysts designed automated consistency tests that identify potential data entry problems with the submitted data entries. The results are provided to the examiner via an automated e-mail system. If the data are missing or have incomplete elements, the system will indicate the error, and the examiner must complete or correct the error(s) and retransmit the data. Once all preliminary tests have passed, the examiner is provided an e-mail indicating the case is ready for closure. Additionally, after all cases have been closed, Office of Research analysts do a post-closure systemic data review check of all the data transmitted. For example, the analysts review the data to determine whether there are any blank cells, the data in the cells make sense, and there is consistency in the responses.

This review was performed with information obtained from the Office of Research located in Washington, D.C.; the Exempt Organizations function examination office located in Dallas, Texas; and the FSLG office located in Austin, Texas, during the period December 2012 through October 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

Examiners Are Generally Completing Required Forms, but Various Supporting Documents Are Not Included in the Electronic Case Files

We determined that examiners generally completed required forms for the NRP Employment Tax Study to document that they considered mandatory, required, and worker classification issues. These required forms related to: (a) filing requirements, (b) worker classification issues, (c) fringe benefits for executives and nonexecutives, (d) Form 1099 filing checks, and (e) backup withholding issues.

However, various supporting documents were not included in electronic case files as required by IRS policy. Specifically, we found that examiners noted that they performed payroll reconciliations on the required forms in 94 of the 95 closed cases⁹ in our statistical sample.¹⁰ However, examiners did not adequately document steps taken to perform payroll reconciliations in 30 (32 percent)¹¹ of the 94 cases reviewed. Specifically, examiners did not document steps taken to reconcile Forms W-2 to the tax returns, Forms 941 to Forms W-2, and the year-end payroll to Forms W-2 and Form W-3, *Transmittal of Wage and Tax Statements*.

NRP employment tax guidelines require that Forms W-2, Form W-3, Forms 941, income tax returns, and payroll summaries all reconcile to each other. Without adequate supporting documentation in the case file, reviewers have no way of knowing if the examination steps were performed or performed adequately to determine employment tax noncompliance.

In addition, examiners did not include other required documentation in the electronic case file. For example, 26 (27 percent) of 95 cases¹² we reviewed did not include copies of all applicable employment tax returns. Another 17 (18 percent) of 95 cases¹³ did not include a complete set of required IRAS reports. Without this information in the electronic case file, it is unclear whether

⁹*****1*****
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*****1*****

¹⁰ See Appendix I for our sampling methodology.

¹¹ Based on our random sample, we are 90 percent confident that the range of potential NRP Employment Tax Study cases for which examiners did not adequately document steps taken to perform payroll reconciliations is between 24 and 40 percent.

¹² Based on our random sample, we are 90 percent confident that the range of potential NRP Employment Tax Study cases that did not include all applicable employment tax returns is between 20 and 35 percent.

¹³ Based on our random sample, we are 90 percent confident that the range of potential NRP Employment Tax Study cases that did not include all required IRAS reports is between 11 and 24 percent.



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the examiner reviewed all tax returns and performed all required reconciliations to determine if the taxpayer was compliant.

IRS and NRP guidelines require that audit procedures and conclusions for each issue examined be supported by written comments in the workpapers to ensure that the statistical data gathered for the NRP Employment Tax Study are accurate and complete. These guidelines also require that all sampled employment tax returns and IRAS reports be included in the electronic case file. Additionally, the examiners' group managers and the NRP coordinators should be reviewing the electronic case file to determine if required documentation is included.

The lack of supporting documentation in the electronic case file was not discovered in part because internal controls requiring managers to complete checksheets indicating that examiners adequately documented the NRP Employment Tax Study examinations were not effective in identifying the issues we found. Group managers are required under NRP guidelines to complete a review of the case, including preparing a closing checksheet. Managers completed these checksheets in 89 (94 percent) of 95 cases we reviewed¹⁴ and indicated that examiners prepared lead sheets and workpapers that adequately documented the scope, depth, and techniques used to support the conclusions in the case, even though we determined that supporting documentation was not included in many of the cases.

Unless examiners provide adequate documentation and managers provide adequate review of the case files, subsequent analysts, researchers, and outside stakeholders may be unable to rely on the information the study was designed to provide. In addition, if steps are not performed consistently in all NRP Employment Tax Study examinations, the study results may be inaccurate, which could lead to less effective allocation of future enforcement resources.

Recommendations

The Commissioner, SB/SE Division, and Commissioner, TE/GE Division, should:

Recommendation 1: Inform staff and managers of issues identified in our report and remind them of the importance of adequately documenting case files for the remainder of the NRP Employment Tax Study.

Management's Response: IRS management agreed with our recommendation. According to the IRS, the SB/SE and TE/GE Divisions' Employment Tax leadership have already begun to communicate to staff and managers about identified issues through a series of virtual interactive discussions. The focus of the calls is on improving the quality of remaining NRP cases through better documentation. The IRS stated that the remaining calls have been scheduled.

¹⁴ Based on our random sample, we are 90 percent confident that the potential range of NRP Employment Tax Study cases for which managers completed the required checksheets is between 90 and 98 percent.



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Recommendation 2: Assess quality review issues TIGTA identified (e.g., lack of supporting documentation for payroll reconciliations), document any lessons learned, and use the information to improve the overall quality of future employment tax examinations.

Management's Response: IRS management agreed with our recommendation. According to the IRS, SB/SE and TE/GE Divisions' Employment Tax leadership will analyze data from quality reviews of NRP cases. Recurring issues will be identified, including documentation deficiencies, and all group managers will be informed of the deficiencies and expectations for reviewing cases involving required filing checks and documentation under current package audit requirements. The IRS stated that a sample workpaper showing how reconciliation should be documented will be created and tied to lead sheets for use by SB/SE and TE/GE examiners. Group Managers will use it in discussions they will have with all examiners to inform them about best practices and techniques to improve employment tax audit quality overall.

Although Valuable Employment Tax Compliance Data Are Being Gathered, Some Data Are Not Accurate

The NRP Employment Tax Study is collecting voluminous amounts of data to assist the IRS in updating examination selection and resource allocation systems and identifying ways to improve voluntary compliance. These data are recorded by examiners when conducting examinations and subsequently uploaded to the NRP databases. From our statistical sample of 95 closed cases, we reviewed 4,748 data elements¹⁵ recorded by examiners. We determined that 1,081 of these data elements were not accurately reflected on the NRP databases.¹⁶ The *Standards for Internal Control in the Federal Government*¹⁷ state that controls should ensure that transactions are completely and accurately recorded.

Programming and data transmission issues resulted in 1,081 inaccurate data elements within the NRP databases. Specifically:

- 922 data elements erroneously reflected zeros instead of “null” when data fields were intentionally left empty or when certain forms were not applicable. As a result, reviewers may misinterpret examination results because they believe examiners entered zeros in certain fields when that was not the case. IRS management agrees that, in some instances, the use of zero instead of null values is a material difference. However,

¹⁵ These key elements involved payroll reconciliations, backup withholding, Form 1099 filings, fringe benefits, and worker classification issues. We also selected elements that reflected wage adjustments as well as tax and penalty assessments that the examiners reported at the close of the examination.

¹⁶ See Appendix IV.

¹⁷ Government Accountability Office (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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IRS management also believes that, in other instances, the values of zero and null are truly equivalent and should not be considered a data error.

- 97 data elements contained inconsistencies. For example, we found inconsistencies in fields related to: 1) whether both Forms W-2 and 1099 were issued to the taxpayer; 2) how many employees should have additional Form W-2 income; 3) whether any additional payments should have been reported on Forms 1099; 4) number of worker classification issues; and 5) whether the indicator showing the payee furnished the Taxpayer Identification Number was provided. In addition, we found instances in which the examiner entered a number in a data field, but the NRP database did not include the number entered by the examiner.
- 35 data elements contained incorrect additional tax and penalties. *****1*****
*****1*****
*****1*****
*****1****. The Office of Research was unable to provide us with a definitive explanation for the inaccuracy.
- 27 data elements contained incorrect wage adjustment amounts for fringe benefits and backup withholding issues. *****1*****
*****1*****
*****1***** According to the Office of Research, these data errors were due to a computer programming issue, the wrong data being uploaded to the NRP database, or a subsequent transmission of data that overwrote the original data incorrectly.

According to the IRS, most of the errors reported were the result of programming errors or the fact that data were not retransmitted to the NRP database after changes were made to examination data. There were some instances in which the Office of Research could not provide us with a definitive explanation for the discrepancies. The Office of Research stated that it was aware of some of these issues and was reloading the NRP databases using source data. In addition, it was in the process of improving the accuracy of the final data sets for the sampled TY 2008 data and plans to improve data accuracy for TYs 2009 and 2010 data thereafter.

Inaccurate information on the NRP databases could lead to less effective allocation of future enforcement resources and may not provide the correct information for improving examination selection and taxpayer education efforts.

Recommendation

Recommendation 3: The Director, Office of Research, should improve the quality of the data compiled for all tax years (approximately 6,800 sampled cases) to provide reasonable assurance that the databases accurately reflect the results of examinations.



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Management's Response: IRS management agreed with our recommendation. According to the IRS, the NRP employs a data perfection process prior to final data delivery to identify and correct data problems. Through this process, the IRS stated that the NRP uncovered the same issues as we did in our audit and has already worked to improve the data. The NRP's perfection processes include enhanced data testing and reloading all final DCI files with correct data. According to the IRS, the final NRP Employment Tax data set will be a substantially accurate reflection of the examiner findings and entries in the data capture instruments.

Office of Audit Comments: IRS management disagreed with the outcome measures in Appendix IV related to the data elements that were not accurately reflected on the NRP databases. The IRS believes that, because the audit occurred during the study's standard data perfection process, the audit was limited by the in-process nature of the data and that the data would be accurate by the end of the study.

Our estimates are based on a review of the NRP database using a statistical sampling methodology of closed cases at a particular point in time. Based on the data errors we identified, we made a recommendation to improve the quality of data. We continue to believe our outcome measures are an accurate reflection of potential data errors if the IRS does not take adequate corrective action.



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Appendix I

Detailed Objective, Scope, and Methodology

Our overall objective was to determine whether the examinations conducted as part of the NRP Employment Tax Study considered mandatory, required, and worker classification employment tax issues and whether examiners properly documented examination work and appropriately recorded examination results. To accomplish our objective, we:

- I. Obtained background information on the NRP Employment Tax Study.
 - A. Obtained and reviewed Internal Revenue Manual 4.22.1 and 4.22.10, existing desk procedures and guidelines, and any planned revisions related to completing the NRP Employment Tax Study.
 - B. Obtained the universe of NRP Employment Tax Study closures and verified the data were complete and accurate.
 1. Requested an extract of all 3,823 closed cases (this figure included 46 cases that were closed without being examined) for the NRP Employment Tax Study as of September 30, 2012, from the Office of Research.
 2. Researched the Audit Information Management System¹ to determine the number of closed NRP Employment Tax Study cases as of September 30, 2012 (this included all the NRP Employment Tax Study closures for TYs 2008, 2009, and 2010 for all business operating divisions).
 3. Validated that the information obtained in Step I.B.1. was the same as the information obtained in Step I.B.2. and concluded that the data provided by the Office of Research were sufficiently reliable for this audit.
- II. Reviewed a statistical sample of cases to determine whether examiners considered and documented mandatory, required, and worker classification issues and if related data were accurately captured on the NRP databases.
 - A. Consulted with a statistician to select a statistical sample of 95 cases from the population of 3,777 closed NRP Employment Tax Study cases (as of September 30, 2012) for which an examination was conducted. We selected our statistical sample using the following criteria: 90 percent confidence level, 10 percent expected error rate, and ± 5 percent precision rate. We selected the cases randomly to

¹ See Appendix VII for a glossary of terms.



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ensure that each of the closed cases had an equal chance of being selected, which enabled us to obtain sufficient evidence to support our results.

- B. Using the statistical sample from Step II.A., determined whether:
1. Required forms were completed for mandatory, required, and worker classification issues, if applicable.
 2. The case file documented completion of the required testing, identification and examination of the issues and, if needed, resolution of the deficiencies.
 3. Determined whether case reviews included documentation to support managerial oversight of the examination for the 95 cases sampled.
 4. Determined whether examination results were being appropriately captured on the NRP databases for the 95 cases sampled.
 - a. Requested a download of the captured NRP results from the Office of Research for the 95 cases sampled.
 - b. Determined if the examination results for the 95 sampled cases relating to the mandatory, required, and/or worker classification issues were accurately captured on the NRP databases. From our statistical sample of 95 closed cases, we reviewed 3,065 data elements² selected from the DCI-1 lead sheets completed by examiners and matched the data to the NRP Employment Tax databases. The key data elements were recorded by examiners on lead sheets that would provide valuable employment tax compliance data for the NRP Employment Tax Study. These elements involved payroll reconciliations, backup withholding, Form 1099 filings, fringe benefits, and worker classification issues.
 - c. Determined if the examination results for the same statistical sample of 95 closed cases related to the reports identifying wage adjustments and tax and penalty assessments were accurately captured on the NRP databases. We reviewed 1,683 data elements selected from the DCI-2 reports completed by examiners at the close of an examination and matched the data to the NRP Employment Tax databases. Our objective was to identify the wage adjustments and the taxes and penalties assessed on these reports and match these data to the data captured on the NRP Employment Tax databases.³

² We looked at the same 37 data elements for each of the 95 cases in our sample. In some instances, we found that the data element was not required for the earlier years of the study. We did not consider these as errors.

³ The number of data elements reviewed for each case was not always the same. Depending on the examination results, examiners may have been required to complete additional data elements.



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5. For Step II.B.4., calculated Reliability of Information outcomes for the number of data elements for which examination results were not accurately captured on the NRP databases.

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: NRP Employment Tax Study and IRS policies as well as procedures and practices for conducting employment tax examinations. We evaluated these controls by interviewing personnel, reviewing documentation, reviewing statistical samples of the NRP Employment Tax Study closed cases, and reviewing the data compiled on the NRP databases.



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Appendix II

Major Contributors to This Report

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Donald J. Martineau, Auditor



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Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Commissioner, Small Business/Self-Employed Division SE:S
Commissioner, Tax Exempt and Government Entities Division SE:T
Director, Office of Research RAS:R
Director, Exempt Organizations, Tax Exempt and Government Entities Division SE:T:EO
Acting Director, Government Entities, Tax Exempt and Government Entities Division SE:T:GE
Director, Specialty Programs, Small Business/Self-Employed Division SE:S:SP
Chief Counsel CC
National Taxpayer Advocate TA
Director, Office of Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis RAS:O
Office Of Internal Control OS:CFO:CPIC:IC
Audit Liaisons:
 Deputy Commissioner for Services and Enforcement SE
 Commissioner, Small Business/Self-Employed Division SE:S
 Commissioner, Tax Exempt and Government Entities Division SE:T
 Director, Office of Research, Analysis, and Statistics RAS



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Appendix IV

Outcome Measures

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

Type and Value of Outcome Measure:

Reliability of Information – Potential; 4,572 DCI-1 data elements that were not accurately reflected on the NRP databases (see page 7).

Methodology Used to Measure the Reported Benefit:

From our statistical sample of 95 closed cases, we reviewed 3,065 data elements¹ selected from the DCI-1 lead sheets completed by examiners and matched the data to the NRP Employment Tax databases. These elements involved payroll reconciliations, backup withholding, Form 1099 (*U.S. Information Return*) filings, fringe benefits, and worker classification issues.

We determined that 1,037 of the 3,065 DCI-1 data elements were not accurately reflected on the NRP databases. This included 922 data elements that erroneously reflected zeros instead of “null” when data fields were intentionally left empty or when certain forms were not applicable. While we consider all of the 1,037 errors to be data errors, we agree with IRS management that, in some instances, the use of zero instead of null values is not material. To be conservative, we only included the remaining 115 inaccurate data elements (1,037 - 922) in our projections.²

Based on our statistical sample, we determined that 47 of the 95 cases contained errors related to the 115 data elements that were not captured accurately on the NRP Employment Tax databases. The average number of errors per case was 1.211. We projected the results of our sample by multiplying the average number of errors per case in our sample by the population of closed cases ($1.210526 \times 3,777$) for a total of 4,572 errors. We are 90 percent confident that the number of errors falls between 3,329 and 5,816.

¹ We looked at the same 37 data elements for each of the 95 cases in our sample. In some instances, we found that the data element was not required for the earlier years of the study. We did not consider these as errors.

² This includes 97 data elements containing inconsistencies and 18 data elements containing incorrect wage adjustment amounts for fringe benefits (page 8).



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Type and Value of Outcome Measure:

Reliability of Information – Potential; 1,749 DCI-2 data elements that were not accurately reflected on the NRP databases (see page 7).

Methodology Used to Measure the Reported Benefit:

From our statistical sample of 95 closed cases, we reviewed 1,683 data elements selected from the DCI-2 reports completed by examiners and matched the data to the NRP Employment Tax databases. Our objective was to identify the wage adjustments and the taxes and penalties assessed on these reports and match these data to the data captured on the NRP Employment Tax databases. Not all of the 95 cases in our sample reflected wage adjustments, taxes, or penalties. When a case documented wage adjustments, taxes, or penalties, we reviewed data elements from those forms that were specific to the case and matched them to the elements on the NRP databases. These elements were not necessarily the same for each case reviewed. If a case had no adjustments, we selected data elements from reports that showed no adjustments and matched those same elements to the NRP databases. In these instances, we found \$0 captured on the NRP databases. We determined that 44 of the 1,683 data elements were not accurately reflected on the NRP databases.³

Based on our statistical sample, we determined that 11 of the 95 cases reviewed contained errors related to 44 data elements. The average number of errors per case was 0.463. We projected the results of our sample by multiplying the average number of errors per case by the population of closed cases ($0.463 \times 3,777$) for a total of 1,749 errors. We are 90 percent confident that the number of errors falls between 638 and 2,861.

³ This includes 35 data elements containing incorrect additional tax and penalties and nine data elements containing incorrect wage adjustment amounts for fringe benefits and backup withholding issues (page 8).



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Appendix V

Tax Forms Referred to in This Report

Tax Form	Form Name and Use
Form 941	<i>Employer's Quarterly Federal Tax Return.</i> Employers who withhold income taxes from wages, or who must pay Social Security or Medicare tax, use Form 941 to report those taxes.
Form 1099 series	<i>U.S. Information Returns.</i> This series of forms is used to report various types of taxable income other than wages, salaries, and tips. A copy of these forms should be furnished to employees to assist in preparing income tax returns.
Form W-2	<i>Wage and Tax Statement.</i> Employers file Forms W-2 to report wages, tips, and other compensation paid to employees as well as Social Security and Medicare taxes and withheld income taxes.
Form W-3	<i>Transmittal of Wage and Tax Statements.</i> Employers use Form W-3 to transmit Forms W-2 to the Social Security Administration.



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Appendix VI

Required Forms Referred to in This Report

Required Form	Description
Multi-Year and Related Returns	This required form contains examination steps the examiner should consider to determine the taxpayer's filing requirements (including both employment and related income tax returns) and determine whether the taxpayer under examination is compliant with those filing requirements. This required form assists the examiner in concluding whether to expand the examination to other tax years (employment taxes) and/or to refer the case to another group of examiners if there is an indication that the entity is not in compliance with income tax requirements.
Payroll Reconciliation	This required form lists the required payroll examination steps that the examiner needs to complete to verify that the Forms W-2, Forms W-3, Forms 941, income tax returns, and payroll summaries reconcile. The Payroll Reconciliation form also includes an extensive list of the required IRAS reports that the examiner needs to review and include in the case file to perform required payroll tests for potential compliance issues relevant to Forms 1099 and W-2 reporting.
Form 1099 Filing Checks	This required form is designed to assist the examiner in identifying issues related to worker classification, including Forms 1099 issued by the taxpayer or Forms 1099 that should have been issued by the taxpayer and whether payments reported on the Forms 1099 should have been reported as wages on a Form W-2.
Fringe Benefits for Executives and Non-Executives	These required forms summarize the adjustments for taxable fringe benefits the examiner identified during the examination and captures all the various benefits the entity could provide its employees.
Backup Withholding	This required form is designed to assist the examiner in determining if there was an omission of Form 1099 income, if backup withholding applies, and if the taxpayer had the employee's Taxpayer Identification Number on file at the time reportable payments were made.
Worker Classification	These forms are additional forms relating to whether workers were misclassified and treated as independent contractors but should have been treated as employees.



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Appendix VII

Glossary of Terms

Term	Definition
Audit Information Management System	This IRS computer system tracks the location, age, and status of tax returns under examination and is used to control tax returns, input assessments/adjustments, and provide management reports.
Backup Withholding	Persons (payors) making reportable payments to payees must deduct and withhold for the IRS a specified percentage of those payments, if a condition for withholding exists.
Business Operating Division	The IRS is comprised of four business operating divisions: the Wage and Investment, SB/SE, LB&I, and TE/GE Divisions.
Data Capture Instrument (DCI)	The DCI consists of two Microsoft Excel workbook files. DCI-1 is a compilation of electronic forms used by the examiner to complete the employment tax examination. DCI-1 is shared by all participating business operating divisions and contains entity data, an issue summary, and the required forms that should be completed during an examination. DCI-2 consists of the report writing package. Data are captured from these files for research and analysis purposes.
Data Elements	DCIs contain multiple spreadsheets. In the context of this report, a data element refers to a single entry in a cell of one of these spreadsheets.
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.
Fringe Benefit	Any cash, property, or service that an employee receives in addition to regular taxable wages.
Information Return Analysis System	The IRAS is a Microsoft Access program that examiners conducting NRP Employment Tax Study examinations must use to perform required payroll tests for potential issues relevant to Forms 1099 and W-2 reporting.



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Term	Definition
Lead Sheets	Preloaded Microsoft Excel workpapers in the DCI created to assist in the examination of mandatory, required, and examiner-identified issues.
Tax Gap	The gross Tax Gap is the difference between what taxpayers should pay on a timely basis and what the IRS collects through voluntary compliance and enforcement activities. The net Tax Gap is calculated by subtracting amounts the IRS expects to recover through enforcement actions and late payments.
Taxpayer Identification Number	A nine-digit number assigned to taxpayers for identification purposes. Depending upon the nature of the taxpayer, the number is an Employer Identification Number, Social Security Number, or Individual Taxpayer Identification Number.
Tax Year	A 12-month accounting period for keeping records on income and expenses used as a basis for calculating the annual taxes due.



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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

APR 17 2014

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

FROM: Karen Schiller 
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – Improvements Are Needed in
Documentation and Data Accuracy for the Employment Tax
Study (#201310023)

Thank you for the opportunity to review your draft report titled, "Improvements Are Needed in Documentation and Data Accuracy for the Employment Tax Study." We agree with all of the recommendations and have already taken actions to improve documentation on the remaining open National Research Project (NRP) cases. We have conducted interactive sessions with most of our examination field groups where we conveyed TIGTA's findings and re-emphasized proper payroll reconciliation and workpaper documentation on the remaining open cases. Furthermore, we have already worked to improve the data. The final data set will be a substantially accurate reflection of the examiners' findings and entries in the data capture instruments.

Prior to the NRP Employment Tax Study in February 2010, a comprehensive study of business taxpayers' compliance with employment taxes had not been conducted since 1984. The current NRP is designed to measure compliance as well as determine compliance characteristics. This will allow the IRS to update return selection criteria, provide training to examiners on emerging issues, and focus on the most significant areas of employment tax non-compliance. This NRP will also provide valuable data that will be used to identify pre-filing activities to help taxpayers comply with the tax law and ensure the fairness of the tax system. The data collected will be used to maximize use of limited resources and improve taxpayer outreach and education materials.

In regards to the two Outcome Measures that there is a potential of 4,572 Data Capture Instrument (DCI)-1 data elements and 1,749 DCI-2 data elements not accurately reflected on the NRP databases, we disagree that data will not be accurate at the end of the study. NRP is running various data perfection tests to ensure delivered data is an accurate reflection of the examiners' findings by cross-referencing both DCI files



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and the Audit Information Management System (AIMS) closed-case database. Because this audit occurred during NRP's standard data perfection process, the audit was limited by the in-progress nature of the data being examined. NRP continues its data perfection efforts and has now developed over 864 data consistency tests to ensure that the data being delivered is of the highest quality possible.

Attached is a detailed response outlining our corrective actions to address your recommendations.

If you have any questions, please contact me, or a member of your staff may contact John H. Imhoff Jr, Director, Specialty Programs at (215) 861-1176.

Attachment



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Attachment

RECOMMENDATION 1:

Inform staff and managers of issues identified in our report and remind them of the importance of adequately documenting case files for the remainder of the NRP Employment Tax Study.

CORRECTIVE ACTION:

SB/SE and TE/GE Employment Tax leadership have already begun to communicate to staff and managers about identified issues through a series of virtual interactive discussions. The focus of the calls is on improving the quality of remaining National Research Project (NRP) cases through better documentation. The remaining calls have been scheduled.

IMPLEMENTATION DATE:

1. Completed
2. July 15, 2014

RESPONSIBLE OFFICIAL(S):

1. Director, Specialty Programs, Small Business/Self-Employed Division
2. Director, Exempt Organizations, Tax Exempt/Government Entities Division

CORRECTIVE ACTION MONITORING PLAN:

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

RECOMMENDATION 2:

Assess quality review issues TIGTA identified (e.g., lack of supporting documentation for payroll reconciliations), document any lessons learned, and use the information to improve the overall quality of future employment tax examinations.

CORRECTIVE ACTION:

SB/SE and TE/GE Employment Tax leadership will analyze data from quality reviews of NRP cases. Recurring issues will be identified, including documentation deficiencies. All group managers will be informed of the deficiencies and expectations for reviewing cases involving required filing checks and documentation under current package audit requirements. Additionally, a sample work paper showing how reconciliation should be documented will be created and tied to lead sheets for use by SB/SE and TE/GE examiners. Group Managers will use it in discussions they will have with all examiners to inform them about best practices and techniques to improve employment tax audit quality overall.

IMPLEMENTATION DATE:

May 15, 2015



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RESPONSIBLE OFFICIAL(S):

Director, Specialty Programs, Small Business/Self-Employed Division
Director, Exempt Organizations, Tax Exempt/Government Entities Division

CORRECTIVE ACTION MONITORING PLAN:

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

RECOMMENDATION 3:

The Director, Office of Research, should improve the quality of the data compiled for all tax years (approximately 6,800 sampled cases) to provide reasonable assurance that the databases accurately reflect the results of examinations.

CORRECTIVE ACTION:

NRP employs a data perfection process prior to final data delivery to identify and correct data problems. Through this process, NRP uncovered the same issues as TIGTA; furthermore, NRP has already worked to improve the data. NRP's perfection processes include enhanced data testing and reloading all final DCI files with correct data. The final NRP Employment Tax (ET) data set will be a substantially accurate reflection of the examiner findings and entries in the data capture instruments.

IMPLEMENTATION DATE:

July 15, 2016

RESPONSIBLE OFFICIAL(S):

Director, Office of Research, Analysis and Statistics, National Research Program

CORRECTIVE ACTION MONITORING PLAN:

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