



*Improvements Are Needed in the Estate and  
Gift Tax Return Examination Process*

**September 26, 2017**

**Reference Number: 2017-30-081**

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

**Redaction Legend:**

1 = Tax Return/Return Information

---

Phone Number / 202-622-6500

E-mail Address / [TIGTACommunications@tigta.treas.gov](mailto:TIGTACommunications@tigta.treas.gov)

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



**To report fraud, waste, or abuse, call our toll-free hotline at:**

**1-800-366-4484**

**By Web:**

**[www.treasury.gov/tigta/](http://www.treasury.gov/tigta/)**

**Or Write:**

Treasury Inspector General for Tax Administration  
P.O. Box 589  
Ben Franklin Station  
Washington, D.C. 20044-0589

Information you provide is confidential and you may remain anonymous.



## HIGHLIGHTS

### IMPROVEMENTS ARE NEEDED IN THE ESTATE AND GIFT TAX RETURN EXAMINATION PROCESS

## Highlights

**Final Report issued on  
September 26, 2017**

Highlights of Reference Number: 2017-30-081 to the Internal Revenue Service Commissioner for the Small Business/Self-Employed Division.

### IMPACT ON TAXPAYERS

The Federal estate tax is a tax on the right to transfer property at death. The Federal gift tax is a tax on transfers of property from a living person to other persons or trusts. Taxpayers could be treated inconsistently if estate and gift tax returns are not properly assigned or examined.

### WHY TIGTA DID THE AUDIT

The IRS reported in its Fiscal Year 2016 Data Book that it proposed more than \$1 billion of additional tax for estate and gift tax returns that were examined and closed during Fiscal Year 2016. TIGTA initiated this audit to determine whether the Estate and Gift Tax Program is effectively processing and selecting estate and gift tax returns for examination and to identify the overall compliance impact of the program.

### WHAT TIGTA FOUND

TIGTA's review of the classification, prioritization, and inventory assignment processes identified improvements that are needed in Internal Review Manual (IRM) guidance, classification sheet documentation, and managerial oversight. TIGTA found that:

- There is minimal IRM guidance for case classification, prioritization, and inventory assignment processes.
- Some classification sheets, when filled out by classifiers, are difficult to read or are incomplete.

- A single employee prioritizes cases selected for examination during classification sessions and assigns these cases to the field for examination, and a lack of documented managerial reviews over the processes poses risks.

Also, case documentation guidelines were not followed in 18 (47 percent) of 38 randomly sampled estate tax examinations and in 17 (46 percent) of 37 randomly sampled gift tax examinations.

Furthermore, the impact of the Estate and Gift Tax Program's compliance efforts is uncertain for several reasons. While the Estate and Gift Tax Program tracks the amount of proposed deficiencies and includes the amount of proposed deficiencies in the IRS Data Book annually, a significant percentage of proposed deficiencies are subject to Office of Appeals determination. TIGTA calculated the rate at which the Office of Appeals sustains estate and gift tax proposed deficiencies; however, the IRS stated that the sustention rate may be inherently flawed because the amount of proposed deficiencies is overstated by the IRS. Estate and gift tax examiners will sometimes issue alternative proposed deficiencies when the IRS is uncertain whether it will prevail on its primary position. In addition, notices of deficiencies that are sent to taxpayers can also include multiple inconsistent tax assessment positions for the same tax issue. While alternative positions are taken to protect the Government's interest, inconsistent proposed deficiencies and notices of deficiency present some risks for taxpayers and the Government.

### WHAT TIGTA RECOMMENDED

TIGTA made several recommendations to improve the examination of estate and gift tax returns, including the creation of a legible classification sheet; revisions to the IRM; strengthening of internal controls; and develop guidance on the circumstances in which it is advisable to propose and issue inconsistent notices of deficiency in estate and gift tax examinations.

In response to the report, IRS officials agreed with the recommendations and plan to take appropriate corrective actions.



TREASURY INSPECTOR GENERAL  
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C. 20220

September 26, 2017

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

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

**SUBJECT:** Final Audit Report – Improvements Are Needed in the Estate and Gift  
Tax Return Examination Process (Audit # 201630013)

This report presents the results of our review to determine whether the Estate and Gift Tax Program is effectively processing and selecting estate and gift tax returns for examination and to identify the overall compliance impact of the program. This audit is included in our Fiscal Year 2017 Annual Audit Plan and addresses the major management challenge of Improving Tax Compliance.

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

Copies of this report are also being sent to the Internal Revenue Service managers affected by the report recommendations. If you have any questions, please contact me or Matthew A. Weir, Assistant Inspector General for Audit (Compliance and Enforcement Operations).



---

*Improvements Are Needed in the  
Estate and Gift Tax Return Examination Process*

---

*Table of Contents*

<a href="#">Background</a> .....	Page 1
<a href="#">Results of Review</a> .....	Page 4
<a href="#">Improvements Could Be Made in the Estate and Gift Tax Classification, Prioritization, and Inventory Assignment Processes</a> .....	Page 4
<a href="#">Recommendations 1 through 3:</a> .....	Page 10
<a href="#">Recommendations 4 and 5:</a> .....	Page 11
<a href="#">Estate and Gift Tax Examiners Do Not Always Follow Case Documentation and Time Frame Guidelines</a> .....	Page 11
<a href="#">Recommendations 6 and 7:</a> .....	Page 15
<a href="#">The Impact of the Estate and Gift Tax Program’s Compliance Efforts Is Uncertain</a> .....	Page 15
<a href="#">Recommendation 8:</a> .....	Page 18
<b>Appendices</b>	
<a href="#">Appendix I – Detailed Objective, Scope, and Methodology</a> .....	Page 20
<a href="#">Appendix II – Major Contributors to This Report</a> .....	Page 23
<a href="#">Appendix III – Report Distribution List</a> .....	Page 24
<a href="#">Appendix IV – Management’s Response to the Draft Report</a> .....	Page 25



*Improvements Are Needed in the  
Estate and Gift Tax Return Examination Process*

---

---

*Abbreviations*

FY	Fiscal Year
IMS	Issue Management System
I.R.C.	Internal Revenue Code
IRM	Internal Revenue Manual
IRS	Internal Revenue Service
WSD	Workload Selection and Delivery



## *Improvements Are Needed in the Estate and Gift Tax Return Examination Process*

---

### *Background*

Internal Revenue Code (I.R.C.) Section (§) 2001(a) requires that a tax be imposed on the transfer of the taxable estate of every decedent who is a citizen or resident of the United States. The Federal estate tax is a tax on the right to transfer property at death and is reported on Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return*. For Calendar Year 2016, Form 706 must be filed for decedents whose gross estate, plus adjusted taxable gifts and specific exemption, is more than \$5.45 million. The gross estate is all property owned by the decedent at the time of death, including real estate, cash, stocks, bonds, businesses, and decedent-owned life insurance policies. Deductions are allowed for items such as funeral expenses, administrative expenses, indebtedness, taxes, casualty loss, and charitable/marital transfers. The taxable estate is calculated as gross estate less allowable deductions.

I.R.C. § 2501(a)(1) requires that a tax be imposed on the transfer of property by gift by any individual resident or nonresident. The Federal gift tax is a tax on transfers of property from a living person to other persons or trusts and is reported on Form 709, *United States Gift (and Generation-Skipping Transfer) Tax Return*. Form 709 is used to report transfers subject to the Federal gift tax and certain generation-skipping transfer taxes, and the allocation of generation-skipping transfer exemptions to property transferred during the transferor's lifetime. The form includes the name of the recipient, recipient's relationship to the donor, type of property, and value of the gifts reported. Additionally, the total value of a donor's lifetime gifts and tax computation items are presented as a cumulative total. Form 709 is generally filed for every year a gift is made if money or property that is gifted is worth more than the annual exclusion for that year, is given to someone other than the donor's spouse, or the gift is not subject to the annual exclusion. The Calendar Year 2016 annual gift exclusion was \$14,000.

All estate and gift tax returns are filed on paper and are processed at the Internal Revenue Service (IRS) Cincinnati, Ohio/Covington, Kentucky Campus. The Campus staff reviews all estate Forms 706 to determine if all filing requirements have been met and if there are any issues pending. After this review, the return will either be classified at the Campus for possible examination or may be accepted as filed and sent to the Campus for processing. The estate and gift tax returns that are selected for examination are sent to the field to be completed by examiners who specialize in estate and gift tax.<sup>1</sup> IRS examinations of returns determine if assets, expenses, and credits are being reported accurately. The Issue Management System (IMS) is used to manage the examiner's workload for all estate and gift tax cases. The IMS is designed to obtain and retain examination information in a centralized location,<sup>2</sup> including all documents that

---

<sup>1</sup> Internal Revenue Manual (IRM) 4.25.3.2.3(1) (Aug. 5, 2015).

<sup>2</sup> IRM 4.25.5.2(1) (Aug. 6, 2015).



*Improvements Are Needed in the  
Estate and Gift Tax Return Examination Process*

support conclusions or provide detail on the audit trail of the examination.<sup>3</sup> Figure 1 presents the total number of estate and gift tax examinations closed in Fiscal Year (FY) 2016, the recommended additional tax after examination, and the average recommended additional tax per return, as reported by the IRS.<sup>4</sup>

**Figure 1: FY 2016 Estate and Gift Tax Examination Proposed Additional Tax**

Type of Return	FY 2016 Examined Returns Closed	Recommended Additional Tax After Examination (in millions, rounded)	Average Recommended Additional Tax Per Return (in thousands, rounded)
Estate Tax	3,187	\$790	\$248
Gift Tax	1,843	\$303	\$164
<b>Total</b>	<b>5,030</b>	<b>\$1,093</b>	

Source: FY 2016 IRS Data Book.

Each year, the IRS establishes work plans for each business unit. Figure 2 provides details of the work plans for the planned and actual estate and gift tax return closures for FYs 2016 and 2017.

**Figure 2: Estate and Gift Tax Return Examination Closures**

Type of Return	FY 2016 Planned Examination Returns Closed	FY 2016 Actual Examined Returns Closed	FY 2016 Difference Between Planned and Actual	FY 2017 Planned Examination Returns Closed
Estate Tax	2,783	3,187	404	2,438
Gift Tax	1,982	1,843	(139)	1,709

Source: FY 2016 and FY 2017 Executive Steering Committee Closures Work Plans and FY 2016 Data Book.

This review was performed with information obtained from the Small Business/Self-Employed Division Headquarters in Lanham, Maryland, and at Estate and Gift Tax Program offices in Cincinnati, Ohio, and Florence, Kentucky, during the period November 2016 through June 2017. 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

<sup>3</sup> IRM 4.25.5.2.3(1) (Aug. 5, 2016).

<sup>4</sup> A fiscal year is 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.



*Improvements Are Needed in the  
Estate and Gift Tax Return Examination Process*

---

objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.



*Improvements Are Needed in the  
Estate and Gift Tax Return Examination Process*

---

*Results of Review*

**Improvements Could Be Made in the Estate and Gift Tax  
Classification, Prioritization, and Inventory Assignment Processes**

The Estate and Gift Tax Program has 254 field examination employees nationally.<sup>5</sup> The classification, prioritization, and inventory assignment processes attempt to make the best use of the program resources to reach yearly examination work plan goals. In Calendar Year 2015, 36,130 estate returns and 238,324 gift returns were filed.<sup>6</sup>

The Estate and Gift Workload Selection and Delivery (WSD) group is part of Exam Case Selection.<sup>7</sup> The WSD group is responsible for the estate and gift tax classification, prioritization, and inventory assignment processes. The process of reviewing the filed estate or gift tax return and determining the potential examination issues is known as classification, which is important in the examination selection process. All estate tax returns go through the classification process, and gift tax returns that meet certain prescreening criteria are also classified. As described in more detail below, the classification process within the Estate and Gift Tax Program is unlike any other examination selection process in the IRS. The Estate and Gift Tax Program primarily relies on quarterly and monthly face-to-face classification sessions to determine which cases pose the highest compliance risks and ultimately which returns are assigned to the field for examination.

During the classification sessions, each estate tax return and prescreened gift tax return is reviewed. Using written classification guidance, the classifier determines if the return should be accepted as filed or if it contains issues that should be examined. When potentially examinable issues are identified, the classifier documents them on the classification sheet template. The classification sheet contains various sections to detail issues such as total gifts reported; issues identified with return schedules; the need for an art panel appraisal; partnership, limited liability company, S Corporation, and C Corporation discounts; and a section for additional details.

After classification, each case that has potentially examinable issues is reviewed by the “national gatekeeper.” The gatekeeper prioritizes the cases based on the classification sheet issues, experience, and knowledge of the Estate and Gift Tax Work Plan and other planned potential work.

---

<sup>5</sup> Estate and gift tax employees on payroll at the end of FY 2016.

<sup>6</sup> Estate returns include taxable Form 1041, *Income Tax Return for Estates and Trusts*, and Form 1041-N, *Income Tax Return for Electing Alaska Native Settlement Trusts*.

<sup>7</sup> Exam Case Selection consists of Field Case Selection, Campus Case Selection, Lead Development Center, Bank Secrecy Act Case Selection, Employment WSD, Estate and Gift WSD, Excise WSD, and Joint Operations Center.



---

## *Improvements Are Needed in the Estate and Gift Tax Return Examination Process*

---

The prioritization categories used by the gatekeeper are:

- “A” and “A-” – Large estates and gifts with complex legal or valuation issues. An “A” case generally has the potential to produce significant adjustments. “A” cases are considered higher priority than “A-” cases because it is believed that “A” cases present a higher tax adjustment than “A-” cases.
- “B+” and “B” – Cases with compliance issues that will affect future returns; however, adjustments will likely result in no taxable change for the current period or return. “B+” cases are considered higher priority than “B” cases because it is believed that “B+” cases present a larger compliance issue than “B” cases.
- “C” – Compliance issues that are not large-scale compliance issues and have uncertain examination potential.

We reviewed a judgmental sample<sup>8</sup> of 130 classified cases awaiting assignment in the inventory queue.<sup>9</sup> We collected data from the classification sheets for all 130 cases and evaluated the cases for consistency within the prioritization classes based on the issues identified on the classification sheets to determine if the gatekeeper accurately prioritized the cases. We identified cases that appeared to be a deviation from the majority of cases and discussed them with IRS management to determine whether these cases should have been prioritized differently.

We generally did not conclude that cases should have been prioritized differently than they were. However, during our review of the classification, prioritization, and inventory assignment processes, we identified improvements that are needed in Internal Revenue Manual (IRM) guidance, classification sheet documentation, and managerial oversight.<sup>10</sup>

### ***There is minimal IRM guidance for case classification, prioritization, and inventory assignment processes***

The classification, prioritization, and inventory assignment processes are an integral part of any IRS examination program. However, the estate and gift tax IRM only provides minimal instruction for these processes.

---

<sup>8</sup> A judgmental sample is a nonprobability sample, the results of which cannot be used to project to the population.

<sup>9</sup> The population size of the inventory queue varies because the inventory is perpetually changing as orders are received and cases are sent to the field to fill these orders. We selected a judgmental sample of 130 cases that were available during our site visit —20 of each of the five prioritization categories for the estate tax returns and 30 gift tax returns.

<sup>10</sup> The IRM is the primary, official source of instructions to staff relating to the organization, administration, and operation of the IRS.



---

*Improvements Are Needed in the  
Estate and Gift Tax Return Examination Process*

---

The IRM provides the following information regarding the classification process:

- During classification, classifiers are required to review all schedules on all returns to identify any significant issues. Such issues must be clearly and completely identified with sufficient detail on the classification sheet.<sup>11</sup>
- The national gatekeeper oversees classification sessions, assists classifiers, and answers technical and procedural questions; however, the national gatekeeper is not a classifier.<sup>12</sup>
- A WSD paralegal is available during classification sessions to assist the classifiers.<sup>13</sup>
- The national gatekeeper, the group manager, and lead attorney are responsible for reviewing returns that are accepted as filed.<sup>14</sup>

After the classification is complete, the IRM states that the national gatekeeper will fill the field groups' orders from the inventory queue in a manner determined by the Chief, Estate and Gift Tax Program, in coordination with the Estate and Gift Tax Territory managers.<sup>15</sup> Based on the gatekeeper's review of the classification sheet, he or she subjectively prioritizes the case. The IRM does not provide details about how the gatekeeper completes the review or the prioritization process.

The Estate and Gift Tax Program has a national inventory and fills requests for examination cases from managers based on national workload priorities. When determining the case assignments, priority is given to the geographic location of the case because examiners are more familiar with their own area, local issues, valuations, State law issues, taxpayers, and representatives.<sup>16</sup> However, the IRM does not include a process to be used in providing estate and gift tax examination cases to the field groups. Although the process is not documented, the WSD staff stated that in response to requests for cases from the field, the gatekeeper sends a case for assignment for a particular geographic region starting with "A" cases for that location that have been in the inventory queue the longest. If there are no "A" cases available, the gatekeeper will try to select "A" cases from another geographic region within a reasonable distance from the order point. Finally, should the gatekeeper run out of options to send out "A" cases for that particular request, the gatekeeper will then send out "B" cases using the same steps as listed for "A" cases.

Income tax returns in the IRS are scored using an objective formula and have minimal human involvement in the selection of cases for examination. For example, the Small Business/Self-Employed Division examination function uses the Discriminant Function to score filed

---

<sup>11</sup> IRM 4.25.3.2.1(1) (Aug. 5, 2015).

<sup>12</sup> IRM 4.25.3.2.1(2) (Aug. 5, 2015).

<sup>13</sup> IRM 4.25.3.2.1(3) (Aug. 5, 2015).

<sup>14</sup> IRM 4.25.3.3.1(1) (Jan. 3, 2014).

<sup>15</sup> IRM 4.25.3.4.2(1) (Jan. 3, 2014).

<sup>16</sup> IRM 4.25.3.4.2(1) and (2) (Jan 1, 2014).



---

## *Improvements Are Needed in the Estate and Gift Tax Return Examination Process*

---

returns.<sup>17</sup> Classifiers in other functions review returns scored by the Discriminant Function and determine which returns should be sent to the field for potential examination based on the Discriminant Function score and issues identified on the return. There is no such option for estate and gift tax returns because they are not filed electronically.<sup>18</sup>

The estate and gift tax classification, prioritization, and assignment processes are perhaps the most important steps of the estate and gift tax examination inventory process because they will determine if and when a case is assigned for examination. The IRM should provide directions to IRS employees that detail the requirements for each process to help ensure that the most productive cases are selected and sent for examination. Additionally, without formal written procedures, a new employee would not have the proper guidance needed to perform the duties required for these processes. Furthermore, formal written procedures for classifying, prioritizing, and assigning cases for field assignment would help ensure the uniform application of tax laws and that taxpayers are treated consistently. IRS management stated that the gatekeeper has a FY 2017 commitment to create a desk guide that will include the process for determining which returns are sent for examination.

### **Some classification sheets are difficult to read or incomplete**

Classifiers are Estate and Gift Tax Program estate tax attorneys who are selected by management to attend large quarterly and small monthly classification sessions. Estate tax attorneys are selected for classification sessions based on a Memorandum of Understanding between the National Treasury Employees Union and estate and gift tax management. The quarterly sessions typically last one to two weeks, with 12 estate tax attorneys reviewing and classifying taxable estate and gift tax returns. The monthly sessions are held on the months when there is not a quarterly meeting and lasts for three days with three estate tax attorneys. WSD and Campus paralegals classify on a continuous basis. IRS officials stated that during the classification sessions in FY 2016, field estate tax attorney examiners and WSD paralegals classified 5,396 estate tax returns and 3,447 gift tax returns.

Classifiers are required to review all schedules on all returns to identify any significant issues. The Estate and Gift Tax Program WSD Handbook instructs classifiers to print legibly and use either black or blue ink so that the classification sheet will be easier to read when copied and scanned into the IMS. During the classification sessions, classifiers have access to a WSD paralegal who can perform additional research and the gatekeeper who has years of experience regarding estate and gift tax examination issues. The gatekeeper begins reviewing the classification sheets during the classifying sessions and reviews the remaining sheets in the weeks following the sessions, when the classifiers are no longer on-site to answer any questions about their notations on the sheets.

---

<sup>17</sup> A mathematical technique used to score income tax returns for examination potential.

<sup>18</sup> IRM 4.1.5.1.2(1) (Aug. 24, 2012).



---

## *Improvements Are Needed in the Estate and Gift Tax Return Examination Process*

---

From our judgmental sample of 100 estate tax classification sheets, we found that 50 sheets were difficult to read and 49 sheets were incomplete.<sup>19</sup> From our judgmental sample of 30 gift tax classification sheets, nine sheets were incomplete. The incomplete classification sheets included missing details about the return, incomplete partnership or corporation discount information, and issues with prior year gift returns without identifying the tax years.

Each classifier has his or her own unique handwriting style and the classification process does not use an electronic form, *e.g.*, a Microsoft Word template. The use of a uniform electronic form would result in consistent and legible classification sheets that the gatekeeper could easily read. The electronic classification sheet could be printed to attach to the case file.

If the WSD staff reviewed all of the classification sheets during the sessions, classifiers could be requested to clarify any difficult to read or incomplete classification sheets. The difficult to read and incomplete classification sheets may result in additional work for the gatekeeper to decipher the classifier's writing or review the case file to attempt to identify the potential issues that were not completely documented on the classification sheet. Without properly completed classification sheets, the gatekeeper may not have all the information he or she needs to accurately prioritize the case for assignment to the field. As a result, the case may be incorrectly prioritized and not assigned to the field or assigned to the field when a more productive case could have been assigned. If incorrectly prioritized, the examination could be delayed or may not occur, which could result in missed revenue collection by not examining the most productive returns.

### **Lack of documented managerial reviews of the gatekeeper function poses risks**

Within the IRS, the quality review process provides a method to monitor, measure, and improve the quality of work. Quality review data are used to provide quality statistics to identify trends, problem areas, training needs, and opportunities for process improvement.<sup>20</sup> However, the Estate and Gift Tax Program does not have specific documented guidance for a quality review process. As previously described, the gatekeeper position has significant responsibilities. The gatekeeper is responsible for overseeing the classification process, prioritizing cases selected for examination, and managing the inventory queue to assign cases to the field.

Only the gatekeeper is responsible for prioritizing cases selected for examination during classification sessions and assigning these cases to the field for examination. If a case is incorrectly prioritized, there is a risk that the IRS loses an opportunity for a quality examination by incorrectly sending cases with limited examination potential or not sending cases with high examination potential. The IRS provided evidence that the gatekeeper and his or her manager exchange e-mails regarding some prioritization and inventory assignment issues. We were also informed that the gatekeeper's work is reviewed by his manager on a quarterly basis, but there is

---

<sup>19</sup> There were 26 estate tax classification sheets that were both difficult to read and incomplete.

<sup>20</sup> IRM 21.10.1.2(1) (Oct. 1, 2016).



---

## *Improvements Are Needed in the Estate and Gift Tax Return Examination Process*

---

no formal written documentation of the reviews, and there are no set standards on which the gatekeeper's prioritization work is evaluated. Because of the lack of formal documentation, we could not verify that the quarterly reviews took place or if the reviews found any issues with the gatekeeper's priority assignments.

Formal review procedures and documentation are essential to employee development and work quality and serve as an internal control measure. Lack of formal written reviews exposes the estate and gift tax process to the risk of lost revenue if the gatekeeper inconsistently or incorrectly prioritizes cases for examination. Lack of feedback could prevent consistent work quality issues from being identified and resolved. Reviews of the gatekeeper's work should be documented to better monitor, measure, and improve the quality of the prioritization process.

While we found no evidence of bias in the selection of returns for examination by the current gatekeeper, resting such significant exam assignment responsibility on a single person gives rise to the potential risk that the gatekeeper will route (or not route) cases for examination based on reasons other than compliance risks. Other classifying operations within the IRS have specific procedures that encourage objectivity and controls in place to avoid even the appearance of bias.<sup>21</sup>

### **The IRS is developing separate performance measures to determine the adequacy of the inventory assignment process**

The IRM requires that the IRS consider strategic, operational, and individual components when setting organizational objectives, establishing goals, assessing progress and results, and evaluating individual performance.<sup>22</sup> In June 2016, the WSD group started using a process to help track the progress of estate tax cases based on case prioritization and the related case examination results to help address these measures for the classification and prioritization processes. Because estate tax examinations take on average approximately 289 days to complete, meaningful data are just becoming available to compare prioritization criteria with examination results.

---

<sup>21</sup> For example, in the Federal, State, and Local Government function of the Tax Exempt and Government Entities Division, the classification process is described with the following language in IRM 4.90.5.2 (July 31, 2007):

- 1) Classification is the process of determining whether a return should be selected for compliance activities, what issues should be the primary focus of the compliance activity, and the type of compliance activity that should be conducted.
- 2) Compliance activities related to government entities can be politically sensitive. Therefore, the process for selection of cases for compliance activities will be structured to avoid the appearance of bias. To the greatest extent possible, the classification process should provide an internal control structure that includes:
  - Checks and balances to ensure that **no one person has the authority and ability to initiate compliance activities**, and
  - Objective case selection criteria that will be used when classifying cases for compliance activities.

<sup>22</sup> IRM 1.5.1.2(1) and (2) (Sep. 4, 2014).



---

## *Improvements Are Needed in the Estate and Gift Tax Return Examination Process*

---

Analysis of these data can be used to generate a high-level view of average examination dollars per prioritization category and to determine which prioritized cases under- or over-performed expectations based on the priority assigned to the case. The data will help gauge whether the estate tax returns being assigned for examination as a result of the classification and prioritization process are productive.

Performance measures provide a way to determine what has been accomplished and whether or not an organization is meeting its stated goals and objectives. The WSD group should continue to develop reports based on the information collected and use these results to improve the inventory assignment process. Additionally, the WSD group should conduct a review of the Estate and Gift Tax Program's examination selection process to identify potential improvements.

### ***Recommendations***

The Commissioner, Small Business/Self-Employed Division, should:

**Recommendation 1:** Ensure that the WSD group creates a version of the classification sheet that will be consistently legible to be used during classification sessions and that the classification sheets are reviewed during the meetings to verify they are understandable and complete.

**Management's Response:** The IRS agreed with this recommendation. It will increase legibility of classification sheets by instructing classifiers to print/use block lettering rather than cursive, including more options for check marks/check boxes on the classification sheet, where possible, and conducting a quality review of classification sheets while classifiers are still on-site.

**Recommendation 2:** Update the IRM to include detailed guidance for the classification, prioritization, and assignment processes.

**Management's Response:** The IRS agreed with this recommendation. It will update the IRM to include detailed guidance for the classification, prioritization, and assignment processes.

**Recommendation 3:** Consider changes to the gatekeeper function and internal controls so that one person does not make all of the final examination referral decisions.

**Management's Response:** The IRS agreed with this recommendation. It stated that it is important to note that no one person makes all of the final examination referral decisions. Nonetheless, it will:

1. Update the classifiers' responsibilities to include determining the prioritization grade on all selected cases in accordance with the case prioritization grading guidelines. The prioritization grade will be recorded on the classification sheet. The national gatekeeper will review the prioritization determination and notate any changes to the



---

## *Improvements Are Needed in the Estate and Gift Tax Return Examination Process*

---

determination on the classification sheet. The Estate and Gift WSD supervisory attorney will conduct formal reviews of the national gatekeeper and document the reviews.

2. Perform a risk analysis of the gatekeeper function and implement a risk mitigation plan, if necessary.

**Office of Audit Comment:** Although IRS officials agreed with the recommendation, they did not agree with statements regarding the gatekeeper's singular role in assigning cases to the field for examination. The report describes the process in which several employees participate in classification sessions that provide cases to the gatekeeper for inventory management; however, the gatekeeper is ultimately responsible for case prioritization and assignment actions. Based on discussions with the IRS and documentation we received, not all cases that are classified and received by the gatekeeper for prioritization are assigned to the field for examination. For example, in FY 2016, 1,441 estate tax returns and eight gift tax returns were not assigned due to excess inventory. Although IRS management stated that a sample of these cases is reviewed by the gatekeeper's manager, there is no formal documentation of these reviews.

**Recommendation 4:** Require that quality standards be documented for the national gatekeeper's work and that managerial reviews are conducted and documented to ensure that estate and gift tax cases are being properly prioritized for examination assignment.

**Management's Response:** The IRS agreed with this recommendation. It will enhance the prioritization review process of estate and gift tax returns selected for examination by considering quality standards and implementing more formal documentation of the reviews.

**Recommendation 5:** Conduct a review of the Estate and Gift Tax Program's examination selection process to identify process improvements to achieve improved compliance results.

**Management's Response:** The IRS agreed with this recommendation. The Estate and Gift WSD group will review the selection process to identify refinements that are likely to improve compliance results.

### **Estate and Gift Tax Examiners Do Not Always Follow Case Documentation and Time Frame Guidelines**

The National Quality Review System provides quality reviewers with information about attributes of a program and its performance rating. The Estate and Gift Tax Program received an overall score of 82.4 percent in FY 2016. The main categories of attributes captured in the system include: planning, investigative and audit techniques, timeliness, professionalism, and documentation and reports.



---

## *Improvements Are Needed in the Estate and Gift Tax Return Examination Process*

---

We reviewed a random sample of 38 estate tax examinations from the population of 3,187 examinations<sup>23</sup> and 37 gift tax examinations from the population of 1,843 examinations<sup>24</sup> that the IRS closed from October 1, 2015, through September 30, 2016. During our case review, we identified issues with documentation and time frame guidelines not being followed during the estate and gift tax examination process.

### **IMS documentation guidelines were not always followed**

The IRM requires that all documents which support conclusions reached or provide detail on the audit trail must be added to the IMS by the employee.<sup>25</sup> Workpapers are issue-specific and can be created in the IMS or they can be uploaded from previously created files. The IRM provides a comprehensive list of IMS documentation requirements.<sup>26</sup>

Documentation is an essential part of the examination process because it provides evidence to reflect the scope and depth of an audit. The IRM provides that lead sheets and supporting workpapers are important to:<sup>27</sup>

- Effectively explain the issues addressed during the audit.
- Provide the evidence to reflect the scope and depth of the audit.
- Support the determination of the tax liability.
- Reflect the audit trail, allowing a subsequent reviewer to trace a transaction or event and related information from beginning to end.<sup>28</sup>

Also, many different users will rely on workpapers for support after a case is completed. In a litigated case, the workpapers become court exhibits; and as a witness in the case, the examiner must rely on his or her workpapers to answer questions regarding actions taken and conclusions reached.<sup>29</sup> A hard copy of the estate and gift tax case file is maintained. According to IRS management, the hard copy file is the official file and the IMS electronic version of the case file is supplemental and is not intended to replace the hard copy file. The IMS case file is beneficial because it can be quickly accessed and reviewed when needed without having to locate and mail the hard copy case file.

---

<sup>23</sup> To select our random sample of estate tax examinations, we used a 95 percent confidence level, a 50 percent error rate, and a  $\pm 16$  percent precision factor.

<sup>24</sup> To select our random sample of gift tax examinations, we used a 95 percent confidence level, a 50 percent error rate, and a  $\pm 16$  percent precision factor.

<sup>25</sup> IRM 4.25.5.2.3(1) (Aug. 5, 2016).

<sup>26</sup> IRM 4.25.5-2 (Aug. 5, 2016).

<sup>27</sup> Lead sheets are included in the case files to provide details of the issues to be examined.

<sup>28</sup> IRM 4.25.5.3(4) (Aug. 5, 2016).

<sup>29</sup> IRM 4.10.9.7(4) (Aug. 11, 2014).



*Improvements Are Needed in the  
Estate and Gift Tax Return Examination Process*

In our review of the estate tax examinations, we found that case documentation guidelines were not followed for 18 (47 percent) of the 38 estate tax examinations. The number of documentation violations ranged from one to five instances per case, with a total of 39 violations identified for the 18 cases. Specifically, we found the following documentation issues in the IMS:

- 12 were missing the classification sheet.
- 8 were missing issue-specific lead sheets.
- 6 were missing the initial contact letter.<sup>30</sup>
- 6 were missing or had an incorrect Form 706.
- 5 were missing, had incorrect, or untimely loaded Statute Verification Lead Sheets.<sup>31</sup>
- \*\*\*\*\*2\*\*\*\*\*

In our review of the gift tax examinations, we found that case documentation guidelines were not followed for 17 (46 percent) of the 37 gift tax examinations. The number of documentation violations ranged from one to five instances per case, with a total of 38 violations identified for the 17 cases. Specifically, we found the following documentation issues in the IMS:

- 16 were missing the classification sheet.
- 8 were missing or had incorrect issue-specific lead sheet(s).
- 6 were missing Form 709.
- 5 were missing the initial contact letter.
- \*\*\*\*\*2\*\*\*\*\*
- \*\*\*\*\*2\*\*\*\*\*

Additionally, we identified three cases for which the wrong taxpayer's documentation was uploaded to another taxpayer's IMS profile. \*\*\*\*\*2\*\*\*\*\*  
\*\*\*\*\*2\*\*\*\*\*

Per the IRM, managers should use the recommended *Manager's Quality Checklist for Closing Cases* while reviewing completed examination case files for closure.<sup>32</sup> The checklist is a guide that details what each examination file should include and provides guidance to ensure the

<sup>30</sup> The initial contact letter is sent by the assigned examiner to the taxpayer or the taxpayer's representative to notify them of the examination and of additional documentation and information needed.

<sup>31</sup> The Statute Verification Lead Sheet is used to verify and protect the statute of limitations which, if it expires, could result in the inability of the IRS to collect taxes owed.

<sup>32</sup> IRM 4.25.10.5.2(1) (Jan. 7, 2014).



---

## *Improvements Are Needed in the Estate and Gift Tax Return Examination Process*

---

completeness of the managerial review. It includes: steps to protect short statutes; a review of Form 3198, *Examination Case Processing*; a review of Form 5344, *Examination Closing Record*; a list of the mandatory lead sheets and forms that should be included in the IMS; and the possible penalties to assess.

For our sampled cases, we determined that 18 of the estate tax cases and 15 of the gift tax cases with documentation issues did not include a completed *Manager's Quality Checklist for Closing Cases* in the IMS. If the checklist had been completed for these cases, the manager might have identified the documentation issues previously mentioned and the examiner could have corrected the IMS case file.

Additionally, because management stated that the hard copy case files were the official files, we reviewed the hard copy files that had missing IMS documentation to ensure that the documents were included in the official records. However, a total of 15 estate and gift tax cases were missing a total of 22 supporting documents from both the IMS and the official file. Specifically, there were five (13 percent) of the 38 estate tax cases missing a total of six documents and 10 (27 percent) of the 37 gift tax cases missing a total of 16 documents from both the IMS and the official hard copy case files. Without complete case files, there is not sufficient documentation to provide support for the examination results and for management to review the adequacy of the examination.

### **Time frame guidelines were not always followed**

The IRM provides national standard procedural time frames, which include the following significant time frames in the examination process:

- The examiner sends an initial contact letter to the taxpayer with a copy to the representative within 45 calendar days from the examiner's receipt of the case.
- The examiner verifies the statute and completes and uploads the Statute Verification Lead Sheet to the IMS within 45 calendar days from the examiner's receipt of the case.<sup>33</sup>

From our sample of 38 estate tax examinations and 37 gift tax examinations, we identified four estate tax examinations and three gift tax examinations for which the case file did not include documentation of the initial contact letter being sent within 45 calendar days from receipt of the case. In addition, we identified six estate or gift tax examinations for which the examiner failed to complete the Statute Verification Lead Sheets within 45 calendar days.

Examiners did not always create the initial contact letters and the Statute Verification Lead Sheets within the required 45 calendar days. Not following the required time frames could lead to taxpayers not being timely notified of the examination and examiners not being aware of a

---

<sup>33</sup> IRM 4.25.1.5.2(2) (Aug, 5, 2016).



---

## *Improvements Are Needed in the Estate and Gift Tax Return Examination Process*

---

potential statute expiration. This could result in a taxpayer's rights issue if taxpayers are not timely notified and the potential of lost revenue if the statute of limitation expires.

### ***Recommendations***

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

**Recommendation 6:** Ensure that Estate and Gift Tax Program managers complete the *Manager's Quality Checklist for Closing Cases* to verify that all applicable documentation is included in the IMS case file and that the IMS case file does not include unrelated taxpayers' documents. If documentation is not included in the IMS, the manager should verify that the missing documentation is included in the hard copy case file.

**Management's Response:** The IRS agreed with this recommendation. The Director, Specialty Examination, Small Business/Self-Employed Division, will issue a memorandum directing Estate and Gift Tax Examination function frontline managers to verify, prior to case closure, that the required documents are included in the case files.

**Recommendation 7:** Ensure that managers verify that key documents are created and included in the IMS case file by the required IRM time frames.

**Management's Response:** The IRS agreed with this recommendation. Estate and Gift Tax Examination function frontline managers will have a commitment included in their FY 2018 performance plans requiring them to verify the Opening Letter and Statute Verification Lead Sheet have been timely uploaded to the IMS by the required IRM time frames.

### **The Impact of the Estate and Gift Tax Program's Compliance Efforts Is Uncertain**

According to the IRS Data Book, in FY 2016, the Estate and Gift Tax Program proposed approximately \$790 million in additional estate taxes and \$303 million in gift taxes.<sup>34</sup> Proposed deficiencies do not reflect the complete compliance impact of IRS examinations because taxpayers have the right to go to the Office of Appeals and the U.S. Tax Court to protest the deficiencies. In order to obtain a more complete understanding of the compliance impact of Estate and Gift Tax Program operations, we analyzed the outcome of estate and gift tax examinations in FY 2016 that went to the Office of Appeals. According to the IRS, its Office of Appeals function's mission "is to resolve tax controversies, without litigation, on a basis which is fair and impartial to both the taxpayer and the Federal Government." It is independent of any other IRS office and provides a venue in which disagreements concerning the application of tax law can be equitably resolved. Taxpayers who disagree with the IRS may generally appeal or

---

<sup>34</sup> FY 2016 IRS Data Book, Table 9.



## *Improvements Are Needed in the Estate and Gift Tax Return Examination Process*

litigate the proposed adjustments prior to or after the assessment of the tax either administratively within the IRS or through the Tax Court, District Court, or the Court of Federal Claims. Settlement authority, with a few limited exceptions, rests solely with the Appeals function as described in the Treasury Regulations.<sup>35</sup>

Settlements are reached by using the authorities found in the I.R.C. to determine applicable law and hazards of litigation. A “hazards” settlement is a resolution that is based on the uncertainty as to how the courts would interpret and apply the law or as to what facts the courts would find. Litigating hazards generally fall into three categories: factual, evidentiary, and legal. An example of a factual hazard is missing records. Evidentiary hazards include a lack of evidence to support the allegations. A legal hazard exists when there is an absence of legal precedent.

If an estate and gift tax examination is closed unagreed, the taxpayer or representative can have the case reviewed by Appeals. Appeals receives the estate and gift tax case hard copy case files and the electronic version through the IMS and the Appeals team manager assigns cases to an Appeals officer in the IMS. At the conclusion of the Appeals case, the Appeals officer uploads the Appeals case memorandum and the approved Form 5402, *Appeals Case Transmittal and Case Memorandum*, into the IMS.

In FY 2016, there were 99 estate tax Appeals cases which resulted in 75 cases in which Appeals revised the proposed deficiencies, and the taxpayer agreed with the revised deficiency. Additionally, there were 123 gift tax Appeals cases which resulted in 119 cases in which Appeals revised the deficiencies, and the taxpayer agreed with the revised deficiency. Figure 3 illustrates the proposed deficiencies versus the total revised deficiencies for these 194 estate and gift tax cases.

**Figure 3: FY 2016 Estate and Gift Tax Appeals Cases Determination Information**

Description	Number of Cases	Total Proposed Deficiency (in millions)	Total Revised Deficiency (in millions)	Reduced Taxable Adjustment (in millions)
Estate Tax Cases	75	\$361	\$55	\$306
Gift Tax Cases	119	\$216	\$43	\$172
<b>Total</b>	194	\$577	\$98	\$478

Source: Appeals Centralized Database System Data for FY 2016.

The data reflect an Appeals sustention rate of 15 percent for estate tax cases and 20 percent for gift tax cases. However, the sustention rate values were due in significant part to six cases that were responsible for more than 51 percent of the reduction. For some compliance operations, the rate at which the Office of Appeals sustains or agrees with the IRS’s decisions may reflect on the performance of the examination or the Appeals program. The 15 and 20 percent sustention rates

<sup>35</sup> Treas. Reg. § 601.106.



---

*Improvements Are Needed in the  
Estate and Gift Tax Return Examination Process*

---

might ordinarily suggest the need for improvement either in the examination function or in the Office of Appeals. However, IRS officials cited statistics to counter the suggestion that these estate and gift tax sustention rates may suggest the evidence of an operations problem. First, IRS officials cite data that 81 percent of their estate and gift tax cases result in either full or partial sustention of the Government's position. Additionally, IRS management cite that only 4.4 percent of estate and gift tax cases go to Appeals. However, while a limited number of cases went to the Office of Appeals in FY 2016, those cases comprised 53 percent of all Estate and Gift Tax Program proposed deficiencies for FY 2016.

Additionally, officials in the Estate and Gift Tax Program stated that the amount of the proposed deficiencies used in the calculation of the sustention rates is overstated because it includes alternative positions. Estate and Gift Tax Program management stated that due to its approach of proposing alternative positions to protect the Government's interest, which includes not allowing credits and deductions until the issue is finally determined by Appeals or Tax Court, the amount of proposed deficiencies reflected in the Appeals Centralized Database System is overstated and therefore does not provide a reliable measure for sustention calculation purposes.

In order to protect the Government's interest, in some examinations in which the IRS and the taxpayers cannot agree on the legal or factual basis for the adjustment, the IRS may propose alternative theories in proposed deficiencies and notices of deficiency in order to prevent being "whipsawed" by related taxpayers in the same transactions in which taxpayers may take inconsistent positions on tax returns.<sup>36</sup> IRS procedures advise revenue agents to bring related parties to a transaction under examination in which "whipsaw" issues are present to prevent inconsistent tax treatment for the same transaction.<sup>37</sup> For example, in the case of estate tax returns and gift tax returns, the IRS may propose to disallow gifts made during the taxpayer's life to bring them back into the estate.<sup>38</sup> In such a case, the IRS may propose alternative deficiencies that reflect the disputed gift in the gift tax return deficiency and the estate tax return deficiency. When the correct tax return position is finally decided (whether by the Office of Appeals, Tax Court, or by agreement), the IRS will concede the alternative positions, allow the appropriate credits and deductions, and correct the proposed deficiency so that the taxpayer under examination does not have to pay tax on the same transaction twice. We asked the IRS for data as to how much of the proposed deficiencies in FY 2016 were due to alternative proposed deficiencies; however, the IRS does not track this information and was unable to provide us with the data.

---

<sup>36</sup> IRM 4.10.7.4.9 (Jan. 1, 2006) describes this situation as follows:

The term whipsaw refers to situations where the government is subjected to conflicting claims by taxpayers. A potential whipsaw situation exists whenever there is a transaction between two parties and correct reporting of the transaction may benefit one and adversely impact the other for tax purposes.

<sup>37</sup> IRM 4.10.7.4.9(3) (Jan. 1, 2006).

<sup>38</sup> For example, a gift may be disallowed if the donor retained control of the gifted property after the gift was made (I.R.C. § 2036).



---

## *Improvements Are Needed in the Estate and Gift Tax Return Examination Process*

---

We also asked the IRS what standards govern the issuance of alternative and inconsistent proposed deficiencies and notices of deficiency, *i.e.*, whether the IRS does this in every examination in which both the decedent's estate and gift tax returns are being examined or only in cases in which the factual development of the case raises doubt or uncertainty about which taxpayer or which tax return should reflect the particular tax due. Estate and Gift Tax Program management stated that the facts and legal analysis applied during the examination will determine what positions are asserted. However, there is incomplete guidance on this issue. There are risks to taxpayers and the Government for asserting unsubstantiated or unsupported positions in notices of deficiency, not for asserting supported and developed alternative positions. If the IRS's tax positions in its proposed deficiencies and notices of deficiency are not substantially justified, the Government can be subject to suits for attorneys' fees pursuant to I.R.C. § 7430.<sup>39</sup> Additionally, inconsistent notices of deficiency that contain alternative positions add an additional layer of complexity onto an already complex tax code and could lead to taxpayers paying the same tax twice in some situations, such as taxpayer error or IRS error. The IRS also reports the amount of proposed estate and gift tax deficiencies as official statistics in its IRS Data Book when the IRS is aware that the number may be substantially incorrect. For example, the total proposed deficiency amounts of \$790 million for estate tax cases and \$303 million for gift tax cases included in the IRS Data Book are overstated because they also include the alternative positions.

### ***Recommendation***

**Recommendation 8:** The Director Examination, Small Business/Self-Employed, should consider developing guidance on the circumstances in which it is advisable to propose and issue notices of deficiency in estate and gift tax examinations that contain alternative positions.

**Management's Response:** The IRS agreed with this recommendation. The IRS stated that while it notes that its procedures are documented in IRM 4.25.10 and the Statutory Notice of Deficiency Job Aid, it will review a sample of closed cases in which notices of deficiency were issued to determine if examiners are following the existing guidance about when protective alternative positions should be proposed. If it determines that its existing guidance is insufficient, it will make the appropriate revisions.

**Office of Audit Comment:** Although IRS officials stated that they agreed with the recommendation, the agreement is conditioned upon a finding that examiners are not following existing guidance. Because there is not clear written guidance on when to

---

<sup>39</sup> In *Estate of Dooley v. Comm'r*, T.C. Memo. 1992-557 (1992), petitioners, including the estate, executrix, and other relatives of the decedent, filed suit for attorneys' fees in which the IRS had issued alternative proposed deficiencies. However, the claim for attorneys' fees was denied (even though the IRS issued multiple inconsistent notices of deficiency and the taxpayers substantially prevailed on the merits of their tax position) because of the incomplete nature of the estate tax return when filed. Because the IRS had to undergo substantial fact finding as part of the examination, the IRS was justified in taking alternative positions.



*Improvements Are Needed in the  
Estate and Gift Tax Return Examination Process*

---

issue alternative and inconsistent proposed notices of deficiency and statutory notices of deficiency, we asked the IRS what standards govern this practice. Estate and Gift Tax Program management stated that the facts and legal analysis applied during the examination will determine what positions are asserted. We do not believe that this is a clear articulation of when it is necessary to take alternative positions. There are risks to taxpayers and the Government for asserting unsubstantiated or unsupported positions in notices of deficiency, rather than asserting supported and developed positions, including that the practice: makes it difficult to determine the true compliance impact of the Estate and Gift Tax Program because IRS Data Book statistics are incorrect; increases the risks of error on the part of the taxpayer and the Government; and subjects the Government to suits for attorneys' fees pursuant to I.R.C. § 7430 when its positions are not substantially justified.



---

*Improvements Are Needed in the  
Estate and Gift Tax Return Examination Process*

---

## **Appendix I**

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

Our overall objective was to determine whether the Estate and Gift Tax Program is effectively processing and selecting estate and gift tax returns for examination and to identify the overall compliance impact of the program. To accomplish this objective, we:

- I. Determined the current state of the Estate and Gift Tax Program and if there is appropriate guidance and oversight.
  - A. Identified current and planned updates to IRS procedures and guidelines used by the Estate and Gift Tax Program during the processing of estate and gift tax returns.
  - B. Interviewed Estate and Gift Tax Program management to determine planned changes to the estate and gift tax process.
- II. Determined if estate and gift tax returns are being appropriately prioritized for possible examination.
  - A. Obtained and reviewed a judgmental sample<sup>1</sup> of current estate tax returns that were prioritized and were awaiting assignment for examination. A judgmental sample was used since we did not plan on projecting the results to the population.
    1. Interviewed the gatekeeper responsible for the prioritization to determine what items on the classification sheet determine the different prioritization levels.
    2. Selected a judgmental sample of 20 estate tax returns from each of the five prioritization levels located at the IRS Florence Campus in Florence, Kentucky.
    3. Reviewed the sample of estate tax returns and:
      - a. Identified items listed on the classification sheet to be examined.
      - b. Identified the level of prioritization assigned and if there was documentation of the reason for the priority level.
      - c. Compared sampled cases to determine if the prioritization levels were consistent based on the items to be examined according to the classification sheet.
      - d. Interviewed the gatekeeper to determine reasons for any questionable differences in prioritization.

---

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



---

*Improvements Are Needed in the  
Estate and Gift Tax Return Examination Process*

---

- B. Obtained and reviewed a judgmental sample of current gift tax returns that were reviewed and awaiting assignment for examination.
    - 1. Interviewed the Florence Campus staff responsible for processing the gift tax returns to determine the extent of their review and the classification and prioritization process.
    - 2. Selected a judgmental sample of 30 gift tax returns located at the Florence Campus. A judgmental sample was used since we did not plan on projecting the results to the population
  - C. Determined if the gatekeeper's manager includes the quality of the prioritizations in the gatekeeper's performance review.
- III. Determined if estate and gift tax return processing and examination guidance is being followed.
- A. Obtained and reviewed a random sample of 143 examined estate tax returns closed in FY 2016 from a population of 3,043. We used a random sample of the estate tax returns so that we could project our results to the population. We used a 90 percent confidence level, a 50 percent error rate, and a  $\pm 7$  percent precision factor. The Treasury Inspector General for Tax Administration's contracted statistician reviewed and assisted in developing the sampling plan; however, based on the high error rate, we did not review the entire sample and did not project the results to the population. We adjusted our sample size to 38 examined estate tax returns, with a 95 percent confidence level, a 50 percent error rate, and  $\pm 16$  percent precision factor.
    - 1. Determined the dates the case was received, the initial contact letter was sent, and the examination was closed.
    - 2. Determined whether documentation guidance was followed.
  - B. Obtained and reviewed a random sample of 135 examined gift tax returns closed in FY 2016 from a population of 1,301. We used a random sample of the estate tax returns so that we could project our results to the population. We used a 90 percent confidence level, a 50 percent error rate, and a  $\pm 7$  percent precision factor. The Treasury Inspector General for Tax Administration's contracted statistician reviewed and assisted in developing the sampling plan; however, based on the high error rate, we did not review the entire sample and did not project the results to the population. We adjusted our sample size to 37 examined gift tax returns, with a 95 percent confidence level, a 50 percent error rate, and  $\pm 16$  percent precision factor.
    - 1. Determined the dates the case was received, the initial contact letter was sent, and the examination was closed.
    - 2. Determined whether documentation guidance was followed.



*Improvements Are Needed in the  
Estate and Gift Tax Return Examination Process*

---

- IV. Determined the Office of Appeals sustention rates and the adjustments made to estate and gift tax return examination assessments in FY 2016.

**Data validation methodology**

During this review, we evaluated the data we received from the IRS for reasonableness by performing validity tests of the total number of cases to the Treasury Inspector General for Tax Administration Data Center Warehouse. The validity test supported that the data were sufficiently reliable and could be used to meet the objective of this audit.

**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: the Small Business/Self-Employed Division's policies, procedures, and practices for estate and gift tax processing and inventory assignment. We evaluated these controls by interviewing IRS WSD management and employees who are involved with inventory processing and assignment.



*Improvements Are Needed in the  
Estate and Gift Tax Return Examination Process*

---

**Appendix II**

*Major Contributors to This Report*

Matthew A. Weir, Assistant Inspector General for Audit (Compliance and Enforcement Operations)  
Carl Aley, Director  
Beverly Tamanaha, Audit Manager  
Brian Foltz, Lead Auditor  
Janis Zuika, Senior Auditor  
Carrie Mares, Auditor



*Improvements Are Needed in the  
Estate and Gift Tax Return Examination Process*

---

**Appendix III**

*Report Distribution List*

Commissioner  
Office of the Commissioner – Attn: Chief of Staff  
Deputy Commissioner for Services and Enforcement  
Chief, Appeals  
Director, Examination Appeals, Appeals  
Director, Examination, Small Business/Self-Employed Division  
Director, Headquarters Examination, Small Business/Self-Employed Division  
Director, Office of Audit Coordination



*Improvements Are Needed in the  
Estate and Gift Tax Return Examination Process*

**Appendix IV**

*Management's Response to the Draft Report*



COMMISSIONER  
SMALL BUSINESS/Self-EMPLOYED DIVISION

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

SEP 05 2017

MEMORANDUM FOR MICHAEL E. MCKENNEY  
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Mary Beth Murphy   
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – Improvements Are Needed in the Estate  
and Gift Tax Return Examination Process (Audit # 201630013)

Thank you for the opportunity to review the above subject draft audit report. Your audit looked at whether the program effectively processed and selected Estate and Gift (E&G) tax returns for examination and to identify the overall compliance impact of the program. We appreciate your acknowledgement that our selection processes are, by nature, different than other examination selection processes in the IRS, but that we have established guidance and procedures to determine which cases pose the highest compliance risks and ultimately which are assigned to the field for examination. You did not conclude that cases should have been prioritized for examination differently than our processes produced.

Our controls ensure that no single employee is responsible for determining whether a return is placed into the audit stream. Classification is performed by E&G employees such as Attorneys, Workload Selection and Delivery (WSD) Paralegals, and Campus Paralegals. These employees review returns to determine whether to accept returns as filed or to select returns for potential examination. Returns that are accepted as filed are reviewed by both the National Gatekeeper and the E&G WSD Supervisory Attorney.

The National Gatekeeper reviews all returns that are selected for potential examination during classification and grades them for overall productivity and technical difficulty. This grading is used to determine whether the case is assigned to an Estate Tax Attorney, Paralegal, or Legal Assistant. The National Gatekeeper records the grading on the Classification Sheet and the Gatekeeper's determinations are reviewed by the E&G WSD Supervisory Attorney. Once the cases are graded by the National Gatekeeper and the determinations are approved by the E&G WSD Supervisory Attorney, the Gatekeeper assigns cases to the field in response to requisition forms submitted by the field, in a manner determined by the EG WSD Supervisory Attorney.

The National Gatekeeper's determinations regarding prioritization and selection are also evaluated during interim reviews (at management discretion), mid-year performance reviews, and annual performance reviews. The classifiers and managerial oversight



---

*Improvements Are Needed in the  
Estate and Gift Tax Return Examination Process*

---

2

assure that no one individual or position is solely responsible for selecting returns for examination.

You provided some recommendations for improving our controls, including improvements to our classification sheet, improving guidance for the classification, prioritization and assignment processes, changes to the role and review of the gatekeeper function and recommending a review of our selection process. We agree with those recommendations and have developed actions to address them.

Your audit also included a look at case file documentation and timeliness of case actions. We appreciate your acknowledgement of the steps we have already taken to address quality and enhance compliance. The E&G Tax Program has a history of focusing on taking proper and timely case actions including the formation, last year, of a team to improve the quality standards of the cases. That effort resulted in improvements in timeliness and case documentation. As your report notes, our National Quality Review System (NQRS) overall case quality score was 82.4 percent in FY 2016. Over the last two years we have consistently included Quality Commitments in the Annual Performance Plan for Senior and Front-Line Managers in the E&G Exam program that have focused on conducting reviews targeted on timeliness and Issue Management System (IMS) documentation. Specifically, in FY16 the front-line managers had a commitment to review the IMS casefile and to ensure that their comments on the case were uploaded to IMS.

Our official record of estate and gift tax examinations is a paper case file. In addition to the paper file, we use the IMS to control our files and as a supplement to the paper case file. The IMS case file is beneficial because it can be quickly accessed and reviewed when needed. We appreciate the additional steps you took to review the official case files and your observation that there were significantly fewer missing documents in those official records. You recommended we take steps to verify that all appropriate documentation is included in the IMS file and that key documents are created and included in the IMS file by the required IRM time frames. We agree with those recommendations.

Your report also spoke to the overall compliance impact of the program. This segment of the audit did not include a review of the underlying cases, but looked only to statistical analysis and presentation and our procedures for situations in which the IRS may raise alternative positions in unagreed cases. The IRS Data Book compiles statistical information regarding, among other things, proposed deficiencies. For FY16, the Data Book reflects that the IRS proposed approximately \$790 million in additional estate taxes and \$303 million in gift taxes. As TIGTA notes, these proposed deficiencies do not reflect the ultimate amount assessed because E&G taxpayers have the right to go to the Office of Appeals and the United States Tax Court to protest the deficiencies.



---

*Improvements Are Needed in the  
Estate and Gift Tax Return Examination Process*

---

3

Ultimately we have the responsibility to protect the government's interest and so, similar to income tax examinations, in some E&G tax examinations the IRS may assert alternative theories in notices of deficiency to prevent being "whipsawed" by taxpayers who take inconsistent positions on tax returns. This procedure ensures the Government's interest is protected in the event a primary position in an audit is not upheld. E&G tax returns are unique in that a larger number of issues can result in a "whipsaw" situation. In whipsaw situations, all parties, including the government, expect that some proposed deficiencies will be conceded. Even if the Government's primary position were upheld in every case, the alternative positions would be conceded. This does not mean that the alternative positions are "unsubstantiated" or "unsupported." TIGTA provided no evidence for its concern that any of our positions were not substantially justified.

To assess the compliance impact of the E&G tax program, your report uses the percentage of dollars conceded by Appeals to assess our legal positions or compliance impact. As we noted, above, because the estate and gift cases can involve a larger number of issues with "whipsaw" situations, using dollars conceded by Appeals results in a superficial and misleading picture of the compliance impact. Further, Appeals considers such calculations of "sustention rates" wholly inaccurate in assessing the quality of a compliance program. A more effective picture would be obtained by comparing the legal issues or positions we developed and looking to see how those issues were resolved. Also, as your report acknowledges, the sustention rate values were due in significant part to six cases that were responsible for over 51 percent of the dollar reduction, but does not account for the compliance impact of over 95% of cases in which the parties agree.

Although we have concerns, as discussed above, with TIGTA's audit finding, we agree with the associated recommendation and will review a sample of cases to ensure our examiners are following existing guidance and to determine if there are any changes needed in that guidance. 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 Brenda Dial, Director, Examination SB/SE, Division at (240) 613-5163.

Attachment



---

*Improvements Are Needed in the  
Estate and Gift Tax Return Examination Process*

---

Attachment

**RECOMMENDATION 1:**

The Commissioner, Small Business/Self-Employed Division, should ensure that the WSD group creates a version of the classification sheet that will be consistently legible to be used during classification sessions and that the classification sheets are reviewed during the meetings to verify they are understandable and complete.

**CORRECTIVE ACTION:**

We agree to increase legibility of classification sheets by (1) instructing classifiers to print/use block lettering rather than cursive; (2) including more options for check marks/check boxes on the classification sheet, where possible; and (3) conducting a quality review of classification sheets while classifiers are still on-site.

**IMPLEMENTATION DATE:**

August 15, 2018

**RESPONSIBLE OFFICIAL:**

Director, Exam Case Selection, Small Business/Self-Employed Division (SB/SE)

**CORRECTIVE ACTION MONITORING PLAN:**

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

**RECOMMENDATION 2:**

The Commissioner, Small Business/Self-Employed Division, should update the IRM to include detailed guidance for the classification, prioritization, and assignment processes.

**CORRECTIVE ACTION:**

We agree and will update the IRM to include detailed guidance for the classification, prioritization, and assignment processes.

**IMPLEMENTATION DATE:**

August 15, 2018

**RESPONSIBLE OFFICIAL:**

Director, Exam Case Selection, Small Business/Self-Employed Division (SB/SE)

**CORRECTIVE ACTION MONITORING PLAN:**

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



---

*Improvements Are Needed in the  
Estate and Gift Tax Return Examination Process*

---

2

**RECOMMENDATION 3:**

The Commissioner, Small Business/Self-Employed Division, should consider changes to the gatekeeper function and internal controls so that one person does not make all of the final examination referral decisions.

**CORRECTIVE ACTIONS:**

It is important to note that no one person makes all of the final examination referral decisions. Nonetheless we will:

1. update the classifiers' responsibilities to include determining the prioritization grade on all selected cases in accordance with the case prioritization grading guidelines. The prioritization grade will be recorded on the classification sheet. The National Gatekeeper will review the prioritization determination and notate any changes to the determination on the classification sheet. The E&G WSD Supervisory Attorney will conduct formal reviews of the National Gatekeeper and document the reviews.
2. perform a risk analysis of the gatekeeper function and implement a risk mitigation plan, if necessary.

**IMPLEMENTATION DATE:**

July 15, 2018

**RESPONSIBLE OFFICIAL:**

Director, Exam Case Selection, Small Business/Self-Employed Division (SB/SE)

**CORRECTIVE ACTION MONITORING PLAN:**

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

**RECOMMENDATION 4:**

The Commissioner, Small Business/Self-Employed Division, should require that quality standards be documented for the national gatekeeper's work and that managerial reviews are conducted and documented to ensure that estate and gift tax cases are being properly prioritized for examination assignment.

**CORRECTIVE ACTION:**

We agree and will enhance the prioritization review process of estate and gift tax returns selected for examination by considering quality standards and implementing more formal documentation of the reviews.

**IMPLEMENTATION DATE:**

August 15, 2018



---

*Improvements Are Needed in the  
Estate and Gift Tax Return Examination Process*

---

3

**RESPONSIBLE OFFICIAL:**

Director, Exam Case Selection, Small Business/Self-Employed Division (SB/SE)

**CORRECTIVE ACTION MONITORING PLAN:**

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

**RECOMMENDATION 5:**

The Commissioner, Small Business/Self-Employed Division, should conduct a review of the Estate and Gift Tax Program's examination selection process to identify process improvements to achieve improved compliance results.

**CORRECTIVE ACTION:**

We agree. E&G WSD will review the selection process to identify refinements that are likely to improve compliance results.

**IMPLEMENTATION DATE:**

October 15, 2018

**RESPONSIBLE OFFICIAL:**

Director, Exam Case Selection, Small Business/Self-Employed Division (SB/SE)

**CORRECTIVE ACTION MONITORING PLAN:**

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

**RECOMMENDATION 6:**

The Director Examination, Small Business/Self-Employed Division, should ensure that Estate and Gift Tax Program managers complete the Manager's Quality Checklist for Closing Cases to verify that all applicable documentation is included in the IMS case file and that the IMS case file does not include unrelated taxpayers' documents. If documentation is not included in the IMS, the manager should verify that the missing documentation is included in the hard copy case file.

**CORRECTIVE ACTION:**

The Director, Specialty Examination, Small Business/Self-Employed Division will issue a memorandum directing Estate and Gift Tax Examination frontline managers to verify, prior to case closure, that the required documents are included in the case files.

**IMPLEMENTATION DATE:**

January 15, 2018



---

*Improvements Are Needed in the  
Estate and Gift Tax Return Examination Process*

---

4

**RESPONSIBLE OFFICIAL:**

Director, Specialty Examination, Small Business/Self-Employed Division (SB/SE)

**CORRECTIVE ACTION MONITORING PLAN:**

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

**RECOMMENDATION 7:**

The Director Examination, Small Business/Self-Employed Division, should ensure that managers verify that key documents are created and included in the IMS case file by the required IRM time frames.

**CORRECTIVE ACTION:**

We agree with this recommendation. Estate and Gift Tax Examination frontline managers will have a commitment included in their FY 2018 performance plans requiring them to verify the Opening Letter and Statute Lead Sheet have been timely uploaded to IMS by the required IRM timeframes.

**IMPLEMENTATION DATE:**

March 15, 2018

**RESPONSIBLE OFFICIAL:**

Director Specialty Examination, Small Business/Self-Employed Division (SB/SE)

**CORRECTIVE ACTION MONITORING PLAN:**

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

**RECOMMENDATION 8:**

The Director Examination, Small Business/Self-Employed Division, should consider developing guidance on the circumstances in which it is advisable to propose and issue notices of deficiency in estate and gift tax examinations that contain alternative positions.

**CORRECTIVE ACTION:**

While we note that our procedures are documented in IRM 4.25.10 and the Statutory Notice of Deficiency Job Aid, we will review a sample of closed cases where notices of deficiency were issued to determine if examiners are following the existing guidance about when protective alternative positions should be proposed. If we determine that our existing guidance is insufficient, we will make the appropriate revisions.



*Improvements Are Needed in the  
Estate and Gift Tax Return Examination Process*

---

5

**IMPLEMENTATION DATE:**

October 15, 2018

**RESPONSIBLE OFFICIAL:**

Director, Specialty Exam Policy, Small Business/Self-Employed Division (SB/SE)

**CORRECTIVE ACTION MONITORING PLAN:**

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