



*The Large Business and International  
Division's Strategic Shift to Issue-Focused  
Examinations Would Benefit From Reliable  
Information on Compliance Results*

**September 14, 2016**

**Reference Number: 2016-30-089**

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

### THE LARGE BUSINESS AND INTERNATIONAL DIVISION'S STRATEGIC SHIFT TO ISSUE-FOCUSED EXAMINATIONS WOULD BENEFIT FROM RELIABLE INFORMATION ON COMPLIANCE RESULTS

## Highlights

**Final Report issued on September 14, 2016**

Highlights of Reference Number: 2016-30-089 to the Internal Revenue Service Commissioner for the Large Business and International Division.

### IMPACT ON TAXPAYERS

For the past several years, the Large Business and International (LB&I) Division has attempted to shift its focus toward examining issues that will have the broadest impact on tax compliance. The LB&I Division has recently accelerated its shift toward issue-focused examinations by reorganizing to focus on emerging tax compliance risks. An issue-focused approach to examinations would allow the LB&I Division to focus on where taxpayers' compliance risks may be greatest and would allow the IRS to harness examination resources more effectively. As part of its reorganization, the LB&I Division is transitioning to selecting returns by "campaigns," which use data analytics and leverage the entire knowledge of the organization to identify areas of noncompliance. Campaigns are intended to identify more productive returns and therefore lessen the burden on compliant taxpayers.

### WHY TIGTA DID THE AUDIT

This audit was initiated to determine whether the LB&I Division effectively uses compliance results to identify compliance risk and allocate resources strategically to improve examination results.

### WHAT TIGTA FOUND

The LB&I Division has represented for several years that it is moving toward issue-focused examinations and has committed substantial

resources to this effort. For example, it has dedicated significant amounts of technical expertise toward "knowledge management," which seeks to maintain a source of standing knowledge of the most important compliance issues. However, the LB&I Division does not know at a corporate level the results of its own compliance efforts, so it cannot use compliance results to inform and improve its issue-focused strategy.

The inability to generate accurate compliance results by issue is due in part to systemic limitations and in part to human error and a lack of emphasis by management to address those errors. LB&I Division's case management system, the Issue Management System, which revenue agents use to enter proposed adjustments, maintains a list of codes for tax issues and sub-issues under which proposed adjustments can be entered. However, many of these codes are too general to provide useful information. Additionally, revenue agents do not always use the codes accurately when inputting issues into the Issue Management System, so reports that are created can be unreliable.

Moreover, the LB&I Division did not follow its internal procedures to ensure that the planning for its "Future State" initiative followed a standardized framework for process improvement initiatives. As it moves to a more issue-focused examination strategy, the LB&I Division should improve the accuracy of its current system for recording issues found in examinations and also ensure that the planning and implementation of its Future State initiative follows established procedures.

### WHAT TIGTA RECOMMENDED

TIGTA recommended that the Commissioner, LB&I Division, should 1) ensure that the LB&I Division considers past compliance results by issue in order to inform its issue-based strategy; 2) develop and implement plans to improve the method used by examiners to enter issues in the Issue Management System; and 3) ensure that planning for the Future State initiative follows published guidance.

In their response, IRS management agreed with TIGTA's recommendations and plans to implement corrective actions.



TREASURY INSPECTOR GENERAL  
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C. 20220

September 14, 2016

**MEMORANDUM FOR** COMMISSIONER, LARGE BUSINESS AND INTERNATIONAL  
DIVISION

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

**SUBJECT:** Final Audit Report – The Large Business and International Division’s  
Strategic Shift to Issue-Focused Examinations Would Benefit From  
Reliable Information on Compliance Results (Audit # 201530020)

This report presents the results of our review to determine whether the Large Business and International Division effectively uses compliance results to identify compliance risk and allocate resources strategically to improve examination results. This audit 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 VIII.

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



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## *Abbreviations*

BPR	Business Performance Review
CIC	Coordinated Industry Case
FTE	Full-Time Equivalent
FY	Fiscal Year
GAO	Government Accountability Office
IC	Industry Case
IMS	Issue Management System
IPG	Issue Practice Group
IPN	International Practice Network
I.R.C.	Internal Revenue Code
IRS	Internal Revenue Service
LB&I	Large Business and International
PA	Practice Area
TIGTA	Treasury Inspector General for Tax Administration
UIL	Uniform Issue List



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## *Background*

The Large Business and International (LB&I) Division is one of the Internal Revenue Service's (IRS) four operating divisions, with the responsibility for conducting examinations of corporations and partnerships with assets of \$10 million or more, as well as high-wealth individuals. Large businesses and high-wealth individuals often operate in a

multi-national environment, employ a sizable workforce, and frequently file returns containing highly complex tax positions. The LB&I Division has traditionally divided its business taxpayers into two broad categories: Coordinated Industry Case (CIC) and Industry Case (IC).<sup>1</sup> CIC taxpayers are generally the largest and most complex entities with examinations conducted by a team of revenue agents and specialists. IC taxpayers are generally less complex and examinations are usually conducted by one revenue agent.

***For the past several years, the LB&I Division has attempted to shift its focus towards examining issues that will have the broadest impact on compliance.***

From Fiscal Year (FY) 2001 to FY 2015, the LB&I Division assigned its examiners to organizations that focused on particular industries or types of taxpayers.<sup>2</sup> The initial decision to organize around industries was in response to the IRS Restructuring and Reform Act of 1998<sup>3</sup> and was intended to create more specialization and expertise among IRS employees, as well as to better serve large taxpayers.<sup>4</sup> The changes following the Act were a part of a larger reorganization of the entire IRS that changed its previous regional structure and rebuilt the IRS around taxpayer segments.

Since 2002, the LB&I Division has made a number of adjustments to its organizational structure. In FY 2011, the Division changed its name from "Large and Mid-Size Business" to "Large Business and International" in order to emphasize the importance of tax compliance risks posed by the dominance of cross-border transactions and strategies. In FY 2015, the LB&I Division's examiners were located in the following organizations:

- Communications, Technology, and Media.
- Financial Services.

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

<sup>2</sup> The LB&I Division was known as the Large and Mid-Size Business Division from FY 2000 to FY 2010.

<sup>3</sup> Pub. L. No. 105-206, 112 Stat. 685 (codified as amended in scattered sections of 2 U.S.C., 5 U.S.C. app., 16 U.S.C., 19 U.S.C., 22 U.S.C., 23 U.S.C., 26 U.S.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.).

<sup>4</sup> IRS News Release 2000-33, *New IRS Division Begins Work to Break Down Barriers for Large & Mid-Size Businesses* (June 5, 2000); see also IRS News Release 2008-90, *Commissioner Doug Shulman Discusses 10-Year Anniversary of the IRS Restructuring and Reform Act of 1998* (July 18, 2008).



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- Heavy Manufacturing and Pharmaceutical.
- Natural Resources and Construction.
- Retailers, Food, Transportation, and Healthcare.
- Global High Wealth.
- International Business Compliance.
- International Individual Compliance.
- Transfer Pricing Operations.

The number of returns filed by LB&I Division taxpayers increased (20 percent) from 220,543 in Processing Year 2011 to 265,218 in Processing Year 2015,<sup>5</sup> while the number of LB&I Division examiners decreased (17 percent) from 5,064 in FY 2011 to approximately 4,201 in FY 2015.<sup>6</sup>

The LB&I Division has typically measured the success of its examination program in a number of ways:

- Percentage of taxpayers audited by size of taxpayer (coverage rate).
- Amount of time it takes to perform the audit (cycle time).
- Dollar amount of the proposed adjustment.
- Employee and customer satisfaction.<sup>7</sup>

For the past several years, the LB&I Division has attempted to shift its focus towards examining issues that will have the broadest impact on compliance.<sup>8</sup> An issue-focused approach to examinations would allow the LB&I Division to focus on where taxpayers' compliance risks may be greatest and would allow the IRS to harness examination resources more effectively. Taxpayer burden would also be reduced if the IRS focuses its attention on the issues with the greatest compliance risk.

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<sup>5</sup> The LB&I Division Tax Return Statistics intranet site. The numbers represent C corporation, partnership, and S corporation filings only.

<sup>6</sup> LB&I Division Field Focus Guides.

<sup>7</sup> Heather Maloy (former Commissioner, LB&I Division), *Can a Change in LB&I Approach Improve Taxpayer Compliance?* Tax Analysts (March 16, 2016).

<sup>8</sup> LB&I Division, *Business Performance Review, FY 2014, 4<sup>th</sup> Quarter Results*, p. 3. Additionally, in LB&I Division's FY 2012 Business Plan, the shift towards *issue-focused* examinations was described as follows: "Significant and sweeping changes were designed to enhance the examination function's ability to identify the highest compliance risks among our taxpayer base, work cases more effectively and efficiently, and find appropriate ways to resolve cases as soon as is practical."



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The LB&I Division has also invested substantial resources into “knowledge management,” including the establishment of Issue Practice Groups (IPG) for its domestic examiners and International Practice Networks (IPN) for its international examiners.<sup>9</sup>

### **LB&I Division reorganization**

As part of its strategic shift to issue-focused examinations and in response to its increasing workload and declining resources, the LB&I Division began transitioning in February 2016 to a new organizational structure, as part of its Future State plan.<sup>10</sup> The LB&I Division’s new structure departs from its previous industry-based organization and returns to a more geographically based structure. Under this concept, compliance employees will be assigned to one of the nine practice areas (PA) shown below.

#### **Geographic Compliance PAs:**

- Central.
- Eastern.
- Northeastern.
- Western.

#### **Subject Matter PAs:**

- Cross Border Activities.
- Enterprise Activity.
- Pass-Through Entities.
- Treaty and Transfer Pricing Operations.
- Withholding and International Individual Compliance.

This reorganization is intended to help the LB&I Division to “strategically identify and prioritize areas of compliance risk to more effectively address taxpayer compliance.”<sup>11</sup> According to LB&I Division planning documents, employees in each PA will be responsible for reviewing

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<sup>9</sup> IPG goals are to 1) provide LB&I Division examiners with clear and timely guidance on how to address issues; 2) promote collaboration between LB&I Division employees; 3) increase accountability and transparency in the resolution of issues; and 4) enable robust lines of communication with taxpayers. The general goal of IPNs is to allow all international personnel, counsel, and other interested parties to share and collaborate on strategic international issues. Presently there are 15 IPGs and 20 IPNs, with numerous LB&I Division employees devoted full-time and part-time.

<sup>10</sup> See LB&I Division’s revised organization chart in Appendix IV.

<sup>11</sup> IRS Document 11809, *FY 2016 Focus Guide, Working Together in New Ways to Enhance Taxpayer Compliance* (Jan. 2016).



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compliance issues within their area of expertise. LB&I Division officials indicated that the majority of the future audit workload will be selected using “campaigns,” which are intended to leverage the knowledge of the organization to identify the greatest risks to tax administration.

This review was performed at the LB&I Division Headquarters in Washington, D.C., and field offices in San Francisco, California; Chicago, Illinois; New York, New York; King of Prussia, Pennsylvania, and Houston, Texas, during the period July 2015 through June 2016. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.



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## *Results of Review*

The LB&I Division has recently accelerated its shift toward issue-focused examinations by reorganizing to focus on emerging tax compliance risks. The organization has also committed substantial resources to knowledge management, which seeks to maintain a source of standing knowledge of the most important compliance issues. However, the LB&I Division does not know at a corporate level the results of its own compliance efforts by issue and cannot use compliance results to inform and improve its issue-focused strategy. The inability to generate accurate compliance results by issue is due in part to systemic limitations and in part to human error and a lack of management emphasis to address those errors. The case management system used by most of the LB&I Division revenue agents to enter proposed adjustments, the Issue Management System (IMS), uses codes to identify tax issues and sub-issues for proposed adjustments. However, many of the codes are too general to provide useful information.<sup>12</sup> Additionally, revenue agents do not always accurately input adjustments to the IMS, making reports created from the system unreliable. LB&I Division management has periodically emphasized correcting these errors. Although these errors do not appear to impact taxpayers, they prevent management from understanding compliance results by issue. The LB&I Division should improve the accuracy of its current system for recording issues found in examinations and also ensure that the planning and implementation of its Future State initiative follow its established procedures for process improvement initiatives.

### ***The Large Business and International Division Does Not Sufficiently Use Compliance Results by Issue***

As noted in its internal program guides and external communications, the most significant strategic action by the LB&I Division over the past several years has been its move toward an issue-focused approach to its work. Although the LB&I Division has now reorganized to be more focused on issues, the organization will need to know the issues with the highest compliance risk for the commitment to an issue-focused approach to be successful. Because a high compliance risk issue is generally one in which the IRS would make a relatively large proposed adjustment if the taxpayer were audited, the LB&I Division should know which issues generate the highest proposed adjustments.

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<sup>12</sup> Examiners in LB&I Division's International Individual Compliance units enter adjustments using the Report Generation Software system, which is a software program utilized in the examination process to 1) compute corrected tax, interest, and penalties, and generate audit reports; 2) create various forms and letters; 3) allow examiners and reviewers to document their actions and findings; and 4) process and archive examination results. We did not review the adjustments entered into this system as part of this audit.



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There are at least five areas in which information on compliance results by issue would be useful to the LB&I Division.

- Audit planning.
- Alignment of existing resources.
- Assessing business results.
- Improving business results.
- Hiring and training.

**Audit planning**

The LB&I Division's annual Compliance Plan is used to communicate the division's operating priorities and compliance objectives. The plan details the allocation of resources needed to achieve these priorities and objectives. According to the FY 2015 LB&I Division Compliance Plan, tax returns were primarily selected for audit based on the activity code of the return, a code that identifies the type of return filed and often the gross receipts or asset dollar amounts involved.<sup>13</sup> For example, a Form 1120, *U.S. Corporation Income Tax Return*, for an entity with assets of \$10 million to less than \$50 million is assigned Activity Code 219. Figure 1 shows a summary of the LB&I Division's FY 2015 Annual Compliance Plan, which included objectives based on activity codes, number of tax returns, and direct staff years.

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<sup>13</sup> The LB&I Division began using a Start Plan for its Compliance Plan in FY 2016, which is based on issues they want to work.



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**Figure 1: LB&I Division FY 2015 Annual Compliance Plan**

Activity Codes	Total Returns	Total Direct Examination Staff Years <sup>14</sup>
Form 1040: 266, 270–281	26,954	274
Form 1120: 203, 209, 213, 215, 217, 219, 221, 223, 226–231	7,074	1,324
Form 1065: 481–483	1,678	193
Form 1120S: 234, 288–290	1,820	152
Other <sup>15</sup>	878	50
<b>Total</b>	<b>38,404</b>	<b>1,994<sup>16</sup></b>

Source: LB&I Division FY 2015 Annual Compliance Plan.

According to LB&I Division planning guidance in effect during FY 2015, the Compliance Plan begins with the planned number of examiner staff years and the anticipated number of return closures. Specific categories of examinations are added to the plan, such as:

- CIC.
- Abusive Tax Avoidance Transactions.
- Compliance Assurance Process.
- Joint Committee.
- National Research Program.
- Compliance Initiative Projects.

In addition to these categories, an IC examination workplan was developed by the Planning, Analysis, Inventory and Research (subsequently Compliance Planning and Analytics) function in collaboration with the industry Planning and Special Program analysts.<sup>17</sup> The Internal Revenue Manual lists the following factors that industry analysts should use to develop the IC examination workplan, none of which include the results of previous examinations:

- Full-Time Equivalent (FTE) availability considering projected attrition and initiative hires.

<sup>14</sup> Generally, one direct examination staff year equals 2,000 staff hours.

<sup>15</sup> The other category may include Form 1041, 1120F, 1042, and employment tax returns.

<sup>16</sup> The column total does not match the sum of the individual numbers due to rounding.

<sup>17</sup> The annual examination plan is an estimate of the number of closures for returns that are already in the audit stream since the majority of the large corporate returns have an audit cycle time longer than 12 months.



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- Training time and returns based on the training plan.
- Activity code mix for return delivery.
- Rates for each activity code.
- Examination cycle time.
- In-process inventory.
- Current plan accomplishment and industry plan.

The factors used to develop the LB&I Division's FY 2015 Compliance Plan did not include previous compliance results by issue, which resulted in a workload plan that is primarily focused on managing inputs (available staff resources) and outputs (completed examinations), rather than focusing on issues designed to improve examination results and voluntary compliance. LB&I Division officials also indicated that the division's compliance plan is driven by the IRS's overall compliance plan, which monitors performance based on completed examinations for various return categories and activity codes.

Managers at all levels periodically generate business reports to monitor these factors, such as reports focused on the cycle time of examinations and expiring statutes of limitation on assessments, but the data for these reports are restricted to the returns assigned to the organization running the report. As part of this audit, we asked LB&I Division management officials what the top 20 compliance issues were for FY 2015, and officials explained that they did not know and do not routinely run such reports. However, upon request, LB&I Division officials created a report with the data shown in Figure 2, which reflects the top 20 compliance issues by proposed adjustment, although management expressed caution about the reliability of the data.



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**Figure 2: LB&I Division Top 20 Audit Issues by Proposed Adjustment Amount**

<b>Uniform Issue List Description</b>	<b>Total Proposed Adjustment Amount</b>
Determining the Proper Character/Source of Income Items	\$63,223,492,220
General Rule for Methods of Accounting (Permissible vs. Not Permissible)	\$18,982,778,830
Income Attributable to Domestic Production Activities	\$7,849,910,636
Transfer or Use of Intangibles	\$7,522,073,217
***** 1*****	***** 1*****
Limitation on Net Operating Loss Carryforwards and Built-In Losses Following Ownership Changes	\$4,418,488,067
***** 1*****	***** 1*****
Other Transfer Pricing Issues	\$4,216,116,738
Allowance of Deductions (Deductible vs. Not Deductible)	\$4,016,816,644
Allocation to Interest Income	\$3,780,179,804
Form vs. Substance	\$3,712,622,167
Accessing Foreign Tax Credits	\$2,910,668,328
Intangible Property Transfers Without Cost Sharing	\$2,319,380,174
Transfers of Intangible Property to Foreign Corporations Under I.R.C. § 367(d)	\$1,947,726,494
Gross Income Versus Not Gross Income	\$1,941,253,584
Cost Plus Method	\$1,916,000,000
Consolidated Net Operating Loss Deduction	\$1,889,236,647
***** 1*****	***** 1*****
Other	\$1,716,804,227
Foreign Tax Credits Generator Transactions	\$1,497,433,561

Source: The LB&I Division Issue Based Management Information System.

Assuming these data were reliable and consistent over a period of time, LB&I Division management could include in its Compliance Plan the taxpayer entities that were more likely to have these tax issues present.

**Alignment of existing resources**

Before the Future State reorganization in February 2016, the LB&I Division was comprised of five domestic industries and the International function. As Figure 3 reflects, in FY 2015 there



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were 3,018 FTE examiner positions in the five domestic industry organizations, with the most examiners in the Natural Resources and Construction industry organization and the fewest in the Communications, Technology, and Media industry organization.

**Figure 3: LB&I Division Employee Positions in Domestic Industry Organizations in FY 2015**

Industry Organization	Examiner Positions (FTE)
Natural Resources and Construction	746
Retailers, Food, Transportation, and Healthcare	738
Heavy Manufacturing and Pharmaceutical	612
Financial Services	477
Communications, Technology, and Media	445
<b>TOTAL</b>	<b>3,018</b>

Source: The LB&I Division's Summary Examination Time Transmission System.

LB&I Division's International function contained a total of 1,063 FTE examiner positions, assigned to the following four functions shown in Figure 4.

**Figure 4: Employee Positions in LB&I Division International Functions in FY 2015**

International Function	Examiner Positions (FTE)
International Business Compliance	577
International Individual Compliance	326
Global High Wealth	92
Transfer Pricing Operations	68
<b>TOTAL</b>	<b>1,063</b>

Source: The LB&I Division's Summary Examination Time Transmission System.



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Under LB&I Division's previous structure, resources were aligned to ensure a certain amount of coverage by industry and geography.<sup>18</sup> Resources were not aligned based on a data-driven analysis of compliance risk. Although some PAs of the LB&I Division's new Future State organization are based on geographic considerations, the Subject Matter PAs include issues with perceived risk, such as Treaty and Transfer Pricing and Cross Border Activities. However, we were not provided with any evidence that the new alignment of resources was based on an analysis of compliance data.

The organization of the IPGs and IPNs do not appear to be immediately affected by the reorganization of the LB&I Division, although remarks by LB&I Division executives indicate that personnel currently assigned to IPGs and IPNs will be located in one of the five subject matter PAs. Prior to the reorganization, there were 15 IPGs and 20 IPNs. The IPGs used an average of 137 FTEs during the last three fiscal years.<sup>19</sup> The IPGs were structured around the issues shown in Figure 5. Although the IPGs were created as repositories of institutional knowledge in these broad categories of taxation issues, we found no evidence that the IPGs were consistently informed or staffed based on compliance results.

**Figure 5: Issues Addressed by the IPGs**

Compensation and Benefits	Corporate Distributions and Adjustments	Corporate Income and Losses
Deductible and Capital Expenditures	Energy and Investment Tax Credits	Financial Instruments
General Business Credits	Inventory and I.R.C. § 263A	Life Insurance
Methods of Accounting and Timing	Non-Life Insurance	Partnerships
Penalties	Regulated Investment Companies, Real Estate Investment Trusts, Real Estate Management Investment Conduits, and Banking	S Corporations and Cooperatives

Source: The LB&I Division management.

<sup>18</sup> There was a geographical component to the previous LB&I Division organization, despite being initially established as an "industry-based" organization. For example, the Financial Services industry was generally located on the East Coast and was centered in New York, New York. However, if a Financial Services taxpayer was located in another industry's geographic footprint (e.g., in Chicago, Illinois, where the Retail, Food, Transportation, and Healthcare industry was located), a Financial Services group would not conduct the audit. Rather, a group from the industry organization located closest to where the financial services company was located would conduct the audit.

<sup>19</sup> This includes senior and frontline managers, as well as administrative staff.



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The 20 issues covered by IPNs are organized within three larger areas as shown in Figure 6.

**Figure 6: Issues Addressed by the IPNs**

<b>Cross Border Activities Practice Area</b>	<b>Withholding and International Individual Compliance Practice Area</b>	<b>Treaty and Transfer Pricing Operations Practice Area</b>
Deferral Planning	Foreign Entities	Economic Inbound
Foreign Currency	Foreign Tax Credit	Economic Outbound
Foreign Tax Credit Management	Jurisdiction to Tax – Outbound	Income Shifting Inbound
Inbound Financing	Offshore Arrangements	Income Shifting Outbound
Information Gathering	U.S. Business Activities	Treaties
Jurisdiction to Tax	Withholding	Exchange of Information
Organization/Restructuring		
Repatriation/Withholding		
Repatriation		

Source: The LB&I Division management.

**Assessing business results**

All IRS operating divisions use some form of a Business Performance Review (BPR) document to demonstrate to the IRS Commissioner the progress of the division toward its strategic objectives. LB&I Division's BPR addresses:

- Return closures.
- Revenue.
- Cycle Time.
- Quality.
- Customer Satisfaction.
- Employee Satisfaction.

The IRS assesses its operating divisions and functions using a “balanced measures” approach.<sup>20</sup> LB&I Division's BPR addresses these balanced measures, but the document does not include a

<sup>20</sup> According to Internal Revenue Manual section 4.46.2, balanced measures show an organization's current status of performance measures and indicate how close the organization is to its goals.



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breakdown of the compliance results from audits of high-risk compliance issues.<sup>21</sup> We discussed with LB&I Division officials the management reports that are used most often to monitor performance and the following types of reports were identified:

- Reports by taxpayer that identify by Uniform Issue List (UIL) codes where examiners are spending their hours.
- Reports by taxpayers that identify case cycle times.<sup>22</sup>
- Reports by taxpayer that identify assessment statutes of limitations.<sup>23</sup>

These are all useful reports for management, but they do not assist the LB&I Division in identifying the issues with the highest tax compliance risk. Some LB&I Division officials indicated that they would run reports that showed which issues appeared most often in different audits, but the reports did not include the size of potential adjustments as a criterion for ranking the issues. However, without the total amount of proposed adjustments, a tax issue that appeared often but had relatively small adjustments might garner more attention than was warranted. As subsequently discussed in more detail, the LB&I Division officials interviewed indicated that the reliability of issue reports is hampered by human errors of revenue agents selecting the incorrect UIL code for the issues they examined.

### **Improving business results**

In recent years, the LB&I Division has used a variety of methods to select returns for examination.

- Forms 1120 were computer-scored using the Discriminant Analysis System, which assigns a risk score that prioritized the audit potential of the return based on predefined criteria for the type of return and asset range or activity code. Generally, a higher score indicates a greater audit potential.
- Forms 1065, *U.S. Return of Partnership Income*, were selected by Discriminant Function and other scoring models, and Forms 1120S, *U.S. Income Tax Return for an S Corporation*, were identified by computer selection models. The Form 1120S returns selected by the computer models were also manually reviewed by examiners to determine potential issues for audit.

We analyzed the LB&I Division's examination productivity statistics for Forms 1120, 1065, and 1120S during the past 10 fiscal years, from FY 2006 through FY 2015. As shown in Figure 7, the LB&I Division closed between 25 percent and 54 percent of its IC examinations during this

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<sup>21</sup> LB&I Division BPRs for FYs 2014, 2015, and 2016 (through 2<sup>nd</sup> quarter).

<sup>22</sup> Cycle time information is useful to all managers because it can describe the time it takes for some groups of employees to close examinations compared to other groups.

<sup>23</sup> Generally, the statute of limitations for the IRS to make an assessment of additional taxes on the taxpayer is three years from the date the return is filed (see I.R.C. § 6501).



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period as no-changes (*i.e.*, without any recommended change to the tax liability reported by the taxpayer). For many return types, the no-change rate decreases as the dollar value of the return increases. A high no-change rate can mean that a significant amount of resources is being devoted to unproductive examinations and unnecessarily burdening compliant taxpayers.<sup>24</sup>

**Figure 7: No-Change Rate for LB&I Division IC Examinations, FYs 2006 – 2015**

Return Type	No Change Rate by Fiscal Year (IC Examinations)									
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
<b>C Corporation</b> (Form 1120)	30%	28%	26%	25%	28%	28%	30%	27%	32%	35%
<b>Partnerships</b> (Form 1065)	48%	36%	37%	43%	53%	46%	49%	49%	54%	50%
<b>S Corporation</b> (Form 1120S)	47%	39%	37%	38%	48%	42%	39%	43%	42%	42%

*Source: IRS Audit Information Management System reports for FYs 2006 through 2015.*

According to LB&I Division internal documentation, factors contributing to the high no-change rate include growing complexities in return filings, shrinking IRS resources, and inefficient and outdated processes for selecting returns for examination. LB&I Division officials also informed us that following the recent economic downturn, there were a number of large corporate filings for refunds of previously paid taxes that were no-changed after mandatory examinations for the Joint Committee on Taxation.

We interviewed examination group managers at several locations and found that the managers will often review tax returns received from the Planning and Special Projects function for audit potential before assigning to a revenue agent. Revenue agents may also conduct a risk analysis of the tax return. Although the returns provided by the Planning and Special Projects function should have the highest Discriminant Analysis System scores for the geographic area and activity code of the return ordered, team managers informed us that they often have to request many more tax returns than they need to obtain the desired number of tax returns with audit potential. Our discussions with LB&I Division officials noted that the local knowledge of managers and revenue agents is important in determining the most productive returns for audit. However, with the LB&I Division announcing plans to move away from its current audit selection process to a process focused on campaigns that address particular risk areas with an intended compliance outcome, it must be able to rely on the accuracy of the examination issue data it collects to ensure that the most productive returns are selected for examination.

<sup>24</sup> Department of the Treasury, IRS, *Report to Congress: IRS Tax Compliance Activities* (July 15, 2003).



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### **Hiring and training**

One of the guiding principles listed in the LB&I Division's Future State planning documents to support the initiative was a "Flexible, Well-Trained Workforce." With this principle, the LB&I Division intends for the Future State initiative to "cultivate an environment of continuous learning to support a flexible workforce." Among the ideas in the Future State planning materials to achieve a flexible, well-trained workforce were:<sup>25</sup>

- *Focus training on transactions and issues that employees will encounter in their work.*
- *Provide timely training needed to address current issues.*
- *Create training curriculum designed to allow employees to grow their skills and have the opportunity to focus in a specific issue area.*
- *Enable mentor-protégé roles and expectations to transfer skill and knowledge.*

Although the LB&I Division has not announced its plans to implement these ideas, accurate and detailed data on compliance issues will be necessary to determine the issues for which employees will require training. In addition, the LB&I Division has outlined limited hiring plans in recent BPRs, to include approximately 20 hires for "specialized knowledge/skills sets," which will require accurate information on compliance issues to determine the knowledge and skills needed by new employees.

### **Recommendation**

**Recommendation 1:** The Commissioner, LB&I Division, should ensure that, as the Future State initiative is implemented, the LB&I Division considers past compliance results by issue in order to inform its issue-based strategy.

**Management's Response:** The IRS agreed with this recommendation. As part of the Future State Campaign Development Process, LB&I Division management stated that it is providing compliance results by issue from the Issue Based Management Information System for use by the practice areas in the development of campaigns.

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<sup>25</sup> IRS, LB&I Division, *IRS Large Business & International Division (LB&I) - Future Structure and Operations*, p.4 (Dec. 2015).



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## **Examination Issues Are Not Captured Accurately in the Issue Management System**

In March 2006, LB&I Division management mandated the use of an electronic workpaper system called the IMS for all LB&I Division employees working examinations. According to LB&I Division officials, the purpose of the system was to help management improve strategic decisions and make informed decisions on resource allocations. Examiners were required to use the IMS to capture information from their audits, such as the type of examination issues pursued and the amounts and reasons for adjustments. The Issue Based Management Information System is used to create reports to deliver information from the IMS to decision makers and field examiners.

Generally, each examination issue has one or more UIL codes, which must be selected before an adjustment for the issue can be proposed in the IMS. Adjustments proposed by examiners are presented to the taxpayer on a Form 5701, *Notice of Proposed Adjustment*. A summary of all proposed adjustments appearing on Form 5701 can be found on Form 4549-B, *Income Tax Examination Changes*, and contains all issue names, adjustment amounts, and tax years. This information should also be reflected on the IMS. For cases without proposed adjustments, any issues considered during the examination should be listed on a risk analysis completed by examiners at the beginning and mid-point of the examination.

To determine the accuracy of IMS data, we selected judgmental samples of 25 CIC examinations and 50 IC examinations, for a total of 75 cases.<sup>26</sup> We compared examination issue information from the case files to the information contained on the IMS. Our review found discrepancies between issue information in the case files and the IMS in 17 (34 percent) of the 50 IC cases and in four (16 percent) of the 25 CIC cases. We considered that a discrepancy or error occurred when there was 1) a difference between an adjustment listed on the Form 4549-B in the case file and what was reported on the IMS, or 2) an adjustment reported in the IMS that did not appear on the Form 4549-B in the case file.<sup>27</sup> For example, we found examined issue adjustments reported in the IMS for millions of dollars but were unable to reconcile the adjustments to any adjustment in the case files. In other cases, we found examined issue adjustments in the paper files but could not locate the adjustments in the IMS. We also considered a case to be an exception if there was a missing or incomplete risk analysis in either IMS or the case file. There were 12 IC cases for which we did not find a risk analysis, or found a risk analysis that did not reconcile between the IMS and the case file.

The IRS agreed with eight of the 17 IC exceptions but did not agree with any of the four CIC exceptions. For the four CIC cases, the majority of the exceptions involved adjustments that

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<sup>26</sup> A judgmental sample is a nonprobability sample, the results of which cannot be used to project to the population.

<sup>27</sup> There are automatic adjustments made by the examiner's tax software to accurately calculate tax due as a result of adjustments made by the examiner that appear on Form 4549-B. These adjustments do not require a Form 5701, and as a result, do not show up in the IMS. We did not count these discrepancies as errors.



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appeared in the IMS or the case file as a negative or a positive amount, but did not match as a negative or a positive amount in the case file or in the IMS. The IRS's responses stated that the IMS or the case file contained correct information and that the information should have been corrected to contain the correct positive or negative amounts, but still did not agree with the exception. We believe that recording an adjustment incorrectly as a positive or a negative amount affects the accuracy of IMS data because the adjustment is either increasing or decreasing a reported tax liability. As shown in Figure 8, we found six adjustments in the IC case files and \*\*\*\*\*1\*\*\*\*\* \$1,227,525\*\*\*\*\*1\*\*\*\*\*, respectively. In the IMS, we found four adjustments that were not reported in the IC case files totaling \$176,879, and eight adjustments that were not reported in the CIC case files totaling \$23,418,555.<sup>28</sup>

**Figure 8: Results of Reconciliation Between Case Files and the IMS**

Case Type	*****1****	Total Tax Adjustment Amount	Adjustment in IMS, Not in Case File	Total Tax Adjustment Amount
IC	6	\$1,227,525	4	\$176,879
CIC	*****1****	*****1****	8	\$23,418,555

Source: Treasury Inspector General for Tax Administration (TIGTA) review of IMS data for selected closed examination cases.

At our request, the LB&I Division created an Issue Based Management Information System report identifying the UILs of the 20 examination issues with the most examiner time charged in FY 2015. As shown in Figure 9, our analysis of the report found that the UILs for six of the top 20 issues described generic situations rather than substantive issues. The descriptions of the UILs included "Issues in Case Not Yet Identified," "Revenue Agents Report," "Not Able to Identify Under Present List," "Other," "Miscellaneous Issues," and "In General."<sup>29</sup>

<sup>28</sup> In some instances, there were multiple discrepancies in a single case.

<sup>29</sup> LB&I Division personnel informed us that this category is used for time charged by Tax Computation Specialists for performing case closing procedures.



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**Figure 9: Top 20 UIL Codes by Examiner Time Used by the LB&I Division in FY 2015**

<b>UIL Description (Generic UILs Highlighted and in Bold)</b>	<b>Ranking</b>
Trade or Business (Deductible vs. Not Deductible)	1
Automatic Data Processing Systems	2
Gross Income vs. Not Gross Income	3
Allocation of Income and Deductions Among Taxpayers	4
<b>Issues in Case Not Yet Identified</b>	5
<b>Revenue Agents Report</b>	6
Qualified Research Expenses	7
<b>Not Able to Identify Under Present List</b>	8
Tax Imposed	9
Intercompany Pricing	10
<b>Other</b>	11
General Rule for Taxable Year of Deduction (Year Paid vs. Not Year Paid)	12
<b>Miscellaneous Issues</b>	13
Income Attributable to Domestic Production Activities	14
Bad Debts	15
<b>In General</b>	16
Depreciation	17
Credit for Increasing Research Activities	18
Capitalization and Inclusion in Inventory Costs of Certain Expenses	19
Examination of Books and Witnesses	20

*Source: Issue Based Management Information System report provided by the LB&I Division.*

LB&I Division officials stated that other personnel working on audits, such as Tax Computation Specialists, were likely responsible for much of the time charged to some of the generic UILs, such as “Revenue Agents Report” and “In General.” The officials also stated that examiners may have initially selected a generic UIL code but did not go back to update the code when a more precise issue was determined. Our review of the sample of 50 IC and 25 CIC examinations found that the generic UILs in the highlighted rows in Figure 9 were used in 11 (22 percent) of 50 IC cases and that the CIC cases did not use the UILs to identify issues. LB&I Division



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officials confirmed that there are no systemic controls in the IMS, or other managerial controls, to prevent examiners from charging large amounts of time to generic UILs, which do not accurately identify the substantive tax issues examined. If examiners' choices of generic UILs were more limited or more closely monitored, the information in the IMS would be more accurate and informative. This would provide more useful information to LB&I Division managers on the tax issues that examiners spent the most time on, as well as the productivity of these issues. Managers could use this information to assist in allocating resources to the most productive issues, as well as determining areas in which examiners may need additional training.

We interviewed five domestic industry directors and asked if they believed the data in the IMS were accurate and reliable. Most stated that they were aware that examiners were not always using the most accurate UIL codes. In response to this concern, LB&I Division management conducted a review of the quality and accuracy of IMS data in FY 2015. Although no formal statistics were gathered on the results of this effort, several managers noted that the UIL code manual contains almost 300 pages and that multiple UIL codes exist for issues related to one section of the I.R.C. For example, 21 UIL codes exist to identify an issue involving I.R.C. § 199<sup>30</sup> and more than 200 UIL codes exist to identify an issue involving I.R.C. § 162.<sup>31</sup> Several managers also stated that examiners reported a lack of guidance on the proper UIL code to use for a given audit situation.

In December 2014, the LB&I Division published plans for a new process that uses campaigns to select taxpayer returns for examination based on issues. Once fully implemented, this process will require accurate information from the IMS to identify the most productive tax issues for examination.

## ***Recommendation***

***Recommendation 2:*** The Commissioner, LB&I Division, should develop and implement plans to streamline the UIL codes available to examiners, provide additional guidance for the appropriate use of UIL codes, and include UIL code accuracy in program and evaluative quality reviews.

***Management's Response:*** The IRS agreed with this recommendation. The LB&I Division stated that it has already streamlined UIL codes for international issues and is developing a strategy for increasing the accuracy of other UIL codes.

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<sup>30</sup> I.R.C. § 199 governs deductions in the area of income attributable to domestic production activities.

<sup>31</sup> I.R.C. § 162 governs deductions in the area of trade or business activities.



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**Planning and Implementation Stages of the Future State Initiative Should Include Key Best Practices**

As noted earlier, the LB&I Division recently began implementing sweeping organizational changes as part of its Future State plan intended to better position itself to more effectively administer the tax laws. According to LB&I Division officials, the new process will change how the division is structured and how work is selected. The Future State plan also includes plans to develop better training and career paths for examiners, as well as to clearly define the compliance goals of all LB&I Division work. The plan lays out the LB&I Division's future direction, defines the necessary organizational capabilities, initiatives, and work areas, and outlines the next steps needed to achieve organizational priorities. The LB&I Division has identified seven initiatives to implement its plan:

1. Compliance risk identification, using internal and external data such as macroeconomic trends combined with data analytics, and leveraging on organizational intelligence, such as examiner expertise, to feed into campaign development.
2. Issue triage and outcome identification to further develop the identified risk areas into specific priority issues with compliance outcomes.
3. Campaign design and planning to ensure that the campaign outcome and the identified objective are achieved. Among the campaign development processes is the use of automated filters and manual classification processes that will enable the issues to be centrally selected. A governing board consisting of senior executives will decide and approve the campaigns to be included in the Compliance Plan and will define compliance goals.
4. Resource allocation that uses a skills matrix assessment to assess the workforce for skill gaps and adjusts resource allocation as necessary.
5. Compliance operations optimization, including creating a treatment stream to ensure that a full spectrum of options is available to address different issues, taxpayers, and scenarios.
6. Dynamic tools, training, and support that leverage information technology to optimize knowledge management and manage case activities, as well as developing capabilities to receive, index, and store electronic returns and information documents.
7. Continuous feedback mechanisms to collect and act upon feedback to improve risk analysis, issue development, work selection, resource allocation, and training.

According to LB&I Division officials, the majority of work will be centrally selected and risk assessed based on these defined compliance initiatives. Compliance risk will be identified based on compliance priorities. In addition to working preselected issues, examiners will also "risk review" returns for material compliance issues not identified through the return selection



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process. Additional issues identified through this process will be considered against the LB&I Division's other work priorities. In addition, the employees are encouraged to suggest campaigns to be included in the workplan.

An April 10, 2009, Large and Mid-Sized Business Division Guidance Memorandum entitled *Use of Standardized Frameworks for the Design and Implementation of Major Process Improvement Initiatives*, provided guidance that requires task forces responsible for the design and implementation of major process improvement initiatives to ensure that they use a standardized process improvement framework, such as the 20-step approach developed by the Government Accountability Office (GAO). The GAO based its framework on its *Business Process Reengineering Assessment Guide* and discussions with managers in private industry as well as in other Federal agencies.<sup>32</sup> According to the GAO, the 20 steps included in its approach help ensure that potential obstacles are considered in planning, problems are pinpointed and addressed through pilot testing, and results are evaluated accurately. Appendix VI provides additional details for each of the items in the GAO approach.

Based on our research and discussions with LB&I Division officials, we found that although a substantial number of planning documents had been produced for the Future State initiative, the division had not followed the documentation requirements of the April 2009 guidance memorandum to ensure that the planning followed the GAO framework or other standardized approach. We reviewed the existing documentation to determine if the LB&I Division had considered the GAO's 20-step approach during its planning activities for the initiative. In making our assessment, it is important to recognize that the first six steps in the approach deal with, in large part, understanding the problem and using empirical data as the basis for deciding to implement a new process or improve an existing one. We believe it is equally important to recognize that, according to the GAO, a degree of discretion is involved in making judgments about each of the steps and some steps will not be appropriate for every project. As shown in Figure 10, LB&I Division planning documents for the initiative did not fully document that several of the steps in the GAO framework were considered.

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<sup>32</sup> GAO/AIMD-10.1.15, *Business Process Reengineering Assessment Guide* (May 1997).



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**Figure 10: Assessment of the Documentation of Key Best Practices in the LB&I Division Future State Planning Process**

<i>Key Best Practices</i>	<i>Documented</i>	<i>Comments</i>
<i>Map current process.</i>	●	
<i>Identify productivity baselines.</i>	○	<i>Productivity baseline, such as number of cases or other metrics, was not identified.</i>
<i>Identify causes of poor performance.</i>	●	
<i>Include complexity and quality in productivity measures.</i>	○	<i>No productivity measures.</i>
<i>Measure gap between current and desired productivity.</i>	○	<i>No specifics on desired productivity, such as number of cases or other metrics.</i>
<i>Compare current productivity to internal and external benchmarks.</i>	○	<i>No comparisons to internal benchmarks.</i>
<i>Use best practices.</i>	●	
<i>Design process to close productivity gap.</i>	○	<i>No quantitative data showing that initiative will improve performance.</i>
<i>Analyze alternatives.</i>	●	
<i>Obtain executive support.</i>	●	
<i>Assess barriers to implementing changes.</i>	●	
<i>Assess resource needs and availability.</i>	●	
<i>Conduct pilot tests.</i>	●	
<i>Adjust process based on pilot.</i>	●	
<i>Define roles and responsibilities.</i>	●	
<i>Establish employee expectations.</i>	●	
<i>Monitor and evaluate the new process.</i>	●	
<i>Establish a change management strategy.</i>	●	
<i>Establish a transition team.</i>	●	
<i>Develop workforce training plans.</i>	●	
● = Documented    ○ = Not fully documented		

Source: TIGTA's analysis of the GAO's 20-step approach to evaluate process improvement and data provided by the IRS.



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As shown in Figure 10, the Future State planning documentation we reviewed lacked detailed productivity measures to assess the success of the initiative. According to the GAO's best practice framework, a sound evaluation plan should contain key elements, such as clearly stated objectives that measure success against well-defined standards and detailed steps for verifying that sufficient benefits are being realized in relation to the costs being incurred. By developing and implementing objective performance measures, the LB&I Division could identify necessary revisions to enhance the initiative, as well as permit internal and external stakeholders to adequately assess the success of the initiative.

Although the LB&I Division announced the Future State plan in February 2016 and initiated a reorganization of the division, it intends to introduce the full concept over a period of time and changes to the plan are likely. The Future State plan is based on the model shown in Appendix V, which includes steps to gather, assess, and incorporate feedback into the division's operations. However, in order to guide this effort, we believe that the LB&I Division should use its standardized process improvement framework to document the detailed steps needed for executives and managers to plan and implement the initiative.

## **Recommendation**

**Recommendation 3:** The Commissioner, LB&I Division, should ensure that the planning for the Future State initiative follows the LB&I Division's published guidance, to include documenting that a standardized process improvement framework was followed.

**Management's Response:** The IRS agreed with this recommendation. LB&I Division management stated that the Campaign Development Process includes a standardized framework for implementing new projects.

**Office of Audit Comment:** While the Campaign Development Process includes a standardized framework for implementing Examination projects, as mentioned above, our concern is that, in planning for the overall Future State Initiative, the IRS lacked documentation showing it followed a framework for implementing new processes, such as the GAO's Business Process Reengineering Assessment Guide.



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## Appendix I

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

The overall objective of this review was to determine whether the LB&I Division effectively uses compliance results to identify compliance risk and allocate resources strategically to improve examination results. After fieldwork for this audit began, the LB&I Division announced plans to reorganize its operations under its Future State concept of operations. We therefore reviewed whether LB&I Division's Future State plans would utilize the compliance results of its examination efforts to inform and improve its issue-focused strategy.

To accomplish our objective, we:

- I. Determined the taxpayer segments serviced by the LB&I Division, organization structure and types of industries involved, number of employees in each industry, types of examinations conducted, and methodologies for performance measurement and return selection.
  - A. Researched IRS.gov, the IRS intranet, and historical documents on the IRS's organization.
  - B. Contacted LB&I Division officials to obtain data on employee staff years per industry.
  - C. Researched Internal Revenue Manual guidance on LB&I Division return selection and reviewed LB&I Division BPR documents.
- II. Determined LB&I Division's Future State organizational structure and plans for audit campaigns. We also determined the LB&I Division's knowledge management techniques.
  - A. Obtained and reviewed LB&I Division documents on Future State and held discussions with LB&I Division officials on the Future State concept and audit campaigns.
  - B. Obtained from LB&I Division officials the purpose and organizational structure of the LB&I Division IPGs and IPNs and staffing information.
- III. Obtained the historical examination statistics for corporations, partnerships, and S corporations. We also obtained a list of the top 20 compliance issues by amount and time charged in the IMS.
  - A. Obtained LB&I Division's Audit Information Management System Management Reports (Table 37) for FYs 2006 through 2015.



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- B. Analyzed the no-change rate for C corporation, partnership, and S corporation examinations in the LB&I Division's Table 37 for FYs 2006 through 2015.
  - C. Obtained and reviewed LB&I Division IMS lists of the top 20 issues by amount assessed and by time charged.
- IV. Interviewed territory and group managers and their industry directors to determine how they select returns for examinations, and their use of the LB&I Division IMS.
- A. Interviewed territory and group managers from LB&I Division offices located in San Francisco, California; Chicago, Illinois; New York, New York; King of Prussia, Pennsylvania; and Houston, Texas, to obtain their experience on current return selection methods and their use of information management system reports, as well as their perspective on the future use of campaigns to identify and select returns for examinations.
  - B. Interviewed industry directors from the Retailers, Food, Transportation, and Healthcare; Financial Services; Heavy Manufacturing and Pharmaceutical; Natural Resources and Construction; Communications, Technology, and Media; and Global High Wealth industries to determine their use of the information management system reports and their perspectives on whether the reports contained accurate information.
- V. Obtained judgmental samples<sup>1</sup> of 50 IC and 25 CIC cases for review to determine whether UILs and other case information were accurately reflected in the IMS.
- A. Coordinated with LB&I Division Quality Review offices in Chicago and San Francisco to obtain judgmental samples of IC and CIC cases. We used judgmental samples due to time constraints. We selected 50 IC cases that were available from the Quality Review offices at the time of our visits. We coordinated with the LB&I Division to obtain five CIC cases from each of LB&I industry for a total sample of 25 cases.
  - B. We made copies of Notice of Proposed Adjustments, Risk Analysis Worksheets, and Form 4540-B from the case files at the time of our visits, and coordinated with the LB&I Division liaison to obtain the remainder of the case files.
- VI. Used the GAO process improvement guide to evaluate the LB&I Division Future State plans to determine whether its guidelines were followed in the Future State development stages.
- A. Researched the LB&I Division intranet and official process improvement guidelines.
  - B. Discussed with LB&I Division officials the use of the official process improvement procedures in the Future State planning process.

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<sup>1</sup> A judgmental sample is a nonprobability sample, the results of which cannot be used to project to the population.



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**Internal controls methodology**

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined that the following internal controls were relevant to our audit objective: IRS policies and procedures for return selection, controls related to the IMS, and reviews of samples of closed cases. We evaluated these controls by interviewing management and analysts responsible for executing the program, reviewing applicable documentation, and reviewing closed examination cases.



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**Appendix II**

*Major Contributors to This Report*

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Robert M. Jenness, Audit Manager  
William Tran, Lead Auditor  
Carole Connolly, Senior Auditor  
Gregory Helias, Senior Auditor



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**Appendix III**

*Report Distribution List*

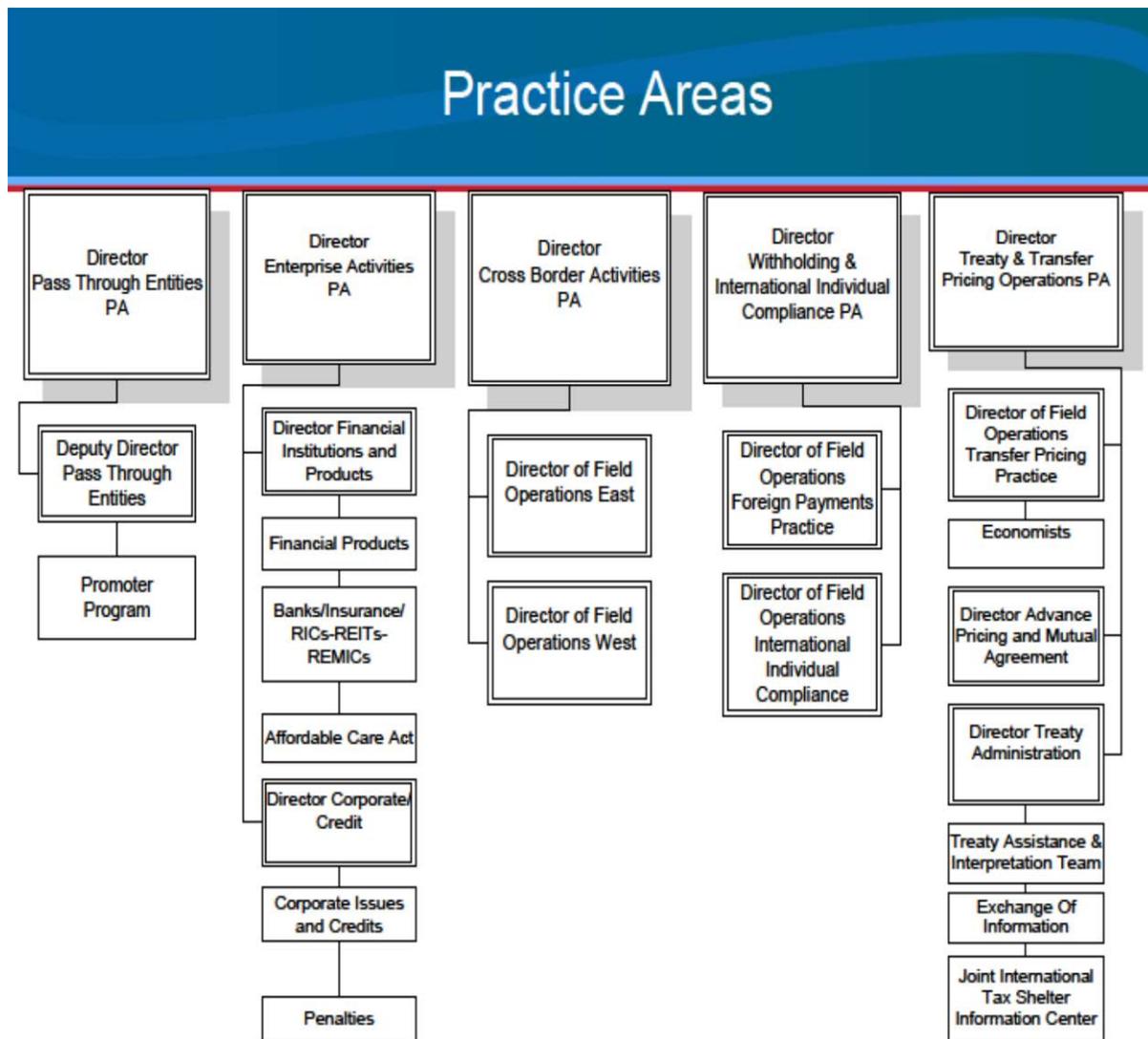
Commissioner  
Office of the Commissioner – Attn: Chief of Staff  
Deputy Commissioner for Services and Enforcement  
Deputy Commissioner, Large Business and International Division  
Director, Central Compliance Practice Area, Large Business and International Division  
Director, Compliance Planning and Analytics, Large Business and International Division  
Director, Cross Border Activities, Large Business and International Division  
Director, Transfer Pricing Operation  
Director, Withholding and International Individual Compliance  
Director, Office of Audit Coordination



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**Appendix IV**

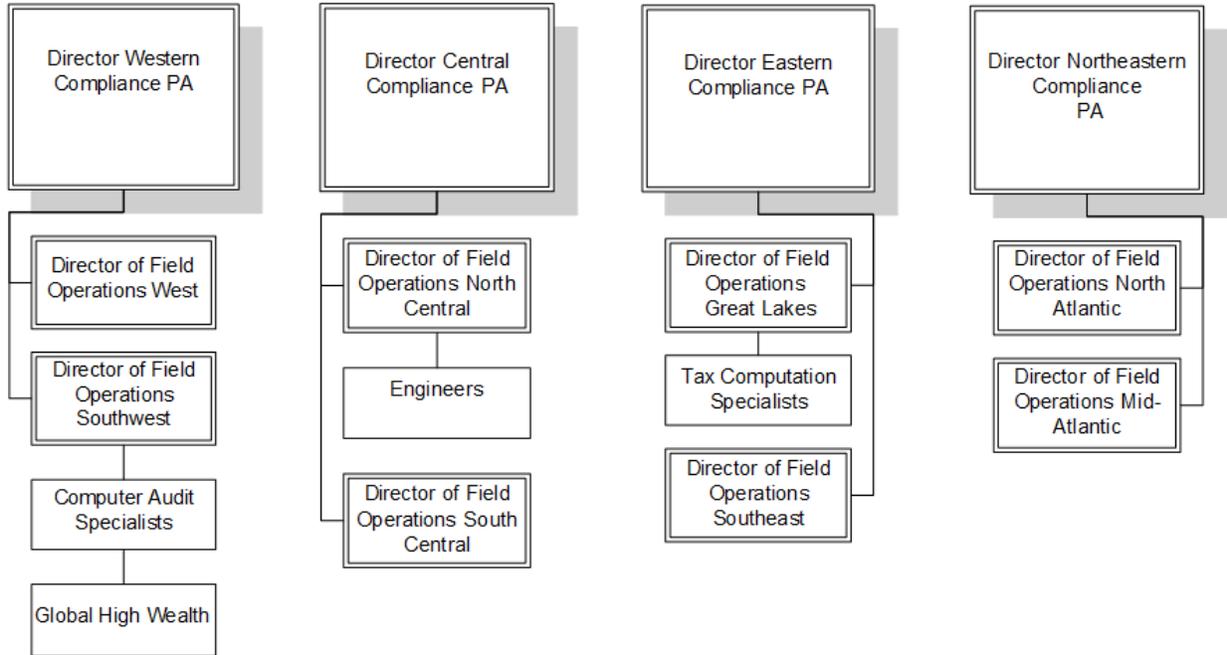
*Large Business and International Division  
Concept of Operations (Future State)  
Organization Chart*



Source: The LB&I Division.



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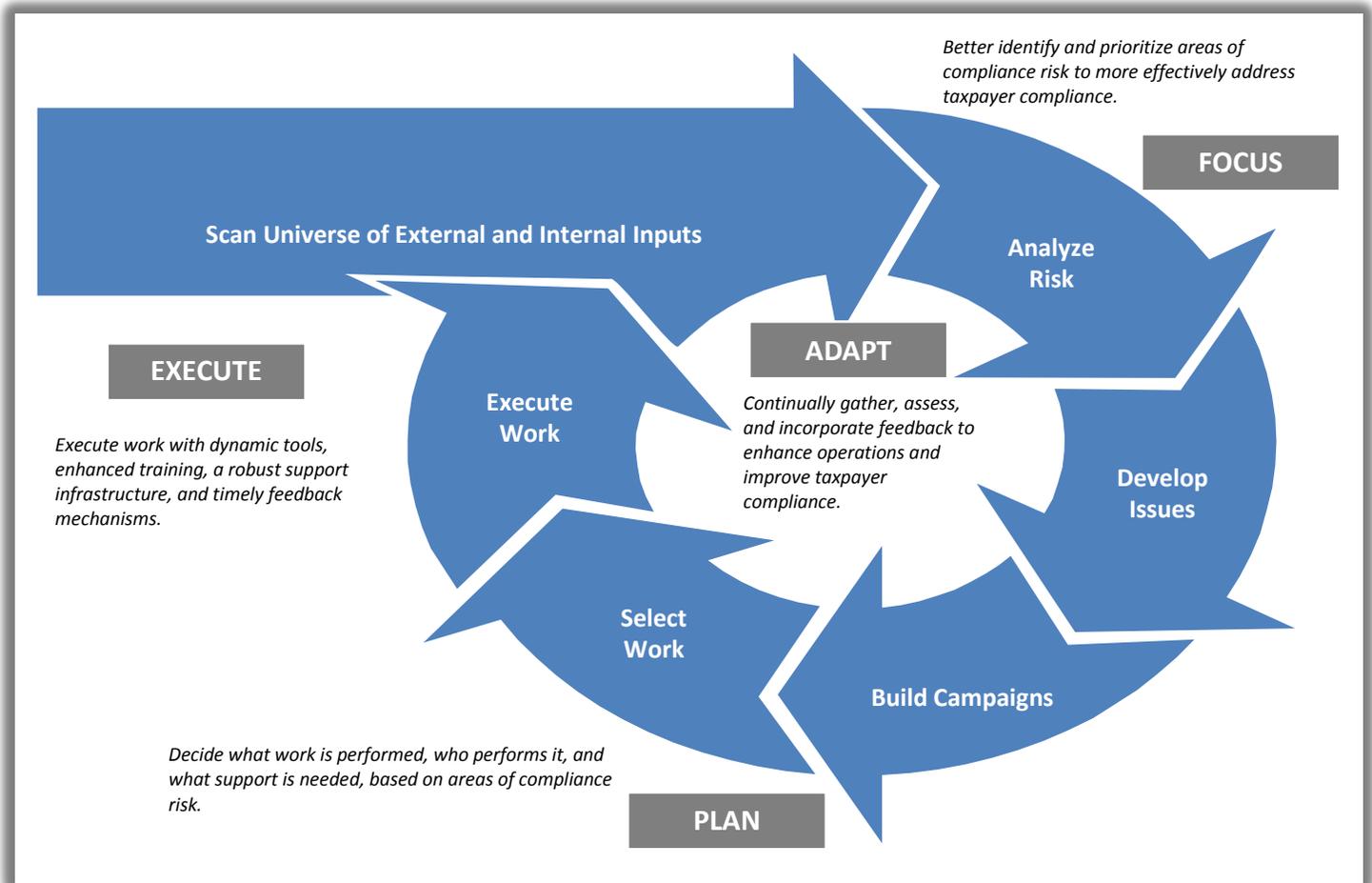
Source: The LB&I Division.



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**Appendix V**

*Large Business and International Division  
Concept of Operations (Future State) Plan*



Source: The LB&I Division.



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**Appendix VI**

*Recommended Approach for Business Process Changes*

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

**Figure 1: Recommended Steps in Considering a Potential Process Change**

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

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



*The Large Business and International Division's Strategic Shift to Issue-Focused Examinations Would Benefit From Reliable Information on Compliance Results*

**Figure 2: Recommended Steps for Planning a Process**

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

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



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**Figure 3: Recommended Steps for Implementing a Process Change**

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

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



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**Appendix VII**

*Glossary of Terms*

<b>Term</b>	<b>Definition for the purpose of this review</b>
Business Performance Review	A quarterly high-level organizational performance document that provides an opportunity for LB&I Division executives to share significant accomplishments as well as evolving concerns with the IRS Commissioner and the IRS Oversight Board.
Fiscal Year	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.
Full-Time Equivalent	The total number of regular straight-time hours ( <i>i.e.</i> , not including overtime or holiday hours) worked by employees divided by the number of compensable hours applicable to each fiscal year. Annual leave, sick leave, compensatory time off, and other approved leave categories are considered to be "hours worked" for purposes of defining FTE employment. One FTE is equal to eight hours multiplied by the compensable days in the particular fiscal year; therefore, one FTE can be equal to 2080, 2088 or 2096 hours depending on the fiscal year.
Issue Management System	IMS is a computer application that supports LB&I Division's existing and new examination processes. It captures information from IC and CIC cases, all Specialist work, open cases, and closed cases. The information captured is related to cases, returns, issues, and cycles. IMS consists of two components, a laptop application (the client), and a centralized data repository (Team Web Site).
Internal Revenue Code	Title 26 of the United States Code enacted by Congress containing all relevant rules pertaining to estate, excise, gift, income, payroll, and sales taxes.
Issue Based Information Management System	A reporting system that delivers information collected and managed by IMS to decision makers and examination personnel in the field.
Knowledge Management	The practice of knowledge and skills transfer between LB&I Division employees through the use of IPGs and IPNs.



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<b>Term</b>	<b>Definition for the purpose of this review</b>
Processing Year	The calendar year in which the tax return or document is processed by the IRS.
Tax Computation Specialist	An IRS employee who specializes in determining the tax liability on LB&I Division cases. The Tax Computation Specialist is a member of the examination team that identifies and analyzes issues that impact tax.
Uniform Issue List	A list of codes used to identify examination issues for IRS researchers to analyze compliance risks.



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**Appendix VIII**

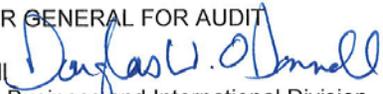
*Management's Response to the Draft Report*



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, DC 20224

September 6, 2016

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Douglas W. O'Donnell   
Commissioner, Large Business and International Division

SUBJECT: Draft Audit Report # 2015-30-020-The Large Business and International Division's Strategic Shift to Issue-Focused Examinations Would Benefit from Reliable Information on Compliance Results

Thank you for the opportunity to review and comment on the subject draft report. We appreciate the considerable time the audit team spent assessing the use of compliance results in planning for examinations. The Large Business and International Division (LB&I) is in the process of making a number of structural and process changes in order to create an organization that:

- Continuously evolves to keep pace with the way the world does business and with our taxpayers.
- Uses our most valuable resource, our employees' time, to achieve pre-determined compliance goals.
- Reflects one LB&I, instead of fragmenting LB&I's collective knowledge and skills into a stratified organization such as International vs. Domestic, Field vs. Headquarters, or Strategy vs. Execution.
- Supports promotional opportunities in all areas of LB&I based on knowledge, skills, and abilities of employees and their willingness to coach, mentor, and transfer skills.
- Supports better collaboration.
- Updates exam processes that have not been refreshed for many years.

We've implemented this new structure, effective February 7, 2016, and LB&I is now organized into 9 Practice Areas, some of which are subject matter-based and some of which are geography-based. We are also in the midst of additional process changes to support and maximize the operational success of LB&I's new organizational structure. The guiding principles for these changes is to position LB&I with a flexible, well trained workforce; to select better work (utilizing data analytics and input from experienced examiners and their management to build coordinated campaigns, etc.); with tailored treatment streams for facilitating compliance (using education, outreach and guidance to compliment traditional enforcement and examination strategies), and allowing for an



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integrated feedback loop to feed into LB&I's compliance plan enabling it to evolve and emerge appropriately and in real time based on the experience borne out of the campaigns and other such initiatives.

As your findings indicate, capturing audit results by issues is an area that presents some challenges. We have taken steps to overcome these challenges, and continue to look for opportunities for improvement and refinement. For example, we've consolidated the international Uniform Issue List (UIL) codes in order to increase accuracy and better reflect compliance areas. We are also undertaking efforts to increase the accuracy of UIL codes for all of our compliance employees. We have also taken steps to ensure that issue results will be used in the planning of campaigns.

We believe that the Future State planning, particularly as it reflects compliance strategy, already encompasses the spirit of the twenty factors that the Government Accountability Office states should be used in project planning. The Campaign Development Process provides for clear and measurable goals and schedules. It assesses the resources needed to effectively execute the campaigns. The process leverages stakeholder input and incorporates lessons learned by evaluating past performance. It evaluates, prioritizes and documents risks. It also includes options for mitigating the risks. We are planning to monitor progress to determine our effectiveness in achieving our stated goal.

Attached is a detailed response outlining the corrective actions that LB&I Division will take to address your recommendations. If you have any questions, please contact me or members of your staff may contact Christopher Larsen, Director, Compliance Planning and Analytics, at (202) 515-4438.

Attachment



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*The Large Business and International Division's Strategic Shift to Issue-Focused Examinations Would Benefit From Reliable Information on Compliance Results*

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3

Attachment

**RECOMMENDATION 1:**

The Commissioner, LB&I Division, should ensure that, as the Future State initiative is implemented, the LB&I Division considers past compliance results by issue in order to inform its issue-based strategy.

**CORRECTIVE ACTIONS:**

We agree with this recommendation. As part of the Campaign Development Process, we are providing compliance results by issue from the IBMIS system for use by the practice areas in the development of campaigns.

**IMPLEMENTATION DATE:**

COMPLETED: 8/15/2016      PROPOSED: \_\_\_\_\_

**RESPONSIBLE OFFICIAL(S):**

Director, Compliance Planning and Analytics

**RECOMMENDATION 2:**

The Commissioner, LB&I Division, should develop and implement plans to streamline the UIL codes available to examiners, provide additional guidance for the appropriate use of UIL codes, and include UIL code accuracy in program and evaluative quality reviews.

**CORRECTIVE ACTIONS:**

We agree with this recommendation. LB&I has already streamlined UIL codes for International issues. It is currently developing a strategy for increasing the accuracy of other UIL codes.

**IMPLEMENTATION DATE:**

COMPLETED: \_\_\_\_\_      PROPOSED: 9/15/2017

**RESPONSIBLE OFFICIAL(S):**

Director, Compliance Planning and Analytics

**RECOMMENDATION 3:**

The Commissioner, LB&I Division, should ensure that the planning for the Future State initiative follows the LB&I Division's published guidance, to include documenting that a standardized process improvement framework was followed.



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*The Large Business and International Division's Strategic Shift to Issue-Focused Examinations Would Benefit From Reliable Information on Compliance Results*

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**CORRECTIVE ACTIONS:**

We agree with this recommendation. The Campaign Development Process includes a standardized framework for implementing new projects.

**IMPLEMENTATION DATE:**

COMPLETED: 4/18/2016      PROPOSED: \_\_\_\_\_

**RESPONSIBLE OFFICIAL(S):**

Director, Compliance Planning and Analytics