



*Improvements Are Necessary to Ensure  
That Individual Amended Returns With  
Claims for Refunds and Abatements  
of Taxes Are Properly Reviewed*

**May 17, 2016**

**Reference Number: 2016-30-032**

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 NECESSARY TO ENSURE THAT INDIVIDUAL AMENDED RETURNS WITH CLAIMS FOR REFUNDS AND ABATEMENTS OF TAXES ARE PROPERLY REVIEWED**

## Highlights

**Final Report issued on May 17, 2016.**

Highlights of Reference Number: 2016-30-032 to the Internal Revenue Service Commissioner for the Small Business/Self-Employed and the Wage and Investment Divisions.

### **IMPACT ON TAXPAYERS**

When taxpayers identify that they need to make a change to their originally filed tax return, they can file an amended tax return, which may include a claim for refund or abatement of taxes. It is incumbent upon the IRS to ensure that claims for refunds and abatements of taxes are properly reviewed. Effective controls for reviewing claims ensure more consistent treatment of taxpayers, promote voluntary compliance, and protect revenue for the Federal Government.

### **WHY TIGTA DID THE AUDIT**

This audit was initiated to determine whether the IRS's controls over the auditing of amended individual tax returns with claims ensure that claims are properly evaluated and accurately processed and are effective in preventing the inappropriate issuance of tax refunds or allowance of tax abatements.

### **WHAT TIGTA FOUND**

IRS controls over the examination of amended individual tax returns with claims did not always ensure that claims were properly evaluated and were not always effective in preventing the potentially inappropriate issuance of tax refunds and allowance of tax abatements. TIGTA reviewed a statistical sample of 84 Fiscal Year 2013 closed surveys and audits of amended individual returns with claims for refunds or abatements of taxes and found that 31 claims were not appropriately substantiated

and/or had large, unusual, or questionable items on the tax return that were not adequately considered and investigated. TIGTA's evaluation indicates that a combination of factors caused these problems and that actions can be taken to better ensure that claims are substantiated (appropriate supporting documentation is obtained) and that issues on the amended returns are recognized, considered, and properly investigated.

When the sample results are projected to the populations, TIGTA estimates that a total of approximately \$34.4 million in tax refunds and abatements may have been inappropriately allowed.

### **WHAT TIGTA RECOMMENDED**

TIGTA recommended that the IRS change specific Examination function controls, tools, and procedures to improve surveying, auditing, and documenting reviews of claims for refunds and abatements of taxes.

IRS management agreed with five of the six recommendations and plans to take corrective actions. IRS management disagreed with our recommendation to require that claims coordinators document the justification for surveying a claim and to evaluate the benefits of requiring claims coordinators to identify and document whether any large, unusual, or questionable items existed on the return.

TIGTA believes that it would be beneficial for claims coordinators to utilize their expertise and research any large, unusual, or questionable items for all returns since they are more knowledgeable of audit issues and perhaps more equipped to identify issues.



TREASURY INSPECTOR GENERAL  
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C. 20220

May 17, 2016

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

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

**SUBJECT:** Final Audit Report – Improvements Are Necessary to Ensure That  
Individual Amended Returns With Claims for Refunds and Abatements  
of Taxes Are Properly Reviewed (Audit # 201330047)

This report presents the results of our review to determine whether the Internal Revenue Service's controls over auditing amended individual returns with claims for refunds or abatements of taxes ensure that the claims are properly evaluated and accurately processed and are effective in preventing inappropriate issuance of tax refunds and allowance of tax abatements. This review is included in our Fiscal Year 2016 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 VII.

If you have any questions, please contact me or Matthew Weir, Assistant Inspector General for Audit (Compliance and Enforcement Operations).



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## *Abbreviations*

FY	Fiscal Year
I.R.C.	Internal Revenue Code
IRM	Internal Revenue Manual
IRS	Internal Revenue Service
LUQ	Large, Unusual, or Questionable
PSP	Planning and Special Programs
SB/SE	Small Business/Self-Employed
TIGTA	Treasury Inspector General for Tax Administration
W&I	Wage and Investment



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## *Background*

When taxpayers need to make a change to their originally filed Form 1040 series tax returns, they can file an amended tax return using Form 1040X, *Amended U.S. Individual Income Tax Return*.<sup>1</sup> Taxpayers can add, delete, update, or change income, exemptions, deductions, credits, filing status, *etc.*, reported on their original tax return, including claiming tax credits and deductions that were not previously claimed. Under Internal Revenue Code (I.R.C.) Section (§) 6511, the general rule is that taxpayers must file a claim for a credit or refund within three years from the time the original tax return was filed or two years from the time the tax was paid, whichever is later.<sup>2</sup> According to Internal Revenue Service (IRS) officials, approximately 4 million amended returns were filed for each of Fiscal Years (FY)<sup>3</sup> 2013 and 2014.

For this review, we focused only on those amended individual tax returns claiming a refund or abatement of taxes (hereafter referred to as a “claim”) equal to or greater than \$5,000.<sup>4</sup> In FY 2013, the IRS’s Examination functions (Field and Campus) closed 3,969 reviews meeting these criteria. For most of these claims (3,383 cases, or 85 percent), the IRS opened an audit, which involves obtaining and reviewing information from the taxpayer to substantiate items on the amended return before issuing a tax refund or allowing a tax abatement. The remaining claims (586 cases, or 15 percent) were surveyed, meaning the claims were accepted as filed without contacting the taxpayer.

### *Processing and auditing of claims*

Current IRS policies and systems only accept amended returns via paper returns. The paper returns are first received by the Submission Processing function, which is part of the IRS’s Wage and Investment (W&I) Division. Tax examiners manually review the claims to determine if they meet certain criteria (*i.e.*, Category A, which is often referred to as CAT-A criteria) requiring additional review. Claims that do not meet the CAT-A criteria are processed within the Submission Processing function and thus are not forwarded for possible audit. Those claims that

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<sup>1</sup> Form 1040 series tax returns include Forms 1040 and 1040A, *U.S. Individual Income Tax Return*; Form 1040EZ, *Income Tax Return for Single and Joint Filers With No Dependents*; Form 1040NR, *U.S. Nonresident Alien Income Tax Return*; and Form 1040NR-EZ, *U.S. Income Tax Return for Certain Nonresident Aliens With No Dependents*. Form 1040X is used to amend all of these various Form 1040 series returns. For the purposes of this report, we are referring to the Form 1040 series tax returns when we reference Forms 1040.

<sup>2</sup> I.R.C. § 6511 provides numerous exceptions to the general refund statute of limitations (three years from the date of the return or two years from the date the tax was paid), including the I.R.C. § 6511(d)(1) seven-year period for claims related to bad debts or worthless securities and the § 6511(h) suspension of the running of the refund statute of limitations for as long as a person is “financially disabled” within the meaning of the statute.

<sup>3</sup> A glossary of terms is included as Appendix VI.

<sup>4</sup> See Appendix I for additional details regarding our data methodology.

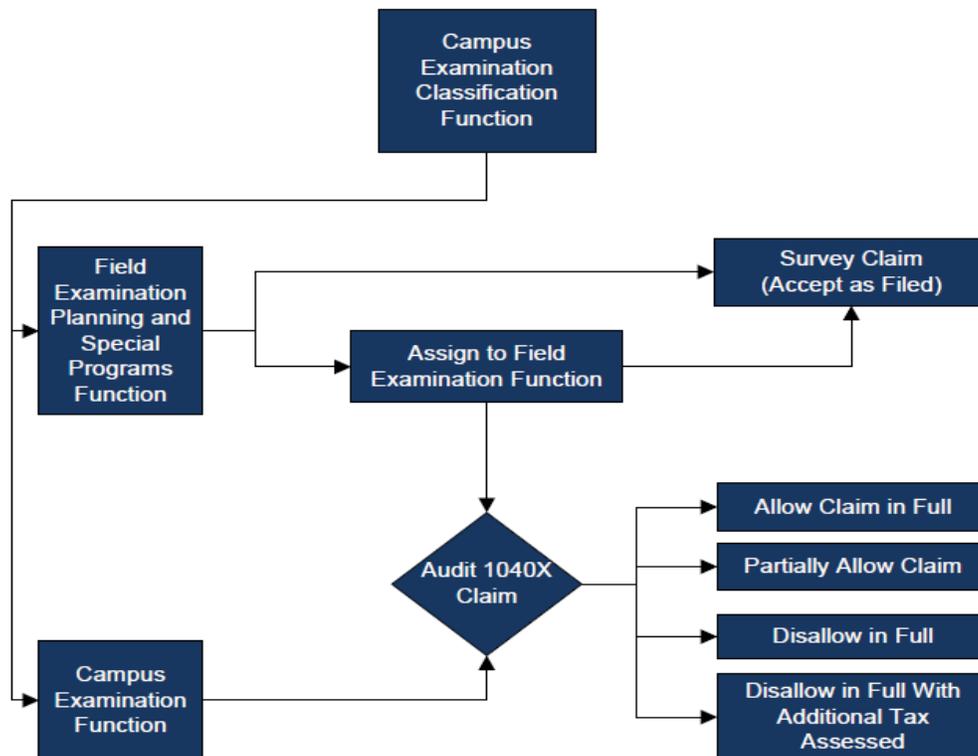


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meet the CAT-A criteria are referred to the IRS’s Accounts Management function. Once the Accounts Management function receives the claim, it is responsible for confirming that the claim in fact meets CAT-A criteria and was not forwarded in error. If a claim meets CAT-A criteria, the claim will be forwarded to the Campus Examination Classification function, where it is reviewed to determine if the IRS should select the claim for audit.

Prior to referring a claim for audit, the Campus Examination classifier will notate the classified issues that need to be addressed by an examiner. Depending on the complexity of the classified issues, the return will either be sent to the Field Examination’s Planning and Special Programs (PSP) function or to the Campus Examination function. Once claims are forwarded to either the Campus or Field Examination functions, they will either be surveyed (*i.e.*, accepted as filed and the IRS issues a tax refund or allows a tax abatement) or audited.<sup>5</sup> Figure 1 depicts the review process of claims within the audit stream.

**Figure 1: Review of a Form 1040X Within the Audit Stream**



Source: Treasury Inspector General for Tax Administration (TIGTA) analysis of IRS audits of Forms 1040X.

<sup>5</sup> According to IRS officials, the Campus Examination function does not have the option to survey claims. TIGTA’s review of a population of claims that were surveyed in FY 2013 confirmed that Campus Examination employees did not survey any claims in FY 2013. All surveyed claims identified were surveyed by the Small Business/ Self-Employed Field Examination function.



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Prior to surveying or auditing a claim, the return is reviewed to determine if the claim for a credit or refund was timely filed and if the documentation provided supports the claim.<sup>6</sup> Typically the claim would be surveyed if the IRS determines that an audit would not result in a material change to the taxpayer's tax liability. To determine whether a material change in tax liability may be likely, the IRS has implemented control procedures that require a risk analysis. The risk analysis that PSP claims coordinators and group managers would perform prior to surveying a return would include reviewing the return and case file information.<sup>7</sup> Although the risk analysis completed by PSP claims coordinators and group managers are similarly a high-level analysis, the group manager is also required to plan, monitor, and direct the input of work to accomplish program priorities and effectively utilize resources, whereas the PSP claims coordinator is not required to do such.

The risk analysis performed by field examiners is more in-depth and typically includes thoroughly reviewing the claim to identify large, unusual, or questionable (LUQ) items, validating that the taxpayer has filed returns for prior and subsequent tax years, and performing some minimum income probes. As noted in Internal Revenue Manual (IRM) 4.10.4.3,<sup>8</sup> minimum income probes are designed as a set of analytical tests intended to determine whether the taxpayer accurately reported income. As a result, in certain circumstances, if a taxpayer is underreporting income, the probes may identify at least a portion of the understatement.

Campus examiners also complete a risk analysis; however, it is not as in-depth as a field examiner's risk analysis. According to IRS officials, campus examiners operate in a different environment and have a higher inventory of less complex returns. For example, campus examiners are not required to perform minimum income probes to identify underreported income. Although the risk analyses performed by both field and campus examiners may indicate that an audit is necessary, the IRS must also consider whether there are available resources as well as the overall audit potential of the claim as compared to that of returns in other inventory streams.

***Previous reports identified problems with IRS controls for processing amended returns claiming a tax refund***

Although the focus of this report is on the audit processes for substantiating claims, it is important to note that TIGTA has previously reported concerns with the adequacy of the IRS's processing of amended tax returns (specifically the process prior to referring a claim for audit).<sup>9</sup>

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<sup>6</sup> According to Form 1040X instructions, taxpayers are not required to provide supporting documentation relating to items on a tax form that is subject to the Paperwork Reduction Act. Supporting documentation can include a copy of the original return being amended along with the supporting schedules and worksheets.

<sup>7</sup> The risk analysis completed by PSP claims coordinators and group managers involve reviewing the case file information and the classified issues (*i.e.*, those identified prior to the return being forwarded to PSP) as well as resource constraints and workload priorities.

<sup>8</sup> IRM 4.10.4.3, *Minimum Requirements for Examination of Income* (Aug. 9, 2011).

<sup>9</sup> According to the IRS, corrective actions have been taken since the issuance of these reports.



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Specifically, since June 2011, TIGTA has issued the following three reports that identified weaknesses related to the processing of amended tax returns that resulted in taxpayers receiving potentially erroneous tax benefits, including tax refunds:

- ***Amended Tax Return Filing and Processing Needs to Be Modernized to Reduce Erroneous Refunds, Processing Costs, and Taxpayer Burden*** (Ref. No. 2014-40-028, issued April 2014) – Manual processing of amended tax returns results in the issuance of potentially erroneous tax refunds. TIGTA estimated that the IRS may have issued more than \$439 million in potentially erroneous tax refunds claimed on 187,421 amended returns in FY 2012.<sup>10</sup>
- ***Processes to Address Erroneous Adoption Credits Result in Increased Taxpayer Burden and Credits Allowed to Nonqualifying Individuals*** (Ref. No. 2012-40-065, issued June 2012) – TIGTA reviewed a sample of 100 amended tax returns with an Adoption Credit and found that the IRS erroneously allowed Adoption Credits, totaling approximately \$239,000, claimed on 22 of the amended tax returns reviewed. For these 22 amended tax returns, TIGTA found that the taxpayers did not provide the required documentation to support their claims.
- ***Control Weaknesses Over Amended Returns Allowed Some Inappropriate Claims for the First-Time Homebuyer Credit to Be Allowed*** (Ref. No. 2011-41-057, issued June 2011) – IRS errors in processing amended tax returns allowed taxpayers to inappropriately avoid the repayment of their First-Time Homebuyer Credits and receive multiple refunds for the credit.

This review was performed with information obtained from the Small Business/Self-Employed (SB/SE) Division Gulf States Area PSP Function in Farmers Branch, Texas; SB/SE Division Headquarters in New Carrollton, Maryland; and W&I Division Headquarters in Atlanta, Georgia, during the period July 2013 through August 2015. We conducted this 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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<sup>10</sup> These point estimate projections were based on a two-sided 95 percent confidence interval. As discussed in the report, we are 95 percent confident that the \$439 million point estimate is between \$280.1 million and \$599.7 million and the 187,421 point estimate is between 136,874 and 237,969 tax returns.



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*Results of Review*

IRS controls for reviewing individual tax returns with claims for refunds or abatements of taxes did not always ensure that claims were properly evaluated and were not always effective in preventing the potentially inappropriate issuance of tax refunds and allowance of tax abatements. We reviewed a statistical sample of 84 FY 2013 closed surveys and audits of individual tax returns with claims for refunds or abatements of taxes. As noted in Figure 2, our review found that 31 (37 percent) of the 84 claims involved taxpayers receiving a tax refund or being allowed an abatement even though the claims were not appropriately substantiated (there was insufficient documentation to support the validity of the claim) and/or involved tax returns that contained LUQ items that were not adequately considered and investigated.

As a result, opportunities may have been missed to further promote voluntary compliance and protect revenue for the Federal Government. Specifically, when our sample results are projected to the populations, we estimate that a total of approximately \$34.39 million in tax refunds and abatements may have been inappropriately allowed; \$3.61 million for surveyed claims and \$30.78 million for audited claims.<sup>11</sup> When forecasted over a five-year period, we estimate that \$171.9 million<sup>12</sup> in tax refunds and abatements may have been inappropriately allowed; \$18 million for surveyed claims and \$153.9 million for audited claims.<sup>13</sup> Our evaluation indicates that a combination of factors caused these problems and that actions can be taken at the examiner and group manager levels to better ensure that appropriate supporting documentation is obtained to substantiate claims and that issues on the returns are recognized and properly investigated.

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<sup>11</sup> The point estimate projections are based on a two-sided 95 percent confidence interval. We are 95 percent confident that taxpayers may have erroneously received tax refunds or abatements between \$1.9 million and \$5.4 million for surveyed claims, between \$6 million and \$32.2 million for field audited claims, and between \$7 million and \$16.4 million for campus audited claims.

<sup>12</sup> Amounts and percentages presented in this report may not add exactly due to rounding.

<sup>13</sup> See Appendix IV. The five-year forecast is based on multiplying the base year by five and assumes, among other considerations, that economic conditions and tax laws do not change. The value of the outcome measure does not include amounts (revenue) that would offset these benefits as a result of directing resources away from auditing other taxpayer returns in order to pursue supporting documentation and/or identify and investigate LUQ items.



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**Figure 2: Results of Review of Surveyed and Audited Claims**

	Totals Number of Exceptions and Returns Reviewed			Range of Exception Claim Amounts	
	Total Exceptions <sup>14</sup>	Exception Rate <sup>15</sup>	Total Reviewed	Low	High
<b>SURVEYS</b>					
PSP	7	39%	18	\$5,500	\$95,300
Field	7	39%	18	\$12,800	\$930,200
<i>Surveyed by Group Managers</i>	4	57%	7	\$12,800	\$930,200
<i>Surveyed by Field Examiners</i>	3	27%	11	\$13,700	\$71,500
<b>Total Surveys</b>	<b>14</b>	<b>39%</b>	<b>36</b>		
<b>AUDITS</b>					
Field	10	34%	29	\$14,400	\$1,300,000
Campus	7	37%	19	***1***	\$56,900
<b>Total Audits</b>	<b>17</b>	<b>35%</b>	<b>48</b>		
<b>Total Surveys and Audits</b>	<b>31</b>	<b>37%</b>	<b>84</b>		

Source: TIGTA summary and analysis of a sample of 84 FY 2013 closed surveys and audits of amended individual returns claiming tax refunds or abatements.

**[Additional Steps Should Be Taken Prior to Accepting Claims As Filed to Ensure That Refunds and Abatements of Taxes Are Only Allowed When Warranted](#)**

While IRS procedures provide some guidance on the steps that should be taken to determine whether to audit or survey a claim, our results indicate that additional improvements are needed. Specifically, as noted in Figure 2, for our review of 36 returns that were surveyed by the PSP and Field Examination functions, we found 14 cases (39 percent) that had issues which warranted further scrutiny typically performed during an audit.

<sup>14</sup> Since the exception cases often contained both types of errors, the number of exceptions for both categories (*i.e.*, lack of LUQ item consideration and lack of documentation) would not equal the total number of exceptions.

<sup>15</sup> The exception rate is based on the raw data (*i.e.*, the number of exceptions divided by the total reviewed). Given that our review included a stratified sample, we calculated the weighted average exception rates and used such to project the results to the populations. For additional details about the stratified sampling methodology and projection, see Appendices I and IV.



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**The PSP function accepted claims as filed that appeared to warrant further investigation**

When a claim is referred to the Field Examination function, it is first received by one of the seven PSP function areas. A PSP claims coordinator reviews a claim and determines whether to survey (*i.e.*, accept the claim as filed and issue the tax refund or allow a tax abatement) or forward the claim to a Field Examination group for further review and possible audit. PSP claims coordinators are responsible for evaluating a significant number of claims for tax refunds and abatements each year and play a key role in determining whether a claim warrants forwarding to a Field Examination group. According to IRS officials, as a result of this key role, PSP claims coordinators are subject matter experts who have been revenue agents or tax compliance officers in a Field Examination group for many years and thus are able to quickly identify issues on the return that would warrant an audit. However, the results of our case reviews indicate that additional guidance and controls are needed to ensure that PSP claims coordinators are identifying issues and forwarding claims for audit when warranted.

Specifically, we found that seven (39 percent) of the 18 claims surveyed by the PSP function during FY 2013 either lacked adequate documentation to substantiate the claim and/or had an LUQ item on the return that was not considered and investigated.<sup>16</sup> Forwarding these claims, ranging from approximately \$5,500 to \$95,300, for audit would have resulted in the claims being disallowed if the taxpayers were unable to provide documentation to substantiate the claims. Alternatively, the claims may have been partially or fully offset by investigating LUQ items. We included several examples of exception cases from our sample in Appendix V; however, they cannot be included in the public version of the report due to restrictions pursuant to I.R.C. § 6103.

Though not an actual case, the example below is reflective of the types of issues and outcomes in our exception cases that should have been referred by the PSP function for further examination.

EXAMPLE: Taxpayer A filed a Form 1040 for Tax Year 2013 reflecting total taxes owed of \$55,000, withholdings of \$50,000, and a balance due of \$5,000, which the taxpayer pays upon the filing of the return. In Calendar Year 2015, Taxpayer A filed a Form 1040X amending his originally filed Tax Year 2013 return and attaches a Form 4684, *Casualties and Thefts*, to report a \$275,000 casualty loss and other items as well, resulting in a \$25,000 tax refund. The IRS accepted the claim as filed and did not request that Taxpayer A provide substantiation for the casualty loss, such as evidence of the casualty event and the impact on the taxpayer's property.<sup>17</sup>

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<sup>16</sup> The IRS generally agreed with our conclusions that the IRS should have contacted the taxpayer to obtain additional documentation to substantiate the claim and/or investigate LUQ items. Of the seven exception cases, the IRS did not fully agree with \*\*\*\*\*1\*\*\*\*\* of these cases.

<sup>17</sup> Under I.R.C. §165(a), taxpayers may deduct losses not compensated by insurance or other means of reimbursement and subject to certain limitations in I.R.C. §165(h).



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The \$275,000 casualty loss claim in the hypothetical example above is an LUQ item under the IRS's definition and should have been subjected to further examination. The tax impact of the casualty loss deduction would be to create a substantial refund for the taxpayer. When taxpayers claim significant refunds of their tax liability, they should be requested to provide documentation to support LUQ items on their amended returns. While not all of these taxpayers may be able to produce records as they may have been destroyed in a disaster, documents such as photographic evidence of the casualty or the results of an insurance claim could be easily obtained by the taxpayers and/or insurance company to substantiate the claims. In our sample of surveyed claims, similar types of issues and amounts were not identified as LUQ items, and the specifics of such cases are outlined in Appendix V. The seven exception cases reviewed by the PSP function had claims that were significant enough to merit further investigation to ensure that the claims were valid as well as ensure the accuracy of the entire return, including identifying and investigating any LUQ items which may result in offsetting the claim. We believe these types of issues were not adequately considered by the PSP function for several reasons.

According to IRM 4.1.1.7,<sup>18</sup> claims coordinators should be subject matter experts and survey claims when warranted. Therefore, determining whether to survey a claim within the PSP function or forward the claim for audit is ultimately left to the discretion of the PSP claims coordinators. While we found that some of the PSP areas require managerial approval prior to surveying a claim, evaluating a PSP claims coordinator's decision to survey a claim would be difficult in most cases since there is no requirement for PSP claims coordinators to provide an explanation or reason to support the decision to survey a claim. For the seven exception cases surveyed by the PSP function, we found that the majority of claims did not contain an explanation or reason as to why the claim was surveyed. After discussing our findings with IRS officials, they informed us that they would consider revising their procedures to ensure that a justification is included in the case file to explain why the claim was surveyed. We believe this type of documentation will help the IRS evaluate the appropriateness of the PSP claims coordinators' decisions during annual operational reviews.<sup>19</sup>

In addition to the lack of detailed guidance for the PSP claims coordinators in the IRM, the PSP function area desk guides also lacked detailed guidance and provided inconsistent guidance from area to area. Specifically, our analysis of the area desk guides identified inconsistencies from area to area in regards to dollar thresholds, explanations of when a survey was warranted, and evaluating the return for LUQ items beyond the reason for the amended return, among other items. The PSP function's area desk guides may need to be geographically specific (to account for the tax treatment of natural disasters and other economic situations); however, we believe that additional controls are needed to ensure that PSP claims coordinators are adequately evaluating and approving claims and that taxpayers are being treated consistently and fairly from area to area.

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<sup>18</sup> IRM 4.1.1.7, *Program Coordination* (Mar. 1, 2013).

<sup>19</sup> Annual operation reviews include reviewing a sample of PSP claims coordinators' inventory at least once a year.



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Furthermore, during our review of the area desk guides, we found that not all areas require PSP claims coordinators to review returns for LUQ items. After notifying the IRS about our findings that the desk guides were inconsistent in regards to whether PSP claims coordinators were required to research LUQ items, we were informed that the IRS plans to revise the guides. Specifically, IRS officials plan to clarify that all PSP function areas should limit their research for LUQ items to those that were identified by the Campus Examination Classification function before the return was forwarded to the PSP function. IRS officials stated that requiring PSP claims coordinators to review for LUQ items beyond those already identified by the Campus Examination Classification function would result in a duplication of efforts and that the only time a PSP claims coordinator should research for LUQ items is if there is no evidence in the case file which shows that the Campus Examination Classification function researched the return for LUQ items.

Although we understand the IRS's position on preventing duplication of efforts, IRS officials consider PSP claims coordinators as subject matter experts (former revenue agents and tax compliance officers) and stated that they play a key role in determining whether a return warrants forwarding to a Field Examination group. As a result, we believe that PSP claims coordinators should use this expertise and research LUQ items for all returns because they are more knowledgeable of audit issues and perhaps more equipped to identify issues beyond those identified by the Campus Examination Classification function. Moreover, we believe that there should be extra scrutiny on claims for refunds and abatements of taxes to protect revenue for the Federal Government, especially since claims surveyed by the PSP function are not subject to any further review by any other IRS function.

Lastly, at the time our sample cases were reviewed, the PSP function's area desk guides allowed PSP claims coordinators to survey a claim if the amount of the claim was under a certain threshold. The majority of the seven exception claims that were surveyed by the PSP function were under the dollar thresholds in the respective PSP function area desk guides. While the PSP claims coordinators may have deemed it acceptable to survey the claims and issue tax refunds or allow tax abatements without adequate documentation to support the validity of the claims, we believe, and the IRS generally agreed, that further scrutiny of these claims was warranted because the claim amounts for these seven claims were material and reduced the taxpayers' tax liabilities by 19 to 96 percent.

During our review, IRS officials informed us that (1) for two of the PSP function areas, the dollar thresholds were not being used and (2) for two other PSP function areas, the dollar thresholds were not intended to serve as thresholds for surveying claims, but instead they were thresholds for determining whether to refer the claim to a tax compliance officer or revenue agent. While this may be the case for these four areas, there was at least one area that used the threshold to determine whether to survey the claim and appeared to adhere to the threshold. IRS officials informed us that they plan to revise the PSP function area desk guides to remove the dollar thresholds for all areas. While we are not recommending that the IRS remove the dollar thresholds, it may be beneficial to implement a threshold for which the claim would be surveyed



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if forwarding the claim for audit would not result in a material change in tax liability. Finally, IRS officials informed us that they began reviewing the PSP function's area desk guides as part of the FY 2015 operational review and will continue to review them on an annual basis.

**Implementation of additional control procedures could better ensure that Field Examination properly evaluates claims for tax refunds and abatements**

If the PSP function determines that a claim should be audited, it forwards the claim to one of the Field Examination groups. Upon receipt of the claim from the PSP function, a Field Examination group manager uses his or her professional judgment to determine whether to survey a claim or assign it to a field examiner for audit. We reviewed 18 claims that were surveyed by either a group manager or a field examiner and found that seven (39 percent) lacked adequate documentation to support the claim and/or had LUQ items present on the return that were not considered and investigated.<sup>20</sup>

Of the seven errors we identified, three were surveyed by field examiners and the remaining four were surveyed by group managers. We have included several examples of exception cases from our sample in Appendix V; however, they cannot be included in the public version of the report due to restrictions pursuant to I.R.C. § 6103. Though not an actual case, the hypothetical example below is reflective of the types of issues and outcomes in our exception cases that should not have been surveyed by the Field Examination function.

EXAMPLE: Taxpayer B filed a Form 1040 for Tax Year 2013 showing \$1,000 on Schedule A as a noncash charitable contribution deduction and a \$1 million noncash charitable contribution carryforward. In Calendar Year 2015, the taxpayer filed a Form 1040X for Tax Year 2013 to increase the Schedule D losses. The \$1 million noncash charitable contribution that was included on the originally filed Tax Year 2013 return remained unchanged on the Form 1040X. The noncash contribution carryforward was not identified as an LUQ item, and the taxpayer was not requested to provide an explanation or substantiation to support the noncash contribution carryforward.<sup>21</sup>

In the hypothetical example, the \$1 million noncash charitable contribution is an LUQ item and should be further investigated. In our sample, similar types of issues and amounts were not identified as LUQ items, and the specifics of such cases are outlined in Appendix V. In addition to large, unsubstantiated deductions such as the noncash charitable contribution deduction in the hypothetical example, LUQ items can also include aspects of the taxpayer's compliance behavior for other tax years, such as unfiled tax returns, and reclassification of large income items to

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<sup>20</sup> The IRS did not always agree with our conclusions that the taxpayer should have been contacted to obtain additional documentation to substantiate the claim and/or investigate LUQ items. Of the seven exception cases, the IRS did not fully agree with \*\*\*\*\*1\*\*\*\*\* of these cases. \*\*\*\*\*1\*\*\*\*\*

<sup>21</sup> Under I.R.C. § 170, charitable contributions are deductible for individuals up to 50 percent of their adjusted gross income in a specific tax year; however, taxpayers can generally carry forward any unused amount for five years.



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nontaxable status, which can decrease the tax liability. The seven exception cases surveyed by the Field Examination function were significant enough to merit further investigation to ensure that the claims were valid.

Additionally, for four of the seven exception cases surveyed by a group manager, we did not find any evidence that the group managers performed a risk analysis or identified the issues we found. According to IRM 1.4.40.4.6.3,<sup>22</sup> the group manager is required to perform a risk analysis and survey the case if it will not result in a material tax change. To determine whether a material change in tax liability may be likely, the IRS implemented control procedures that require the group manager to perform a risk analysis prior to surveying the claim. Although a risk analysis is not clearly defined in the IRM or in any other guidance, we believe that there are some minimum steps that should be performed to determine if a material tax change would be likely if the IRS proceeded with auditing the claim. For instance, the group managers would need to look for underreported income by conducting a minimum income probe and/or a preliminary Financial Status Analysis (commonly referred to as a preliminary Cash-T analysis). The Cash-T analysis is based on the assumption that taxpayers need to earn a certain amount of money to cover their expenses, including basic living expenses, and among other information, should be reporting an income that is large enough to cover those expenses. Additionally, according to IRS officials, a group manager's decision to survey a claim is based on consideration of a number of factors including, but not limited to, a comparison of the potential benefits to be derived from auditing a return to the resources required to perform the audit as well as the nature of the work, review of return and case file information, available resources, and other priority work in the group.

According to IRS officials, group managers are not required to document the required risk analysis and its results, nor are they required to document their consideration of LUQ items. For the four exception cases surveyed by group managers, IRS officials stated that they believe the group managers made the appropriate decisions in these cases because they most likely evaluated their inventory and resource constraints and determined that other inventory was of a higher priority. Notwithstanding the IRS's resource challenges, we believe the risk analysis is imperative in determining which tax returns should be surveyed and which returns should be audited. For the four claims we took exception with that were surveyed by group managers, we believe the claim amounts were material enough to warrant an audit because the average claim for a refund or abatement of taxes was in excess of \$24,000.

In addition, although we agree with IRS management that group managers, as well as PSP claims coordinators, must have the flexibility to survey claims based upon items such as their professional judgment, knowledge of tax law, the specific issues of each claim, available resources, and other priority work within the examination group's inventory, we believe that improvements could be made to ensure that the audit case files include the results of the risk analysis as well as a justification regarding why a claim for a refund or abatement of taxes was

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<sup>22</sup> IRM 1.4.40.4.6.3, *Surveying Cases* (May 19, 2010).



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allowed without contacting the taxpayer to obtain supporting documentation and/or considering and investigating LUQ items. According to IRM 4.10.9,<sup>23</sup> an audit case file should support the reason for case closure. While this IRM section is specific to field examiners, we believe that it is also necessary for group managers to document their risk analyses in a similar manner. Such documentation would help better ensure that the group managers' decisions to survey claims, as well as prioritize their inventory, are properly supported.

## ***Recommendations***

The Director, Examination, SB/SE Division, should:

**Recommendation 1:** Establish controls to ensure that the PSP function's area desk guides are consistent in their instructions and requirements for the processing of claims.

**Management's Response:** The IRS agreed with this recommendation and stated that it will conduct an annual review of the PSP function's area desk guides to ensure the accuracy and consistency of the guidance.

Although the IRS agreed with the recommendation and plans to take corrective actions, the IRS did not agree with the measurable impact (outcome measures) that our recommended corrective actions will have on tax administration. IRS management stated that the outcome measures are overstated because they believe that (1) there were significant differences between cases worked by Field and Campus examiners, and the IRS employees, using all available information, reached the appropriate conclusion in most instances; (2) TIGTA did not account for cases that would have a partial claim allowance when the taxpayer can substantiate some of the claim; and (3) the LUQs in these cases had "relatively low audit potential."

**Office of Audit Comment:** We maintain our position that our outcome measures are valid and reasonable as presented. Our sample and estimate projections are statistically valid and were developed with the assistance and concurrence of our contract statistician. The evidence obtained during our audit provides a reasonable basis for our findings and conclusions, including those related to our sample cases, for which the report properly distinguished the results (sample, error rates, and projections) by the Field and Campus Examinations functions.

In addition, our outcome measure estimates already reflect that fact that neither we nor the IRS know with any degree of certainty what percentage of our exception cases would have resulted in a different outcome if the examiner would have properly identified and investigated the claim and/or LUQs. To reasonably estimate how many taxpayers may have been able to substantiate their claims, we analyzed FYs 2013 through 2015 data available in the Audit Information Management System and found that, on average,

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<sup>23</sup> IRM 4.10.9, *Examination of Returns, Workpaper System and Case File Assembly* (Aug. 11, 2014).



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claims audited by the Field Examination and Campus Examination functions were fully allowed 19 percent and 21 percent of the time, respectively (*i.e.*, the examiners did not make any adjustments to the claim amounts requested by the taxpayer because they were able to verify the claims with support from the taxpayers). Based on the known data limitations, we believe that these rates provided TIGTA and the IRS with the best reasonable estimate for reducing the outcome measures. It is important to note that we presented this approach for estimating the outcome measures to the IRS during our review, and IRS management stated that they agreed with our methodology for reducing the outcome measures.

**Recommendation 2:** Revise procedures to ensure that the justification for PSP claims coordinators surveying a claim is documented and evaluate the benefits of requiring them to identify and document whether any LUQ items existed on the return.

**Management's Response:** IRS management disagreed that it was necessary to revise procedures. According to management, a limited number of the total claims meeting the criteria noted in this report were surveyed in the PSP function. Managers approve all closures from the PSP function, including surveys of claims. They further explained that managers already have the ability to evaluate the PSP claims coordinator's decision to survey a claim at the time of closure and discuss any concerns that they may have. IRS management stated that they fail to see sufficient potential benefits to warrant expending limited resources on creating documentation to support the reason for surveys in the PSP function. With regard to identifying and documenting LUQ items, the IRS stated that the Campus Examination function conducts a review of the return and identifies LUQ items, and requiring PSP claims coordinators to review the return again for the same items would be a duplication of efforts and an inappropriate use of limited IRS resources.

**Office of Audit Comment:** We maintain our position that the PSP claims coordinators' decision to survey a claim should be documented. Without a written explanation to support the decision to survey a claim, evaluating a PSP claims coordinator's decision to survey a claim would be difficult. This type of documentation will help the IRS evaluate the appropriateness of the PSP claims coordinators' decisions, especially during annual operational reviews. We also maintain our position that PSP claims coordinators should identify and document whether any LUQ items existed on the return. During our audit, IRS officials stated that they consider the PSP claims coordinators subject matter experts (former revenue agents and tax compliance officers) who play a key role in determining whether a return warrants forwarding to a Field Examination group. As a result, we continue to believe that it would be beneficial for PSP claims coordinators to utilize their expertise and research LUQ items for all returns since they are more knowledgeable of audit issues and perhaps more equipped to identify issues beyond those identified by the Campus Examination Classification function. Moreover, we believe that there should be extra scrutiny on claims for refunds and abatements of taxes to protect revenue for the Federal Government, especially since



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claims surveyed by the PSP function are not subject to further review by any other IRS function.

**Recommendation 3:** Establish a process for group managers to document their decisions to survey claims, which would include documenting the results of their risk analyses.

**Management's Response:** IRS management agreed with our recommendation and stated that they will define the group manager's risk analysis and evaluate the need to require documentation of the group manager's decision to close an amended return as surveyed. They will initiate any related IRM changes necessary.

**Audit Procedures for Amended Returns With Claims for Refunds and Abatements of Taxes Should Be Improved**

As noted in Figure 2, our case reviews found that 17 (35 percent) of 48 sampled audited claims for tax refunds and/or abatements were not appropriately reviewed by either the Field Examination or Campus Examination functions.<sup>24</sup> Specifically, claims were either allowed without adequate documentation to substantiate the claim and/or LUQ items on the return were not properly considered and investigated. If the examiners had followed applicable procedures and obtained adequate documentation to support the claims and/or considered and investigated the LUQ items present on these 17 tax returns, the claims, ranging from approximately \$14,400 to \$1.3 million for the field cases and approximately \$8,000 to \$56,900 for the campus cases, would have either been substantiated or partially or fully offset.

**Field examiners approved returns with claims that lacked adequate documentation and/or contained LUQ items that were not adequately considered and investigated**

Claims selected for audit and assigned to field examiners are subject to procedures in the IRM that require the examiners to evaluate the return in its entirety to identify any LUQ items during all audits, including audits of claims. Specifically, IRM 4.10.2<sup>25</sup> details the responsibility of field examiners to perform a thorough review of any audit case file in order to identify LUQ items beyond those which may have been previously identified before the return was assigned to the Field Examination function. In addition, IRM 4.10.3<sup>26</sup> requires examiners to ensure that sufficient and competent evidence is obtained to support the validity of the claims.

For 10 (34 percent) of the 29 sample claims we reviewed, field examiners either did not consider and investigate LUQ items and/or did not obtain adequate documentation to support the validity

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<sup>24</sup> For these 17 exception cases, 10 were worked by the Field Examination function and seven were worked by the Campus Examination function.

<sup>25</sup> IRM 4.10.2, *Examination of Returns, Pre-contact Responsibilities* (Jan. 17, 2012).

<sup>26</sup> IRM 4.10.3, *Examination Techniques* (Mar. 1, 2003).



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of the claims, which ranged from approximately \$14,400 to \$1.3 million.<sup>27</sup> During our review of the claims audited by the Field Examination function, we found that seven (24 percent) of the 29 audit case files we reviewed had LUQ items on the returns that were not adequately considered and investigated. We researched the audit case files for these seven claims and found that the field examiners noted that they reviewed the return for LUQ items in all of the seven cases. However, the examiners did not identify the LUQ items we identified in the majority of the seven cases. We included examples of cases from our sample in Appendix V; however, they cannot be included in the public version of the report due to restrictions pursuant to I.R.C. § 6103. Though not an actual case, the hypothetical example below is reflective of the types of issues and outcomes in our exception cases that should receive further examination by the Field Examination function.

**EXAMPLE:** Taxpayer C filed a Form 1040 for Tax Year 2013 reflecting items of income and expenses consistent with previous years except that the deduction for State and local income taxes were \$700,000, nearly five times higher than in any previous tax year. The Tax Year 2013 Form 1040 was not selected for examination. However, Taxpayer C amended the originally filed Tax Year 2013 return in Calendar Year 2015 by filing a Form 1040X for Tax Year 2013 claiming a \$300,000 refund and reflecting a \$2 million theft loss due to a well-publicized fraud by an investment brokerage firm. Because the State and local tax issue was on the original return and did not change on the amended return, it was not further examined. The \$2 million theft loss was not deemed an LUQ because the theft was well-publicized and known by the examiner.

In the example above, there are two LUQ items: the anomaly of the significantly higher State and local income tax deduction (which was on the original return) and the theft loss on the amended return. In our sample, similar types of issues and amounts were not identified by the Examination function as LUQ items, and the specifics of such cases are outlined in Appendix V. According to the IRM 4.10.2, examiners are required to consider LUQ items even if they were present on the original return and did not change on the amended return. Additionally, a well publicized theft should still be substantiated on a case-by-case basis by examiners.

In some of the exception cases, the examiners documented that they researched LUQ items using only a checkbox response that they had investigated LUQ items without providing detailed explanations anywhere else in the audit case files. Although the IRS revised the applicable examiner lead sheets in FY 2015 to remove the checkbox response, we are uncertain whether the enhancements will fully address our concerns, and we will not be able to test the effectiveness of such revisions until a subsequent review in this area. However, our initial observation is that the revised lead sheets do not provide examples of the type of LUQ items that the examiner should

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<sup>27</sup> The IRS did not always agree with our conclusions that the taxpayer should have been contacted to obtain additional documentation to substantiate the claim and/or investigate LUQ items. Of the 10 exception cases, the IRS did not fully agree with five (50 percent) of these cases.



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research and the instructions on the lead sheets do not require the examiner to document the results of the research.

In addition to claims lacking adequate review of LUQ items, we also found that six (21 percent) of the 29 audit case files reviewed lacked adequate documentation to support the validity of the claim. For example, examiners approved claims averaging approximately \$310,500 without obtaining the documentation to support these claims (such as final court documents and receipts). According to IRM 4.10.3, examiners are required to obtain and evaluate sufficient competent evidence to ensure that a taxpayer's return is accurate. Instructions in IRM 4.10.9 detail that audit case files must include all the information necessary to support audit results. It is important for examiners to evaluate the accuracy of the tax return by obtaining sufficient competent evidence. Without obtaining this evidence, there is no way for the examiner to evaluate and determine the accuracy of the tax return.

**Campus Examination function controls are not effective in ensuring the validity of claims for tax refunds and abatements and identifying potentially unreported income and financial status issues**

Given that campus examiners do not have the same experience and training as field examiners and operate in a different capacity than field examiners, the IRS developed guidance in IRM 4.19<sup>28</sup> that applies only to campus examiners. One distinct difference between the requirements for the field and campus is that campus examiners are not required to perform an in-depth precontact analysis similar to the analysis field examiners must perform.

Our review of 19 claims that were audited by the Campus Examination function found that campus examiners did not obtain adequate documentation to support the validity of taxpayer claims or consider and investigate LUQ items for seven (37 percent) claims.<sup>29</sup> These claims averaged approximately \$30,000. Without further review of these LUQ items, we believe that the IRS lost an opportunity to potentially offset the claims.

We have included several examples of exception cases from our sample in Appendix V; however, they cannot be included in the public version of the report due to restrictions pursuant to I.R.C. § 6103. Though not an actual case, the hypothetical example below is reflective of the types of issues and outcomes in our exception cases that should receive further examination by the Campus Examination function.

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<sup>28</sup> IRM 4.19.10, *Liability Determination, Examination General Overview* (Dec. 2, 2014).

<sup>29</sup> Of the 19 audited claims we reviewed that were worked by the Campus Examination function, nine were conducted by the SB/SE Division Campus Examination function and 10 were conducted by the W&I Division Campus Examination function. Although the IRS agreed with the facts of each case, it did not always agree with our conclusions that the examiner should have contacted the taxpayer to obtain additional documentation to substantiate the claim and/or investigate LUQ items. The IRS did not fully agree with all seven of these cases.



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EXAMPLE: Taxpayer D filed a Form 1040 for Tax Year 2013 claiming \$20,000 of income from a dog grooming business and mortgage interest of \$10,000. Taxpayer D claimed four child dependents along with the Earned Income Tax Credit, the Child Tax Credit, and the Additional Child Tax Credit, therefore claiming a refund of \$5,000. In Calendar Year 2015, Taxpayer D filed a Form 1040X amending the originally filed Tax Year 2013 return to claim the Adoption Credit for the four child dependents, increasing the refund from \$5,000 to \$50,000. The case was selected for audit, and while the Adoption Credit was addressed in the audit, the campus examiner did not identify the mortgage interest deduction as an LUQ item nor did the examiner pursue (or document the reasons why the examiner did not pursue) the possibility of underreported income that is suggested by the relatively low income and relatively high mortgage interest deduction.

In the hypothetical example above, the relatively large interest deduction is an LUQ item and should have been further investigated or the examiner should have documented why the item was not audited. In our sample, similar types of issues and amounts were not identified by the Campus Examination function as LUQ items, and the decision to not pursue questionable items was not documented. Taxpayers are claiming significant refunds or abatements of taxes, sometimes as a result of a refundable credit, and this is particularly risky because the taxpayers are not always required to provide the IRS with support, such as court documents, receipts, cancelled checks, and similar third-party documentation.

While some technical LUQ items would be beyond the scope of a campus examiner, the LUQ items we identified were not technical issues, and the IRS could implement controls to better ensure that LUQ items similar to the ones we identified are addressed during audits performed by campus examiners, especially those that involve claims for refunds and abatements of taxes.

The main reason the LUQ items we identified were not addressed is attributable to the fact that campus examiners are instructed to only review returns for LUQ items that were identified prior to campus examiners receiving the return. These preidentified issues would typically only include the reason for the adjustments on the amended return and would involve contacting the taxpayer, through correspondence, to obtain documentation to substantiate such adjustments. Due to the Campus Examination function's approach to compliance, the IRS is not adequately ensuring that all income is reported. To put this in perspective, in FY 2013 the Campus Examination function closed 2,040<sup>30</sup> (60 percent) of the 3,383 claims over \$5,000 that were audited by the Campus and Field Examination functions. When we project the results<sup>31</sup> of our review of the 19 sample cases audited by the Campus Examination function, *i.e.*, the exception

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<sup>30</sup> These 2,040 claims totaled approximately \$34.3 million.

<sup>31</sup> The exception rate for cases that included only LUQ items that were not identified and investigated was 19.83 percent and was calculated using a weighted average exception rate by determining the weight of each stratum in our population and the exception rate per stratum and then multiplying the weight of each stratum by the exception rate per stratum and summing the results. The 19.83 percent is a point estimate projection and is based on a two-sided 95 percent confidence interval. We are 95 percent confident that the exception rate is between 1.72 percent and 37.93 percent. See Appendix IV for additional details.



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rate for those cases that had LUQ items (financial status issues) that were not identified and investigated, we estimate that returns with \$8.7 million<sup>32</sup> in claims may have contained LUQ items that were not addressed due to the current policies and procedures in the Campus Examination function.

Furthermore, while our audit was limited to claims for refunds or abatements of taxes, the Campus Examination function audits approximately one million tax returns on an annual basis and thus the financial status issues and underreported income issues going unaddressed is likely not limited to claims because the scope limitations discussed in this report apply to all tax returns, not just claims, that are audited by the Campus Examination function. As a result, it is imperative that the IRS implement controls to identify underreported income, especially on individual returns with claims for refunds or abatements of taxes, to better ensure that revenue is protected for the Federal Government.

## ***Recommendations***

The Director, Examination, SB/SE Division, should:

**Recommendation 4:** Issue guidance to field examiners and group managers that stresses the importance of obtaining adequate documentation to support the validity of claims as well as their responsibility to review and document LUQ items considered during audits.

**Management's Response:** The IRS agreed with this recommendation and stated that it will issue a memo reminding field examiners and group managers of the importance of examiners documenting their consideration of LUQ items as well as examined issues.

**Recommendation 5:** Ensure that the lead sheets designed to document the field examiners' consideration and investigation of LUQ items effectively address the concerns noted in this report.

**Management's Response:** The IRS agreed with this recommendation and stated that they will review relevant lead sheets and revise them if needed.

The Director, Campus Exam, SB/SE Division, and the Commissioner, W&I Division, should:

**Recommendation 6:** Take steps to ensure that potential underreported income and financial status issues on returns with claims for refunds or abatements of taxes are adequately addressed.

**Management's Response:** IRS management agreed with this recommendation and stated that they plan to issue a reminder to compliance personnel about available IRM

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<sup>32</sup> The point estimate projection is based on a two-sided 95 percent confidence interval. We are 95 percent confident that the dollar amount of claims audited by the Campus Examination function contained LUQ items that were not addressed and may have resulted in taxpayers receiving erroneous refunds or abatements of taxes is between approximately \$4 million and \$13.4 million. This \$8.7 million is included in the \$30.78 million outcome measure as reported in Appendix IV. See Appendix IV for additional details.



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and training material and the requirement to adequately consider LUQ items. Management also explained that they already provide guidance on the treatment of claims when there are items not classified that meet the standard of LUQ as presented in IRM 4.19.13.2.1, *Standard 1 – Adequate Consideration of Significant Issues*. They further explained that they also ensure consideration of LUQ items by providing a specific auditing standard to define and address these potential issues and requiring examiners and managers to attend Correspondence Examination Tax Examiner Continuing Professional Education that addresses when and how to refer issues for additional examination consideration.



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## Appendix I

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

Our overall objective was to determine whether the IRS's controls over the auditing<sup>1</sup> of amended individual tax returns with claims for refunds or abatements ensure that the claims are properly evaluated and accurately processed and are effective in preventing the inappropriate issuance of tax refunds and allowance of tax abatements. To meet this objective, we performed the following tests:

- I. Determined the applicable policies, procedures, and controls that are in place for surveying and auditing claims on amended individual tax returns. This was accomplished by reviewing and documenting applicable sections within the IRM,<sup>2</sup> conducting a walk-through of one of the PSP function area offices, interviewing IRS management and employees, and evaluating any ongoing efforts relating to surveying and auditing amended individual tax returns.
- II. Determined whether IRS PSP claims coordinators and SB/SE Division field examiners are properly evaluating and processing claims on amended individual returns that are surveyed.
  - A. Obtained a data extract of the population of individual tax returns with claims that were closed as surveyed during FY 2013 (October 1, 2012, through September 30, 2013) for which the IRS fully allowed<sup>3</sup> the claim of greater than or equal to \$5,000. This analysis identified a total population of 586 surveyed claims.
  - B. Validated the accuracy of the data obtained in Audit Test II.A. Specifically, we reconciled a judgmental sample<sup>4</sup> of 20 surveyed claims from our population of closed FY 2013 surveyed claims and compared the data in the sample to the Integrated Data Retrieval System and the IRS's Statistics of Income Table 37 to validate that the surveys were in fact closed during FY 2013. Based on our validation, we determined that the data were reliable for the purposes of this report.
  - C. Stratified the population of surveyed claims identified in Step II.A into three strata based on the claim amount. We then selected a statistically valid random sample of 36 individual tax returns with claims that were surveyed from the population of 586 surveyed claims. Our sample of 36 surveyed claims was selected using a

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<sup>1</sup> A glossary of terms is included as Appendix VI.

<sup>2</sup> IRM sections pertaining to the SB/SE Division Field Examination function (IRM 4.10), the SB/SE Division and W&I Division Campus Examination functions (IRM 4.19), and the PSP function (IRM 4.1).

<sup>3</sup> Claims that are surveyed are accepted as filed, which means the IRS fully allowed the claim.

<sup>4</sup> A judgmental sample is a nonprobability sample, the results of which cannot be used to project to the population.



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- 95 percent confidence level,  $\pm 16$  percent precision rate, and 50 percent occurrence rate as discussed with TIGTA's contracted statistician. A statistical sample was taken because we wanted to estimate the number of surveyed claims that may have been inappropriately allowed for the population of 586 claims surveyed during FY 2013.
- D. Determined whether IRS employees are properly surveying claims for tax refunds and abatements on amended individual returns by reviewing audit case file documentation and sharing our results with IRS officials.
  - E. Collaborated with TIGTA's contracted statistician in developing the sampling plans and forecasts.
- III. Determined whether IRS campus and field examiners are properly evaluating and processing claims on amended individual returns that are audited.
- A. Obtained a data extract of the population of all audited individual tax returns with claims that were closed during FY 2013 (October 1, 2012, through September 30, 2013) for which the IRS fully allowed<sup>5</sup> the claim. We filtered the data to obtain those records with a minimum amount allowed of greater than or equal to \$5,000. This analysis identified a total population of 3,383 audited claims.
  - B. Validated the accuracy of the data obtained in Step III.A. Specifically, we reconciled a judgmental sample of 20 audited claims from our population of closed FY 2013 audited claims and compared the data in the sample to the Integrated Data Retrieval System and the IRS's Statistics of Income Table 37 to validate that the audits were in fact closed during FY 2013. Based on our validation, we determined that the data were reliable for the purposes of this report.
  - C. Stratified the population of audited claims identified in Step III.A into three strata based on the claim amount. We then selected a statistically valid random sample of 48 individual returns with claims that were audited from the population of 3,383 audited claims. Our sample of 48 audited claims was selected using a 95 percent confidence level,  $\pm 14.1$  percent precision rate, and 50 percent occurrence rate as discussed with TIGTA's contracted statistician. A statistical sample was taken because we wanted to estimate the number of audited claims that may have been inappropriately allowed for the population of 3,383 claims audited during FY 2013.
  - D. Determined whether IRS employees are properly auditing claims on amended individual returns by reviewing audit case file documentation and sharing our results with IRS officials.

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<sup>5</sup> To identify the population of records for which the claim was fully allowed, we filtered the data to only those records for which the refund or abatement amount was equal to the amount the taxpayer requested on the amended return.



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- E. Collaborated with TIGTA's contracted statistician in developing the sampling plans and forecasts.

**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 that the following internal controls were relevant to our audit objective: IRS policies, procedures, and practices for surveying and auditing amended individual tax returns with claims for refunds and abatements of taxes. We evaluated these controls by reviewing source materials, discussing controls with management, reviewing a sample of 84 surveyed and audited claims case files, and researching taxpayer accounts.



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## **Appendix II**

### *Major Contributors to This Report*

Matthew A. Weir, Assistant Inspector General for Audit (Compliance and Enforcement Operations)  
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Malissa Livingston, Lead Auditor  
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Gregory Helias, Auditor



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**Appendix III**

*Report Distribution List*

Commissioner  
Office of the Commissioner – Attn: Chief of Staff  
Deputy Commissioner for Services and Enforcement  
Director, Audit Oversight, Planning, Programming and Audit Coordination  
Deputy Commissioner, Small Business/Self-Employed Division  
Deputy Commissioner, Wage and Investment Division  
Director, Customer Account Services, Wage and Investment Division  
Director, Examination, Small Business/Self-Employed Division  
Director, Refundable Credits Exam Operations, Wage and Investment Division  
Director, Refundable Credits Policy & Program Management, Wage and Investment Division  
Director, Campus Exam, Small Business/Self-Employed Division  
Director, Exam AUR Policy, Small Business/Self-Employed Division  
Director, Exam Planning Performance & Analysis, Small Business/Self-Employed Division  
Director, Field Exam, Small Business/Self-Employed Division  
Director, Headquarters Exam, Small Business/Self-Employed Division  
Director, Office of Audit Coordination



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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:

- Revenue Protection – Potential; \$3.61 million from examiners<sup>1</sup> not appropriately ensuring that taxpayers are entitled to refunds or abatements of taxes when claims are surveyed; \$18.05 million<sup>2</sup> over five years<sup>3</sup> (see page 6).<sup>4</sup>

#### Methodology Used to Measure the Reported Benefit for Surveyed Claims:

To estimate the potential revenue protection associated with the IRS Examination functions' inappropriate issuance of tax refunds and allowance of tax abatements without appropriate supporting documentation and/or identifying and investigating LUQ items, we:

- Selected and reviewed a statistically valid random stratified sample, as shown in Figure 1, of 36 claims from a population of 586 FY 2013 closed surveys of individual tax returns with claims that resulted in the issuance of a tax refund or allowance of a tax abatement equal to or greater than \$5,000.

**Figure 1: Statistical Sampling Data for Closed Surveyed Claims**

Strata	Population Size per Stratum	Sample Size per Stratum
<b>Stratum 1: Claim amounts of \$500,000 or greater</b>	**1**	**1**
<b>Stratum 2: Claim amounts of \$50,000 to \$499,999</b>	**1**	**1**
<b>Stratum 3: Claim amounts of \$5,000 to \$49,999</b>	**1**	**1**
<b>Totals</b>	<b>586</b>	<b>36</b>

Source: Summary of our sample of surveys closed during FY 2013.

<sup>1</sup> A glossary of terms is included as Appendix VI.

<sup>2</sup> Amounts and percentages presented in this appendix may not add exactly due to rounding.

<sup>3</sup> The five-year forecast is based on multiplying the base year by five and assumes, among other considerations, that economic conditions and tax laws do not change.

<sup>4</sup> The value of the outcome measure does not include amounts (revenue) that would offset these benefits as a result of directing resources away from auditing other taxpayer returns in order to pursue supporting documentation and/or identify and investigate LUQ items.



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- Calculated the weighted average dollar amount of tax refunds and abatements that may have been inappropriately allowed in our population, which was required due to our stratified sampling methodology. To calculate the weighted average dollar amount, we performed the following steps.
  - Determined the weight of each stratum in our universe. To do so, we divided the number of surveyed claims in each stratum by the total surveyed claims in the population, as shown in Figure 2.

**Figure 2: Weight of Stratum in Closed Surveyed Claims Population**

Strata	Population Size per Stratum	Weight of Stratum in Population
<b>Stratum 1: Claim amounts of \$500,000 or greater</b>	**1**	0.51%
<b>Stratum 2: Claim amounts of \$50,000 to \$499,999</b>	**1**	13.14%
<b>Stratum 3: Claim amounts of \$5,000 to \$49,999</b>	**1**	86.35%
<b>Totals</b>	<b>586</b>	<b>100.00%</b>

Source: Summary of our sample of surveys closed during FY 2013.

- Calculated the average exception dollars for each stratum by dividing the total exception dollars per stratum by the total number of surveyed claims reviewed, as shown in Figure 3.

**Figure 3: Average Exception Dollars per Stratum**

Strata	Exception Dollars per Stratum	Sample Size per Stratum	Average Exception Dollars per Stratum
<b>Stratum 1: Claim amounts of \$500,000 or greater</b>	\$0.00	**1**	\$0.00
<b>Stratum 2: Claim amounts of \$50,000 to \$499,999</b>	\$217,171	**1**	\$21,717
<b>Stratum 3: Claim amounts of \$5,000 to \$49,999</b>	\$137,558	**1**	\$5,502
<b>Totals</b>	<b>\$354,729</b>	<b>36</b>	

Source: Summary of 1) our sample of surveys closed during FY 2013 and 2) results of surveyed case file testing.

- Multiplied the average exception dollar amounts per stratum by the weight of each of the respective stratum in our population and summed the results for each stratum to arrive at the weighted average exception dollars for our sample. See Figure 4 for details of our calculation.



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**Figure 4: Weighted Average Exception Dollar Calculation**

Strata	Average Exception Dollars per Stratum	Weight of Stratum in Population	Weight of Average Exception Dollars
<b>Stratum 1: Claim amounts of \$500,000 or greater</b>	\$0.00	0.51%	\$0.00
<b>Stratum 2: Claim amounts of \$50,000 to \$499,999</b>	\$21,717	13.14%	\$2,854
<b>Stratum 3: Claim amounts of \$5,000 to \$49,999</b>	\$5,502	86.35%	\$4,751
<b>Weighted average exception dollars for sample</b>			<b>\$7,605</b>

Source: Summary of 1) our sample of surveys closed during FY 2013 and 2) results of surveyed case file testing.

- To calculate the potential amount of tax refunds and abatements that may have been inappropriately allowed in our population, we multiplied the population by the weighted average exception dollars for our sample of surveyed claims [586 x \$7,605 = \$4.46 million]. The \$4.46 million represents the point estimate for the total potential dollar amount of tax refunds and abatements that may have been inappropriately allowed for a one-year period.<sup>5</sup> Based on a 95 percent confidence interval, the total potential dollar amount of tax refunds and abatements that may have been inappropriately allowed ranges from \$2.3 million to \$6.6 million.
- Given that the taxpayers in our exception cases may have been able to provide support to substantiate the claims and/or LUQ items if the IRS requested such support, we believe the outcome measure should be reduced accordingly. Neither TIGTA nor the IRS knows with any degree of certainty what percentage of our exception cases would have resulted in the taxpayers being able to substantiate their claims, which, in turn, would have resulted in the claims being fully allowed. However, we analyzed FYs 2013 through 2015 data available in the Audit Information Management System and found that, on average, claims audited by the Field Examination and Campus Examination functions were fully allowed 19 percent and 21 percent of the time, respectively (*i.e.*, the examiners did not make any adjustments to the claim amounts requested by the taxpayer because they were able to verify the claims with support from the taxpayers).<sup>6</sup> Based on the data limitations, we believe these rates provide TIGTA and the IRS with the best reasonable estimate for reducing the outcome measure.

<sup>5</sup> It is important to note that our projections are based on exception rates calculated from reviewing a sample of amended returns for which the IRS fully allowed the claims, and we only project the exception rates back to the population from which we selected our sample, *i.e.*, the population of FY 2013 amended returns for which the IRS fully allowed the claims.

<sup>6</sup> Given that the IRS does not track or publish the rates for which audited claims are fully allowed (*i.e.*, no adjustments to the claim amount requested by the taxpayer), we analyzed IRS data to identify all audited claims for which the taxpayer received the exact amount of the claim amount, which would reasonably indicate that the claim was fully allowed.



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Although the results of our audit indicate that there are issues with the rates at which claims were fully allowed, there are too many unknowns to determine a more precise rate for when the taxpayers in our exception cases would have been able to substantiate their claims if documentation would have been requested by the IRS. Given the many unknowns surrounding this outcome measure, as well as the fact that the IRS disagreed with us that the taxpayers should have been contacted in some of our cases, we believe that reducing the outcome measure by the rates for which audited claims are fully allowed (19 percent for Field Examination audits and 21 percent for Campus Examination audits)<sup>7</sup> is the most appropriate approach. Specifically, the \$4.46 million point estimate was reduced by 19 percent to \$3.61 million.<sup>8</sup> The confidence interval ranging from \$2.3 million to \$6.6 million was also reduced by 19 percent to a range of \$1.9 million to \$5.4 million. Based on a 95 percent confidence interval, the total potential dollar amount of refunds and abatements of taxes that may have been inappropriately allowed ranges from \$1.9 million to \$5.4 million for surveyed claims. TIGTA's contracted statistician reviewed our methodology and forecasts.

**Type and Value of Outcome Measure:**

- Revenue Protection – Potential; \$30.78 million from examiners<sup>9</sup> not appropriately ensuring that taxpayers are entitled to refunds or abatements of taxes when claims are audited; \$153.9 million over five years<sup>10</sup> (see page 14).<sup>11</sup>

**Methodology Used to Measure the Reported Benefit for Audited Claims:**

To estimate the potential revenue protection associated with the IRS Examination functions' inappropriate issuance of tax refunds and allowance of abatements without appropriate supporting documentation and/or identifying and investigating LUQ items, we:

- Selected and reviewed a statistically valid random stratified sample, as shown in Figure 5, of 48 closed audits from a population of 3,383 FY 2013 closed audits of individual tax returns with claims that resulted in a tax refund or abatement equal to or greater than \$5,000. The

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<sup>7</sup> To reduce this outcome measure, we used the 19 percent for Field Examination audits as surveys are only completed by Field Examination; thus, the 21 percent for Campus Examination audits does not apply to surveyed claims.

<sup>8</sup> Surveyed claims are worked by the Field Examination function; therefore, we reduced the \$4.46 million by the rate for which audited claims are fully allowed by the Field Examination function (*i.e.*, 19 percent).

<sup>9</sup> The \$30.78 million is comprised of \$19.06 million from field examiners and \$11.72 million from campus examiners.

<sup>10</sup> The five-year forecast is based on multiplying the base year by five and assumes, among other considerations, that economic conditions and tax laws do not change.

<sup>11</sup> The value of the outcome measure does not include amounts (revenue) that would offset these benefits as a result of directing resources away from auditing other taxpayer returns in order to pursue supporting documentation and identifying and investigating LUQ items.



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sample consisted of 29 closed audits from the Field Examination function and 19 closed audits from the Campus Examination function.

**Figure 5: Statistical Sampling Data for Closed Field and Campus Audited Claims**

Strata	Population Size per Stratum		Sample Size per Stratum	
	Field	Campus	Field	Campus
<b>Stratum 1: Claim amounts of \$500,000 or greater</b>	13	0	13	0
<b>Stratum 2: Claim amounts of \$50,000 to \$499,999</b>	305	54	8	**1**
<b>Stratum 3: Claim amounts of \$5,000 to \$49,999</b>	1,025	1,986	8	**1**
<b>Totals</b>	<b>1,343</b>	<b>2,040</b>	<b>29</b>	<b>19</b>

Source: Summary of our sample of audits closed during FY 2013.

- Calculated the weighted average dollar amount of tax refunds and abatements that may have been inappropriately allowed in our population, which was required due to our stratified sampling methodology. To calculate the weighted average dollar amount, we performed the following steps.
  - Determined the weight of each stratum in our populations. To do so, we divided the number of audited claims in each stratum by the total audited claims in the population for both samples, as shown in Figure 6.

**Figure 6: Weight of Stratum in Closed  
Field and Campus Audited Claims Population**

Strata	Population Size per Stratum		Weight of Stratum in Population	
	Field	Campus	Field	Campus
<b>Stratum 1: Claim amounts of \$500,000 or greater</b>	13	0	0.97%	0.00%
<b>Stratum 2: Claim amounts of \$50,000 to \$499,999</b>	305	54	22.71%	2.65%
<b>Stratum 3: Claim amounts of \$5,000 to \$49,999</b>	1,025	1,986	76.32%	97.35%
<b>Totals</b>	<b>1,343</b>	<b>2,040</b>	<b>100.00%</b>	<b>100.00%</b>

Source: Summary of our sample of audits closed during FY 2013.

- Calculated the average exception dollars for each stratum by dividing the total exception dollars per stratum by the total number of surveyed claims reviewed, as shown in Figure 7.



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**Figure 7: Average Exception Dollars per Stratum**

Strata	Exception Dollars per Stratum		Sample Size per Stratum		Average Exception Dollars per Stratum	
	Field	Campus	Field	Campus	Field	Campus
<b>Stratum 1: Claim amounts of \$500,000 or greater</b>	\$4,801,340	\$0.00	13	0	\$369,334	\$0.00
<b>Stratum 2: Claim amounts of \$50,000 to \$499,999</b>	\$276,567	\$110,416	8	**1**	\$34,571	\$55,208
<b>Stratum 3: Claim amounts of \$5,000 to \$49,999</b>	\$63,876	\$101,441	8	**1**	\$7,985	\$5,967
<b>Totals</b>	\$5,141,783	\$211,857	29	19		

Source: Summary of 1) our sample of audits closed during FY 2013 and 2) results of audited case file testing.

- o Multiplied the average exception dollar amounts per stratum by the weight of each of the respective strata in each of our populations and summed the results for each stratum to arrive at the weighted average exception dollars for each of our samples. See Figure 8 for details of our calculation.

**Figure 8: Weighted Average Exception Dollars for Field and Campus Audited Claims**

Strata	Average Exception Dollars per Stratum		Weight of Stratum in Population		Weight of Average Exception Dollars	
	Field	Campus	Field	Campus	Field	Campus
<b>Stratum 1: Claim amounts of \$500,000 or greater</b>	\$369,334	\$0.00	0.97%	0.00%	<b>\$3,575</b>	<b>\$0.00</b>
<b>Stratum 2: Claim amounts of \$50,000 to \$499,999</b>	\$34,571	\$55,208	22.71%	2.65%	<b>\$7,851</b>	<b>\$1,461</b>
<b>Stratum 3: Claim amounts of \$5,000 to \$49,999</b>	\$7,985	\$5,967	76.32%	97.35%	<b>\$6,094</b>	<b>\$5,809</b>
<b>Weighted average exception dollars for samples</b>					<b>\$17,520</b>	<b>\$7,271</b>

Source: Summary of 1) our sample of audits closed during FY 2013 and 2) results of audited case file testing.

- To calculate the potential amount of refunds and abatements of taxes that may have been inappropriately allowed in each of the populations, we multiplied each of the populations by the weighted average exception dollars for our sample of audited claims.<sup>12</sup>

<sup>12</sup> It is also important to note that our projections are based on exception rates calculated from reviewing a sample of amended returns for which the IRS fully allowed the claims, and we only project the exception rates back to the population from which we selected our sample, *i.e.*, the population of FY 2013 amended returns for which the IRS fully allowed the claims.



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- Field audited claims: Based on the weighted average exception dollars of \$17,520, we calculated the potential amount of refunds and abatements of taxes that may have been inappropriately allowed for field audited claims to be \$23.53 million [1,343 x \$17,520 = \$23.53 million]. The \$23.53 million represents the point estimate for the total potential dollar amount of refunds and abatements of taxes that may have been inappropriately allowed for a one-year period. Based on a 95 percent confidence interval, the total potential dollar amount of refunds and abatements of taxes that may have been inappropriately allowed ranges from \$7.3 million to \$39.7 million.
- Campus audited claims: Based on the weighted average exception dollars of \$7,271, we calculated the potential amount of refunds and abatements of taxes that may have been inappropriately allowed for campus audited claims to be \$14.83 million<sup>13</sup> [2,040 x \$7,271 = \$14.83 million]. The \$14.83 million represents the point estimate for the total potential dollar amount of refunds and abatements of taxes that may have been inappropriately allowed for a one-year period. Based on a 95 percent confidence interval, the total potential dollar amount of refunds and abatements of taxes that may have been inappropriately allowed ranges from \$8.9 million to \$20.8 million.
- Given that the taxpayers in our exception cases may have been able to provide support to substantiate the claims and/or LUQ items if the IRS requested such support, we believe the outcome measure should be reduced accordingly. Neither TIGTA nor the IRS knows with any degree of certainty what percentage of our exception cases would have resulted in the taxpayers being able to substantiate their claims, which, in turn, would have resulted in the claims being fully allowed. However, we analyzed FYs 2013 through 2015 data available in the Audit Information Management System and found that, on average, claims audited by the Field Examination and Campus Examination functions were fully allowed 19 percent and 21 percent of the time, respectively (*i.e.*, the examiner did not make any adjustments to the claim amounts requested by the taxpayers because they were able to verify the claim with support from the taxpayers).<sup>14</sup> Based on the data limitations, we believe these rates provide TIGTA and the IRS with the best reasonable estimate for reducing the outcome measure.

Although the results of our audit indicate that there are issues with the rates at which claims were fully allowed, there are too many unknowns to determine a more precise rate for when

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<sup>13</sup> The \$14.83 million from campus examiners appropriately ensuring that taxpayers are entitled to refunds or abatements of taxes when claims are audited encompasses the \$8.7 million that was specific to cases with LUQ items that went unaddressed by the Campus Examination function, as noted earlier in the report.

<sup>14</sup> Given that the IRS does not track or publish the rates for which audited claims are fully allowed (*i.e.*, no adjustments to the claim amount requested by the taxpayer), we analyzed IRS data to identify all audited claims for which the taxpayer received the exact amount of the claim amount, which would reasonably indicate that the claim was fully allowed.



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the taxpayers in our exception cases would have been able to substantiate their claims if documentation would have been requested by the IRS. Given the many unknowns surrounding this outcome measure, as well as the fact that the IRS disagreed with us that the taxpayers should have been contacted in some of our cases, we believe that reducing the outcome measure by the rates for which audited claims are fully allowed (19 percent for Field Examination audits and 21 percent for Campus Examination audits) is the most appropriate approach. Specifically, the point estimate for field audited claims was reduced by 19 percent, from \$23.53 million to \$19.06 million, and the point estimate for campus audited claims was reduced by 21 percent, from \$14.83 million to \$11.72 million. We also reduced the confidence intervals for field and campus audited claims by 19 percent and 21 percent, respectively. We reduced the confidence interval for field audited claims from a range of \$7.3 million to \$39.7 million to a range of \$6 million to \$32.2 million, and the confidence interval for campus audited claims was reduced from a range of \$8.9 million to \$20.8 million to a range of \$7 million to \$16.4 million. Based on a 95 percent confidence interval, the total potential dollar amount of refunds and abatements of taxes that may have been inappropriately allowed ranges from \$6 million to \$32.2 million for field audited claims and \$7 million to \$16.4 million for campus audited claims. TIGTA's contracted statistician reviewed our methodology and forecasts.



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**Appendix V**

*Examples of Exception Cases*

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**Appendix VI**

*Glossary*

<b>Term</b>	<b>Definition</b>
<b>Abatement</b>	An abatement is a reduction in unpaid assessed taxes or fees.
<b>Accounts Management Function</b>	This is the organization within the W&I Division responsible for taxpayer relations by answering tax law/account inquiries and adjusting tax accounts. In addition, it is responsible for providing taxpayers with information on the status of their returns/tax refunds and for resolving the majority of issues and questions to settle their accounts.
<b>Area</b>	A geographic organizational level used by IRS business units and offices to help their specific types of taxpayers understand and comply with tax laws and issues.
<b>Audit</b>	Field and campus examinations of individuals, partnerships, and corporations that occur through correspondence, interviews at an IRS office, and/or at the taxpayer's home or place of business.
<b>Campus Examination Function</b>	The Examination function for both the SB/SE Division and W&I Division that utilizes a correspondence audit process, which is less intrusive, more automated, and conducted by examiners who are trained to deal with less complex tax issues.
<b>Category A Criteria (often referred to as CAT-A)</b>	Criteria that identifies issues that require a referral to the examination classifiers prior to allowing a taxpayer's claim.
<b>Classified Issues</b>	The process used by IRS Examination functions to determine which issues should be audited.
<b>Examiners</b>	IRS employees who examine tax returns to determine whether taxpayers accurately reported their tax liabilities.
<b>Field Examination Function</b>	The IRS organization responsible for examinations of individuals, partnerships, and corporations that occur either at the taxpayer's place of business or through interviews at an IRS office.



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<b>Term</b>	<b>Definition</b>
<b>Fiscal Year</b>	Any yearly accounting period, regardless of its relationship to a calendar year. The Federal Government's fiscal year begins on October 1 and ends on September 30.
<b>Group Manager</b>	A first-line manager in the Examination function responsible for supervision of IRS examiners.
<b>Integrated Data Retrieval System</b>	The IRS computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer's account records.
<b>Internal Revenue Code</b>	Title 26 of the United States Code enacted by Congress, containing all relevant rules pertaining to estate, excise, gift, income, payroll, and sales taxes.
<b>Internal Revenue Manual</b>	Contains the policies, procedures, instructions, guidelines, and delegations of authority that direct the operation for all divisions and functions of the IRS. Topics include tax administration, personnel and office management, and others.
<b>Large, Unusual, or Questionable (LUQ) Item</b>	Items that appear on a tax return which, if left unexplained, might raise doubt or cause confusion to a reviewer of the completed examination. The definition of an LUQ item will depend on the classifier's perception of the return as a whole and the separate items that comprise the return. Factors to be considered are the comparative size of the item, the absolute size of the item, the inherent character of the item, evidence of intent to mislead, <i>etc.</i>
<b>Planning and Special Programs</b>	The IRS organization responsible for planning, ordering, and delivering tax returns for examination to field examination groups.
<b>Revenue Agent</b>	An employee in the Examination function who conducts face-to-face audits of more complex tax returns, such as businesses, partnerships, corporations, and specialty taxes ( <i>e.g.</i> , excise tax returns).



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<b>Term</b>	<b>Definition</b>
<b>Small Business/ Self-Employed Division</b>	The IRS organization that services self-employed taxpayers and small businesses by educating and informing them of their tax obligations, developing educational products and services, and helping them understand and comply with applicable tax laws.
<b>Submission Processing Function</b>	The data processing arm of the IRS. The function processes paper and electronic submissions, corrects errors, and forwards data to the Computing Centers for analysis and posting to taxpayer accounts.
<b>Tax Compliance Officer</b>	An employee in the Examination function who primarily conducts audits of individual taxpayers through interviews at IRS field offices.
<b>Tax Examiner</b>	Among other duties, a tax examiner processes tax returns, establishes and edits tax account records, and determines proper tax liabilities.
<b>Tax Year</b>	The 12-month period for which tax is calculated. For most individual taxpayers, the tax year is synonymous with the calendar year.
<b>Wage and Investment Division</b>	The IRS organization that services individual taxpayers filing a Form 1040, <i>U.S. Individual Income Tax Return</i> , by educating and informing them of their tax obligations and helping them to comply with applicable tax laws.



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Refunds and Abatements of Taxes Are Properly Reviewed*

**Appendix VII**

*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 16 2016

MEMORANDUM FOR MICHAEL E. MCKENNEY  
DEPUTY INSPECTOR GENERAL FOR AUDIT

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

SUBJECT: Draft Audit Report – Improvements Are Necessary to Ensure  
That Individual Amended Returns With Claims for Refunds and  
Abatements of Taxes Are Properly Reviewed  
(Audit # 201330047)

Thank you for the opportunity to review and comment on the subject draft audit report. Taxpayers use Form 1040X, *Amended U.S. Individual Income Tax Return*, to change their original Form 1040 series tax return to include new information. As you've noted, currently the IRS processes millions of amended paper returns each year. Once received, the returns are manually reviewed to determine if they meet audit criteria and if they do, they are referred to Examination for additional review and consideration. Once an amended return is forwarded to Examination, it is either surveyed (i.e., accepted as filed) or audited. In making the decision to survey or audit, Examination must also consider whether resources are available, as well as consider the overall audit potential of the amended return as compared to returns in other inventory streams.

We appreciate that TIGTA recognized IRS has procedures in place for a thorough evaluation of claims to determine whether a material change in tax liability may be likely. These control procedures require a risk analysis to be performed at various points in time throughout the audit process. The risk analysis a Planning and Special Programs (PSP) Claims Coordinator and Group Manager perform prior to surveying a return would include reviewing the return and case file information. Field examiners complete a more in-depth risk analysis that typically includes thoroughly reviewing the claim to identify large, unusual, or questionable (LUQ) items, validating that the taxpayer has filed returns for prior and subsequent tax years, and performing a minimum income probe.

We are continually evaluating and improving our process. We updated Internal Revenue Manual (IRM) 4.10.2, *Pre-Contact Responsibilities* and IRM 4.10.3, *Examination Techniques*, in February 2016, to provide additional guidance to assist Field employees with risk analysis decision-making. We appreciate your feedback and suggestions to improve our processes and plan to take actions accordingly. These actions include:



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- Implementing an annual review of the PSP Exam Area Desk Guides to ensure the accurate and consistent guidance across the seven exam areas.
- Issuing a memorandum reminding field examiners and group managers of the importance of documenting consideration of LUQ items as potential issues for examination, as well as documenting the results of examined issues.
- Reviewing and revising the examiner lead sheets, if necessary.

We do not agree with your outcome measures. While there were unusual fact patterns in a number of TIGTA's exception cases, we believe the employees, using all available information, reached the appropriate conclusion in most instances. Thus, we believe the "exception rates" throughout the body of the report and the outcome measures are overstated. TIGTA estimated the dollar amount of unexamined or unsubstantiated LUQ items on amended returns and then reduced the estimate by the historic rate at which examined LUQ items are fully allowed when computing the outcome measures. However, TIGTA does not account for cases that would have a partial claim allowance when the taxpayer can substantiate some of the claim. Moreover, Exam employees had evaluated the cases identified by TIGTA and, using their professional judgment, had concluded that the LUQs in these cases had "relatively low audit potential." Therefore, these cases would likely have yielded less than the average LUQ claim examined. The outcome measures also do not account for the significant differences with respect to claims and amended returns worked in the Field versus the Campus as well as the opportunity costs associated with redeploying resources away from other workload.

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 Shenita Hicks, Director, Examination, Small Business/Self-Employed Division at 513-263-3239.

Attachment



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Attachment

The Director, Examination, Small Business/Self-Employed Division should:

**RECOMMENDATION 1:**

Establish controls to ensure that the PSP function's area desk guides are consistent in their instructions and requirements for the processing of claims.

**CORRECTIVE ACTION:**

We agree and will conduct an annual review of the PSP Exam Area Desk Guides to ensure the accuracy and consistency of the guidance.

**IMPLEMENTATION DATE:**

March 15, 2017

**RESPONSIBLE OFFICIAL:**

Director, Exam Case Selection, Small Business/Self-Employed Division

**CORRECTIVE ACTION MONITORING PLAN:**

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

**RECOMMENDATION 2:**

Revise procedures to ensure that the justification for PSP surveying a claim is documented and evaluate the benefits of requiring PSP Claims Coordinators to identify and document whether any LUQ items existed on the return

**CORRECTIVE ACTION:**

We disagree with your recommendation. A limited number of the total claims meeting the criteria in this report were surveyed in PSP. Managers approve all closures from PSP including surveys of claims. Managers already have the ability to evaluate the claims coordinator's decision to survey a claim at the time of closure and discuss any concerns that they may have. We fail to see sufficient potential benefits to warrant expending our limited resources on creating documentation to support the reason for surveys in PSP. With regard to identifying and documenting LUQs, the Campus Examination Function conducts a review of the return and identifies LUQs. Requiring PSP coordinators to review the return again for the same items would be a duplication of efforts and an inappropriate use of our limited resources.

**IMPLEMENTATION DATE:**

N/A

**RESPONSIBLE OFFICIAL:**

N/A



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**CORRECTIVE ACTION MONITORING PLAN:**

N/A

**RECOMMENDATION 3:**

Establish a process for group managers to document their decision to survey claims, which would include documenting the results of their risk analyses.

**CORRECTIVE ACTION:**

We will define the group manager's risk analysis and evaluate the need to require documentation of the group manager's decision to close an amended return as Survey Before Assignment (SBA), and will initiate any IRM changes necessary.

**IMPLEMENTATION DATE:**

June 15, 2017

**RESPONSIBLE OFFICIAL:**

Director, Exam/AUR Policy, Small Business/Self-Employed Division

**CORRECTIVE ACTION MONITORING PLAN:**

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

**RECOMMENDATION 4:**

Issue guidance to field examiners and group managers that stresses the importance of obtaining adequate documentation to support the validity of claims, as well as their responsibility to review and document LUQ items considered during audits.

**CORRECTIVE ACTION:**

We agree. We will issue a memo reminding field examiners and group managers of the importance of examiners' documenting their consideration of LUQ items, as well as examined issues.

**IMPLEMENTATION DATE:**

June 15, 2017

**RESPONSIBLE OFFICIAL:**

Director, Exam/AUR Policy, Small Business/Self-Employed Division

**CORRECTIVE ACTION MONITORING PLAN:**

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



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**RECOMMENDATION 5:**

Ensure that the lead sheets designed to document the field examiners' consideration and investigation of LUQ items effectively address the concerns noted in this report.

**CORRECTIVE ACTION:**

We agree and will review the relevant lead sheets and revise if needed.

**IMPLEMENTATION DATE:**

June 15, 2017

**RESPONSIBLE OFFICIAL:**

Director, Exam/AUR Policy, Small Business/Self-Employed Division

**CORRECTIVE ACTION MONITORING PLAN:**

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

**RECOMMENDATION 6:**

The Director, Exam/AUR Policy, Small Business/Self-Employed Division and the Commissioner, Wage and Investment Division should take steps to ensure that potential underreported income and financial status issues on returns with claims for refunds or abatements of taxes are adequately addressed.

**CORRECTIVE ACTION:**

We agree. We already provide guidance on treatment of claims when there are items not classified that meet the standard of LUQ as presented in IRM 4.19.13.2.1, *Standard 1 — Adequate Consideration of Significant Issues*. We also ensure consideration of LUQ items by providing a specific auditing standard to define and address these potential issues; and requiring examiners and managers to attend Correspondence Examination Tax Examiner Continuing Professional Education (CPE) that addresses when and how to refer issues for additional examination consideration. We agree to issue a reminder to our compliance personnel about available IRM and training material and the requirement to adequately consider LUQ items.

**IMPLEMENTATION DATE:**

June 15, 2017

**RESPONSIBLE OFFICIAL(S):**

Director, Exam/AUR Policy, Small Business/Self-Employed Division

**CORRECTIVE ACTION MONITORING PLAN:**

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