



*Improvements Are Needed to Ensure
Adequate Consideration of the Pickup
of Prior and/or Subsequent Returns
During Field Examinations*

September 17, 2018

Reference Number: 2018-30-073

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

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HIGHLIGHTS

IMPROVEMENTS ARE NEEDED TO ENSURE ADEQUATE CONSIDERATION OF THE PICKUP OF PRIOR AND/OR SUBSEQUENT RETURNS DURING FIELD EXAMINATIONS

Highlights

**Final Report issued on
September 17, 2018**

Highlights of Reference Number: 2018-30-073
to the Commissioner of Internal Revenue.

IMPACT ON TAXPAYERS

The IRS Field Examination policy is that examinations assigned to field examiners not only cover the single tax period that initiated the examination but also consider all open tax periods for examination potential. When field examiners do not adequately expand to the prior and/or subsequent tax return years, the IRS loses the opportunity to identify the same noncompliance existing over multiple tax years.

WHY TIGTA DID THE AUDIT

In Fiscal Year 2017, the IRS examined 1,059,924 tax returns by either correspondence or field examinations. Of these tax returns, 309,062 (29 percent) were field examinations and 750,862 (71 percent) were correspondence examinations. These examinations resulted in approximately \$24 billion in recommended additional tax assessments. This audit was initiated to determine if IRS field examiners are reviewing prior and/or subsequent year returns as required.

WHAT TIGTA FOUND

TIGTA determined that 34 of 103 Field Examination case files reviewed were not adequately expanded. The IRS could have potentially conducted examinations on 18,860 prior and/or subsequent year tax returns with approximately \$246 million in potential additional revenue to the Government.

For 13 of the 34 cases in which field examiners did not expand the examination to include prior or subsequent years, the field examiner listed an

insufficient amount of time until the expiration of the statute of limitations as the primary reason for not expanding into the prior tax return year. Additionally, the primary return was over-age in 12 of the 34 cases in which the field examiner did not appropriately expand. Furthermore, in 10 of the 34 cases, a detailed comparative analysis that could have identified examination items in prior and/or subsequent years was not completed.

During the review of the 103 cases, TIGTA determined that field examiners did not adequately document case files during examinations. This included not always documenting the reasons for not expanding and not always retaining the examination request form in the case file when expanding the reviews to prior and/or subsequent years.

WHAT TIGTA RECOMMENDED

TIGTA recommended that the IRS should: update the Internal Revenue Manual with additional guidance on when it is appropriate to expand an examination even though the statute of limitations on assessment expires in less than 12 months; provide additional training to field examiners on when to expand examinations; update the Internal Revenue Manual with guidance on when field examiners should conduct a more detailed comparative analysis on multiple years' tax returns; and provide additional training to ensure that the field examiners document an adequate explanation for not expanding and to ensure that appropriate approval documentation is retained.

In response to the report, IRS officials partially agreed with two recommendations, agreed with three recommendations, and plan to take corrective action on all five recommendations. The IRS does not agree with requiring a manager's signature on the examination request form or providing specific details on how to document the comparative analysis for individual nonbusiness returns. TIGTA believes managerial approval on the examination request form should be documented in the official case file.



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

September 17, 2018

MEMORANDUM FOR COMMISSIONER OF INTERNAL REVENUE

FROM: Michael E. McKenney
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Improvements Are Needed to Ensure Adequate Consideration of the Pickup of Prior and/or Subsequent Returns During Field Examinations (Audit # 201730034)

This report presents the results of our review to determine whether field examiners are reviewing prior and/or subsequent year returns as required. This audit is included in our Fiscal Year 2018 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 VI.

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

CDE	Compliance Data Environment
CEAS	Correspondence Examination Automation Support
FY	Fiscal Year
I.R.C.	Internal Revenue Code
IRM	Internal Revenue Manual
IRS	Internal Revenue Service
LUQ	Large, Unusual, or Questionable
SB/SE	Small Business/Self-Employed
TCO	Tax Compliance Officer
TIGTA	Treasury Inspector General for Tax Administration



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Background

Internal Revenue Code (I.R.C.) Section (§) 7602 allows the Internal Revenue Service (IRS) to perform examinations of tax returns by reviewing the accuracy of returns and determining tax liabilities of taxpayers. Generally, the IRS has three years from the date a tax return is filed to assess any tax.¹ A goal of the Small Business/Self-Employed (SB/SE) Division Field Examination function is to conduct efficient and quality examinations while encouraging compliance with the tax laws. The Field Examination function includes revenue agents that conduct field examinations at the taxpayer's home, place of business, and/or accountant's office and tax compliance officers (TCO) that conduct office examinations at IRS offices.

Field Examination's policy is that field examiners examine not only the tax return for the single period that initiated the examination but also consider all open tax periods for examination potential. Examining the prior and/or subsequent year tax returns and all related tax returns concurrently has greater tax compliance impact.² Field examiners should always inspect the taxpayer's related and prior and/or subsequent year returns for proper filing to evaluate examination potential.

The field examiner's professional judgment is required to determine if potential compliance issues exist warranting expanding the examination. Field examiners are required to review other open tax returns for those cases in which the tax year under examination contains proposed adjustments or there are large, unusual, or questionable (LUQ) items identified on the other returns. If the field examiners do not select other returns for examination, they are required to provide an explanation as to why they did not select these returns. Field examiners should always consider and, if appropriate, pursue prior and/or subsequent year returns containing the same issues as the tax year examined.

In Fiscal Year (FY) 2017, the IRS examined 1,059,924 tax returns by either correspondence or field examinations. Of these tax returns, 309,062 (29 percent) were field examinations and 750,862 (71 percent) were correspondence examinations. These examinations resulted in approximately \$24 billion in recommended additional tax assessments.³ Our review focused on the appropriate expansion to prior and/or subsequent returns during field examinations of individual tax returns conducted in FY 2015.⁴

¹ I.R.C. § 6501(a).

² Related returns are returns that have a relationship to the return under examination and can include corporate, partnership, employment tax, and excise tax returns.

³ 2017 IRS Data Book.

⁴ Selected field examinations from FY 2015 so that we could verify if there was appropriate pickup of subsequent year returns.



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This review was performed during the period October 2017 through July 2018 with information obtained from the SB/SE Division Headquarters in Lanham, Maryland, and Examination function offices in Long Beach, California; Woodland Hills, California; and Austin, Texas. 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 objectives, 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

Field Examiners Are Not Always Appropriately Expanding to the Prior and/or Subsequent Tax Return Years

The Internal Revenue Manual (IRM) provides the IRS Field Examination function with guidance on expanding to prior and/or subsequent year returns. A field examiner's professional judgment is required to determine if potential compliance issues exist that warrant expanding an examination.⁵ In addition, the IRM states that field examiners should conduct prior and/or subsequent return examinations concurrently with the assigned/primary return.⁶

We selected a random sample from the population of Field Examination primary individual tax return cases closed in FY 2015 that had an additional tax liability over \$2,000. In our sample of 103 cases (33 revenue agent and 70 TCO cases), we identified 40 primary year returns that did not have a pickup of a prior and/or subsequent year.⁷ Of these 40 cases, we determined that 34 cases (33 percent) had examination potential and field examiners should have expanded the examinations to additional years. The following are the reasons we identified that the field examiners did not appropriately expand in our sample cases:

- 13 cases in which the field examiner did not expand due to insufficient time remaining on the statute of limitations for assessment on the prior year's tax return.⁸
- 13 cases in which the field examiner documented in the file that there were no LUQ items in the prior and/or subsequent year; however, we determined the prior and/or subsequent year tax returns had LUQ items or similar issues that were present on the primary return.
- 8 cases in which the field examiner documented compliance issues in the case histories but did not appropriately follow up on the issues. The case files did not include any explanation as to why the field examiner did not follow up.

When field examiners do not properly expand to prior and/or subsequent returns that have similar issues to the primary return or issues are identified that are not pursued, it could result in lost revenue to the Federal Government. In addition, if the prior and/or subsequent tax return

⁵ IRM 4.10.5.2.4 (June 1, 2010).

⁶ IRM 4.10.5.3.2 (June 1, 2010).

⁷ The IRS states that the official case file is the hard-copy case file and not the electronic case file stored in the Correspondence Examination Automation Support (CEAS) system. However, we reviewed some case files electronically using the CEAS system because the IRS was unable to provide the hard-copy case files. See Appendix I for additional information.

⁸ I.R.C. § 6501(a).



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year(s) are later selected for an examination after the primary return examination is closed, the taxpayer will be examined a second time and most likely will have a new field examiner unfamiliar with the taxpayer's facts and circumstances, causing additional taxpayer burden. For the 34 cases that should have had prior and/or subsequent returns picked up for examination, the average tax liability due from the taxpayer based on the primary return examination adjustments was \$13,140. When projected to the population, we estimate that the IRS could have potentially conducted examinations on 18,860 prior and/or subsequent year returns with approximately \$246 million in potential additional tax liability for these examinations.⁹

Field examiners sometimes did not expand to prior and/or subsequent tax returns due to statute of limitations or over-age concerns

Field examiners have the primary responsibility for identifying and protecting the statute of limitations for assessment for returns in their custody.¹⁰ Field examiners must obtain the approval of their group manager before they solicit a consent for statute extension from the taxpayer. Taxpayers may refuse to extend the statute of limitations, and the examiner must notify the taxpayer of this right.¹¹ IRS procedures provide that the following conditions warrant soliciting the taxpayer for a consent to extend the statute of limitations.

- The limitation period for the taxable year under examination will expire within 180 days and there is insufficient time to complete the examination and the administrative processing of the case.
- The field examiner discovers firm indications that substantial additional tax is due for prior periods, the statute of limitations for any of the prior periods will expire within 180 days, and there is insufficient time to complete the examination and administrative processing of the case.

The IRM provides that field examiners can initiate an examination on a return with less than 12 months remaining on the statute of limitations if they obtain managerial approval.¹² Managerial approval is not needed if more than 12 months remain. Field examiners and managers we interviewed told us that the time remaining on the statute of limitations is considered when deciding whether to expand to the prior year tax return. However, when we asked them how much time needed to be on the statute to expand the examination, their responses ranged from six to 16 months.

⁹ The projection is based on a two-sided 95 percent confidence interval. We are 95 percent confident that the actual total amount is between \$119,195,301 and \$373,233,322 and the actual total taxpayers is between 13,624 taxpayers and 24,096 taxpayers. The actual amount could be different because resources spent examining the prior and/or subsequent year return could have otherwise been used to examine another taxpayer's tax return, which could also result in additional tax liabilities.

¹⁰ IRM 4.10.2.2.1 (Jan. 17, 2012).

¹¹ I.R.C. § 6501(c)(4).

¹² IRM 25.6.22.2.1 (Aug. 26, 2011).



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We determined that for 13 of the 34 exception cases in which field examiners did not expand the examinations to prior tax return years, the field examiners listed a short statute as the main reason for not expanding the examinations. Four of the 13 cases had over 12 months of statute remaining, and the other nine cases had statutes between six and 11 months. These cases already had the majority of the work completed on the primary return; therefore, they would not necessarily need the same amount of time to complete the additional work on the prior returns. The field examiners should have expanded the examination to tax years that had over 12 months remaining on the statute. For the other nine cases, the field examiners should have obtained management approval to expand and considered requesting taxpayer consents for a statute extension.

Another potential reason that field examiners might not expand the examination is if a case is over-age. The IRM considers cases over-age when they have been in an examiner's inventory more than 180 days for TCOs and 270 days for revenue agents.¹³ We determined that the primary return was over-age for 12 of the 34 cases in which the examiner did not appropriately expand to the prior and/or subsequent returns. During our interviews with field examiners, they told us that they sometimes feel the need to close over-age cases to meet timeliness requirements without giving sufficient consideration to opening prior and/or subsequent returns.

For cases with a short statute of limitations or those that are over-age, the field examiner should consider "split closing" the multiple tax year cases separately. Split closing cases allows a field examiner to close separate year examinations on the taxpayer, as needed, to address statute or over-age concerns. The IRM specifically addresses split closures as an option for closing short statute cases separately from other tax years when needed.¹⁴ Field examiners with over-age cases should also consider split closing cases by closing the primary tax return year and opening the prior and/or subsequent tax return year(s) as a separate examination.

Field examiners are not completing a detailed comparative analysis

A comparative analysis is used by field examiners to compare the primary tax year under examination to other tax years to determine if similar issues were present on the other returns and/or if there are any LUQ items in the other tax years that might require examination. Therefore, the comparative analysis provides field examiners with the details needed to determine if they should expand the examination to prior and/or subsequent tax years. For individual nonbusiness tax return examinations, the IRM allows field examiners to review the three-year comparative analysis provided by the Compliance Data Environment (CDE) system when they receive the return for examination and use their professional judgement to determine if a more detailed analysis is required.¹⁵

¹³ IRM 4.10.1.5.2(5) (May 14, 1999).

¹⁴ IRM 4.10.15.3.3.1 (Apr. 29, 2011).

¹⁵ IRM 4.10.5.3.1 (June 1, 2010).



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However, the CDE comparative analysis does not always provide all of the line items from the returns needed to adequately conduct a detailed comparative analysis of the other years. For example, the CDE system sometimes groups numerous business expenses from the taxpayer's Schedule C, *Profit or Loss From Business (Sole Proprietorship)*, into a category called "other expenses/non-transcribed expenses."¹⁶ Grouping expenses does not always adequately reflect details of the filed return and does not always allow field examiners to identify all LUQ items. There is no additional guidance for field examiners conducting individual nonbusiness return examinations on when to conduct a more detailed comparative analysis or on what it should include. The additional detail might not be necessary on a simple return; however, it should be considered on returns that are more complicated. For example, the IRM requires a more detailed comparative analysis for examinations of business returns, and similar guidance could be used for individual nonbusiness returns.¹⁷ The business analysis provides percentage-based analytics to better identify potential examination issues that might not be evident when using the three-year comparative analysis provided by the CDE system.

We determined that a more detailed comparative analysis was not included in 10 of the 13 case files that had LUQ items present on the prior and/or subsequent tax year return, yet there was no expansion of the examination into those tax years. If the field examiners would have conducted a more detailed comparative analysis rather than rely on the CDE system analysis alone, they might have identified the LUQ items and expanded to the other years as needed. In nine cases, we determined that a more detailed comparative analysis was not performed on individual business returns as required by the IRM. In three cases, we found that the CDE system analysis did not include the subsequent return year; therefore, the field examiner should have researched if the subsequent return had been filed prior to relying on the CDE system to conduct an adequate comparative analysis.

When field examiners use the CDE system instead of tax returns for their comparative analysis, they do not have all of the return details available for comparison, and they lose the potential to update their comparative analysis when they secure copies of tax returns from the taxpayer. Not conducting a thorough comparative analysis increases the risk of missing patterns and LUQ items in the prior and/or subsequent tax return years, which would indicate the need to expand to the additional years. Additional guidance should be provided to field examiners conducting individual nonbusiness tax return examinations on when and how to conduct a more detailed comparative analysis. For the 10 cases that did not include a detailed comparative analysis when LUQ items were present, the average additional tax liability resulting from the primary return examination adjustments was \$14,031.

¹⁶ The business expenses that are sometimes grouped together on the CDE system include car and truck expenses, travel, meals and entertainment, office expenses, and supplies.

¹⁷ IRM 4.10.4.3.3.8 (Aug. 9, 2011).



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Recommendations

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

Recommendation 1: Update the IRM with additional guidance on when it is appropriate to conduct an examination even though the statute is less than 12 months, and include statute extensions as an option to alleviate statute of limitation concerns.

Management's Response: The IRS agreed with this recommendation. The IRM will be updated to clarify examination cycle exceptions and when it is appropriate to start an audit with less than 12 months remaining on the assessment statute of limitations. Although the IRS agreed with the recommendation, it did not agree with the related outcome measure. The IRS stated that the outcome measure fails to account for the opportunity costs associated with lost revenue and reduced audit rates that would occur if more resources were allocated to expanding existing examinations to prior and/or subsequent year returns instead of auditing additional taxpayers.

Office of Audit Comment: IRS Field Examination policy requires field examiners to cover the single tax period that initiated the examination as well as all open tax periods for examination potential. The report acknowledges that time spent examining other tax periods could otherwise be used to examining other taxpayers. The purpose of our outcome measure is to inform stakeholders of the size and scope of the issue. Our outcome measure reflects the potential unreported revenue we believe the IRS could address by adequately expanding examinations to the prior and/or subsequent return years.

Recommendation 2: Provide additional training to field examiners on when to expand examinations into the prior and/or subsequent tax return years, including the use of split closing for cases nearing the statute limitation or over-age cases and requesting statute extensions as needed.

Management's Response: The IRS agreed with this recommendation. It will create a training presentation for Field Examination managers and examiners that emphasizes proper documentation of required filing checks. The training will explain related IRM updates clarifying examination cycle exceptions and when it is appropriate to start an audit with less than 12 months remaining on the assessment statute of limitations.

Recommendation 3: Update the IRM with guidance on when field examiners should conduct a more detailed comparative analysis for individual nonbusiness returns and specific details on how it should be documented.

Management's Response: The IRS partially agreed with this recommendation. Management will update the IRM to clarify when field examiners may need to conduct a detailed comparative analysis for individual nonbusiness returns.



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Office of Audit Comment: We agree that the IRS's corrective action meets the intent of the recommendation.

Field Examiners Are Not Adequately Documenting Case Files

The IRM requires that field examiners document their case files with their findings. Proper documentation is necessary to reflect what occurred throughout the examination and to allow the manager to verify that the examination was proper and complete.¹⁸ During the review of our random sample, we determined that field examiners are not adequately documenting case files during examinations.¹⁹ This includes not always documenting the reasons for not expanding the examination into other tax years on the Lead Sheet 130, *Multi-Year and Related Returns*, and not always retaining Form 5345-D, *Examination Request – Examination Returns Control System Users*, in the case file when expanding the reviews to prior and/or subsequent years.

Field examiners are not adequately documenting reasons for not expanding their examinations to prior and/or subsequent tax returns on the Lead Sheet 130

The IRM requires that field examiners index their supporting workpapers to Lead Sheet 130 and document their decisions to expand or not expand their examinations to prior and/or subsequent returns.²⁰ Field examiners must explain why they did not expand when they propose adjustments in the year under examination or if there are any LUQ items in the prior and/or subsequent year returns. In addition, the IRM includes that the group manager is responsible for ensuring that quality examinations are conducted. When a field examiner closes a case, the group manager should review the case to ensure that it is procedurally and technically correct and that the examiner considered and documented the prior and/or subsequent year returns.²¹

We determined that in 55 (53 percent) of the 103 sample cases, field examiners did not adequately document their determinations for not expanding to a prior and/or subsequent return on the Lead Sheet 130. In seven of these 55 cases, although the field examiner did not note the reason, we determined that the cases could not be expanded to the prior tax year because the statute of limitations had already expired (four cases) or the other years had already been examined (three cases). We could not determine why the exam was not expanded for the remaining 48 cases.

Proper documentation on whether to expand examinations to the prior and/or subsequent years is important to support the field examiner's decision. We determined that field examiners are not always properly documenting their decisions on the Lead Sheet 130 as required, and we could

¹⁸ IRM 1.4.40.4.11 (May 19, 2010).

¹⁹ The IRS states the official case file is the hard copy case file and not the electronic case file stored in CEAS. However, TIGTA reviewed some case files electronically using CEAS because the IRS was unable to provide the hard copy case files. See Appendix I for additional information.

²⁰ IRM 4.10.5.2.4 (June 1, 2010).

²¹ IRM 1.4.40.4.11 (May 19, 2010).



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not determine if managers reviewed the lead sheet to identify missing documentation prior to closing cases. We found that there was a FY 2016 training course related to the importance of documenting reasons for not expanding to prior and/or subsequent year returns on Lead Sheet 130; however, according to IRS management, the training is still available but not required on a recurring basis. Also, the Lead Sheet 130 was updated in November 2015 and is now formatted for examiners to use a narrative format to explain their decision on whether to expand to prior and/or subsequent years. If the Lead Sheet 130 does not include proper documentation, the field examiner may not include key items needed to make adequate prior and/or subsequent year expansion determinations and reviewers will not be able to easily verify that the field examiner properly considered and documented the prior and/or subsequent tax return years for expansion as required.

Form 5345-D is not always included in the primary tax return case file

Field examiners prepare Form 5345-D to request that examinations be open on the prior and/or subsequent tax years. The IRM provides that the field examiners should submit Form 5345-D along with the appropriate transcripts to their manager for review. The manager reviews the form and provides it to the group secretary. The secretary reviews the form, adds the examination requisition into the Examination Return Control System, and then the manager approves the requisition electronically in the system.²²

Although the IRM describes the importance of managerial approval to open additional returns for examination, it specifically states that no manager signature is required on Form 5345-D.²³ During our interviews with field managers and field examiners, employees emphasized the importance of the manager's signature on Form 5345-D and insisted that the prior and/or subsequent years would not be added to the Examination Return Control System without the manager's signature. Furthermore, the IRM directs the manager or secretary to maintain the Form 5345-D until the examination is available on the Audit Information Management System.²⁴ Once it is available on the system, the Form 5345-D is to be returned to the field examiner to include in the case file.²⁵

We determined that 45 of the 63 case files that were expanded to a prior and/or subsequent year did not include a copy of the Form 5345-D. The field examiners that we interviewed stated that they did not always place the Form 5345-D in the case file to show the managerial approval for the expansion and that they were not aware of the requirement to retain the form. Therefore, field examiners are not always including the Form 5345-D in the file as required to support the manager's approval for the examination of the additional tax years.

²² IRM 4.7.5.6.1 (Sept. 18, 2013).

²³ IRM 4.7.5.6.1(2) (Sept. 18, 2013) and IRM 4.7.5.9 (Sept. 18, 2013).

²⁴ IRM 1.4.40.4.2.1 (May 19, 2010).

²⁵ IRM 4.4.23.4 (Aug. 7, 2013).



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By not including the form in the case file, there is no documented approval to support opening the examination of additional tax years. Manager approval is required to open additional years on the Examination Return Control System; however, since they are maintaining the hard-copy file as the official examination file, a copy of the approval should be included. If the form is not maintained in the case file and there is not a manager's signature on the Form 5345-D, there is no documentation of the manager's approval for the expansion.

Recommendations

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

Recommendation 4: Provide additional training to field examiners and managers to ensure that the Lead Sheet 130 includes an adequate explanation for not expanding to prior and/or subsequent year returns.

Management's Response: The IRS agreed with this recommendation. It will create a training presentation for Field Examination managers and examiners that emphasizes proper documentation of required filing checks. It will also explain related IRM updates clarifying examination cycle exceptions and when it is appropriate to start an audit with less than 12 months remaining on the assessment statute of limitations.

Recommendation 5: Update the IRM to require that Form 5345-D include the manager's signature and update the form with a manager signature line. In addition, field examiners should be reminded of the need to retain the Form 5345-D in the case files of all years examined.

Management's Response: The IRS partially agreed with this recommendation. It will publish an article in the Technical Digest reminding field examiners and managers of the need to retain Form 5345-D in the administrative case file. However, Form 5345-D will not be updated to include a manager's signature line. Managerial approval is completed in the Examination Returns Control System, and an audit trail is maintained showing who approved the opening of a return.

Office of Audit Comment: During this audit, when documentation or other support was not found in the electronic files, management emphasized that the hard-copy case file was the "official" file, indicating that it was important that the hard-copy file included all of the necessary supporting documentation. Documentation missing from the official case file can weaken the IRS's position if it is later challenged in tax court.



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Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine whether field examiners¹ are reviewing prior and/or subsequent year returns as required. To accomplish our objective, we:

- I. Reviewed current IRM guidelines to identify the criteria for reviewing prior and/or subsequent returns.
- II. Interviewed IRS field examiners and field managers to determine the procedures used in field offices as they relate to prior and/or subsequent return pickups.
- III. Determined whether field examiners followed procedures regarding the pickup of prior and/or subsequent year returns during individual tax return examinations.
 - A. Identified the total population of primary individual return Field Examination cases of taxpayers with an additional tax liability over \$2,000 that were closed in FY 2015 from the Audit Information Management System.
 - B. Selected a statistically valid sample of 103 cases, from the total population of 57,142 cases (17,815 revenue agent cases and 39,327 TCO cases) that were stratified by revenue agent cases (33) and TCO cases (70). We selected a random sample so that we could project our results to the population. We used a 95 percent confidence interval, a 50 percent error rate, and a ± 10 percent precision factor. The Treasury Inspector General for Tax Administration's (TIGTA) contracted statistician reviewed and assisted in developing the sampling plans and projections.

Case review limitation

On November 21, 2017, we requested 131 hard-copy cases (42 revenue agent cases and 89 TCO cases) for case reviews, which included a 20 percent oversample. As of May 2018, we had received 75 of the requested cases (19 revenue agent cases and 56 TCO cases). For our sample case review, 103 cases were required (33 revenue agent cases and 70 TCO cases) to project our findings with a 95 percent confidence interval. The IRS uses the CEAS system to electronically maintain case file information; therefore, we used the CEAS system to electronically review the remaining 28 cases (14 revenue agent cases and 14 TCO cases). The IRS stated that the official case file is the hard-copy case file and that TIGTA should not use the CEAS system case files for case reviews; however, due to the inability to obtain the hard-copy case files, we used the CEAS case file documentation to complete our case reviews.

¹ See Appendix V for a glossary of terms.



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Data reliability methodology

During this review, we assessed the reliability of the data we received from the TIGTA Data Center Warehouse for reasonableness by performing validity tests and tracing a judgmental sample of cases to the IRS Integrated Data Retrieval System. 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: SB/SE Divisions' policies, procedures, and practices for prior and/or subsequent year return pickups. We evaluated these controls by interviewing IRS management and employees and reviewing a statistical sample of Field Examination primary individual tax return cases closed in FY 2015 that had an additional tax liability over \$2,000.



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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
Erik Martinez, Lead Auditor
Eugenia Smoak, Senior Auditor



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Appendix III

Report Distribution List

Deputy Commissioner for Services and Enforcement
Commissioner, Small Business/Self-Employed Division
Director, Examination, Small Business/Self-Employed Division
Director, Office of Audit Coordination



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Appendix IV

Outcome Measure

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

Type and Value of Outcome Measure:

Increased Revenue – Potential; \$246,214,311 (see page 3).

Methodology Used to Measure the Reported Benefit:

We selected a random statistical sample of 103 cases (from a total population of 57,142) individual return cases with additional tax liabilities over \$2,000 that were closed in FY 2015.

Our case review determined that 34 (33 percent) field examiners (11 revenue agent and 23 TCOs) did not adequately expand to the prior and/or subsequent return years. In 13 of the 34 cases, the field examiner documented in the file that there were no LUQ items in the prior and/or subsequent year; however, we determined that the prior and/or subsequent year tax returns had LUQ items or similar issues that were present on the primary return. These cases had issues that should have been examined by the field examiners. The average increase in tax liability on these cases was \$13,140. Based on our sample results, we estimate that the IRS could have potentially conducted examinations on 18,860 prior and/or subsequent tax returns with approximately \$246 million in potential additional revenue to the Government. Our random sample was selected using a 95 percent confidence interval, a 50 percent anticipated error rate, and a ± 10 percent precision. We are 95 percent confident that the actual total amount is between \$119,195,301 and \$373,233,322.



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Appendix V

Glossary of Terms

Term	Definition
Audit Information Management System	A computer system used by the SB/SE Division to control returns, input assessments/adjustments into the Master File, and provide management reports.
Comparative Analysis	Part of the required filing checks for examiners. Used by examiners to compare the primary tax year under examination to other tax years to determine if similar issues were present on the other tax returns and/or if there are any LUQ items in the other tax years that might require examination.
Compliance Data Environment	A system that replaced the Midwest Automated Compliance System. It is a workload identification, planning, and delivery system that operates in a web-based environment used to filter, order, classify, and deliver tax returns.
Data Center Warehouse	An online database maintained by TIGTA. The Data Center Warehouse pulls data from IRS system resources, such as IRS Collection files and IRS Examination files, for TIGTA access.
Examination	Field examinations of individuals, partnerships, and corporations that occur either at the taxpayer's place of business or through interviews at an IRS office.
Examination Return Control System	An automated inventory management system used to requisition tax returns, assign returns to examiners, change codes such as status and project codes, and charge time.
Field Examiner	Revenue agents and tax compliance officers/tax auditors located in one of the seven SB/SE Field Examination areas who conduct field examinations of income tax returns filed by individuals, small businesses, and other entities to ensure compliance with Federal tax laws.
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.
Individual Tax Returns	Form 1040, <i>U.S. Individual Income Tax Return</i> , series are annual income tax returns filed by citizens or residents of the United States.



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Term	Definition
Integrated Data Retrieval System	IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer's account records.
Internal Revenue Manual	The primary, official source of instructions to staff relating to the organization, administration, and operation of the IRS.
Large, Unusual, or Questionable Items	Items that appear on the return which, if left unexplained, might raise doubt or cause confusion to a reviewer of the completed examination. Some factors to consider when identifying LUQ items are: <ul style="list-style-type: none"> • The comparative size of the item. • The absolute size of the item. • The inherent character of the item. • Evidence of intent to mislead.
Master File	The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.
Primary Return	A return that is not a prior year, subsequent year, or related return pickup. In other words, a return that has been assigned for examination.
Revenue Agent	An employee in the Examination function who conducts face-to-face examinations of more complex tax returns, such as businesses, partnerships, corporations, and specialty taxes (<i>e.g.</i> , excise tax returns).
Schedule C, Profit or Loss From Business (Sole Proprietorship)	A schedule filed with Form 1040 to report a profit or loss from a business.
Tax Compliance Officer	An employee in the Examination function who primarily conducts examinations of individual taxpayers through interviews at IRS field offices. The position title was changed in 2002 from tax auditor to TCO.



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Appendix VI

Management's Response to the Draft Report



COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

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

September 4, 2018

MEMORANDUM FOR MICHAEL E. MCKENNEY

DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM:

Mary Beth Murphy

Commissioner, Small Business/Self-Employed (SB/SE) Division

SUBJECT:

Draft Audit Report – Improvements Are Needed to Ensure
Adequate Consideration of the Pickup of Prior and/or
Subsequent Returns During Field Examinations (Audit #
201730034)

Thank you for the opportunity to review the above subject draft audit report. The Internal Revenue Service's mission is to help taxpayers understand and meet their tax responsibilities, and enforce the law with integrity and fairness to all. We accept most federal tax returns as filed. However, some returns are examined, or audited, to determine if the tax reported is substantially correct. Audits can be conducted via correspondence or face-to-face in our Field Examination operations. Generally, field examiners are required to complete required filing checks to determine if taxpayers are following all federal tax and information return filing requirements, and that all returns reflect the substantially correct tax. When warranted, they expand the audit to include additional returns, which increases our overall compliance coverage.

We rely upon our examiners to follow Internal Revenue Manual (IRM) guidance and use their professional judgment to make proper determinations regarding the expansion of an audit. In addition to IRM guidance, to assist examiners in making proper determinations, we have developed and implemented:

- Formal classroom and on-the-job training that focuses on required filing checks.
- Mandatory lead sheets to address required filing checks.
- Managerial interactions and reviews to assess the quality of work performed by examiners.
- Operational reviews performed by Territory-level and Area-level staff to ensure audits are conducted effectively.
- Quality reviews performed by independent staff on a statistically valid sample of cases to assess the degree of compliance with policies and procedures.



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We continue to assess and implement new approaches to ensure examiners accurately complete and document the required filing checks. Your review focused on returns that were audited between October 1, 2014 and September 30, 2015. After that time, we took the following actions to improve performance related to required filing checks:

- Redesigned Lead Sheet 130, *Multi-Year and Related Returns*, to remove check boxes and require more narrative documentation in November 2015. The lead sheet was released in the June 2016 Report Generation Software (RGS) update.
- Revised IRM 4.10.2, *Pre-Contact Responsibilities*, in February 2016, to clarify documentation requirements when the examination cycle cannot be met; expectations regarding the examination of large, unusual or questionable items; and actions examiners should take to evaluate audit potential.
- Created and delivered a mandatory continuing professional education course during FY 2016 on "Workpapers and Lead Sheets," which focused on the changes to Lead Sheet 130 and emphasized the importance of documenting the facts, procedures, audit techniques used, managerial involvement and conclusions reached related to the required filing checks, and provided examples of proper documentation for numerous scenarios.
- Highlighted the importance of required filing checks and picking-up prior and/or subsequent year returns as part of a quality examination in the July 2016 "Keys to Success" newsletter.
- Revised IRM 4.10.5, *Required Filing Checks*, in June 2017, to clarify expectations and documentation requirements and add references to IRM 4.10.2.3.3, *Required Filing Checks*, and IRM 4.10.4, *Examination of Income*, related to completion of the comparative analysis.

We do not agree with your outcome measure of \$246,214,311. The measure fails to account for the opportunity costs associated with lost revenue and reduced audit rates that would occur if we focused even more of our resources on expanding existing examinations to prior and/or subsequent year returns instead of auditing additional taxpayers.

In closing, we value your insight and believe there are more actions we can take to improve in this area. 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 Operations.

Attachment



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Attachment

RECOMMENDATION 1:

The Director, Examination, SB/SE Division should update the IRM with additional guidance on when it is appropriate to conduct an examination even though the statute is less than 12 months, and include statute extensions as an option to alleviate statute of limitation concerns.

CORRECTIVE ACTION:

We agree with this recommendation. We will update the IRM to clarify examination cycle exceptions and when it is appropriate to start an audit with less than 12 months remaining on the assessment statute of limitations.

IMPLEMENTATION DATE:

October 15, 2019

RESPONSIBLE OFFICIAL:

Director, SB/SE Examination Field and Campus Policy

CORRECTIVE ACTION MONITORING PLAN:

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

RECOMMENDATION 2:

The Director, Examination, SB/SE Division should provide additional training to field examiners on when to expand examinations into the prior and/or subsequent tax return years, including the use of split closing for cases nearing the statute limitation or over-age cases and requesting statute extensions as needed.

CORRECTIVE ACTION:

We agree with this recommendation. We will create a training presentation for Field Examination managers and examiners that emphasizes proper documentation of required filing checks. It will also explain related IRM updates clarifying examination cycle exceptions and when it is appropriate to start an audit with less than 12 months remaining on the assessment statute of limitations.

IMPLEMENTATION DATE:

January 15, 2020

RESPONSIBLE OFFICIAL:

Director, SB/SE Examination Field and Campus Policy



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CORRECTIVE ACTION MONITORING PLAN:

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

RECOMMENDATION 3:

The Director, Examination, SB/SE Division should update the IRM with guidance on when field examiners should conduct a more detailed comparative analysis for individual non-business returns and specific details on how it should be documented.

CORRECTIVE ACTION:

We agree with this recommendation in part. We will update the IRM to clarify when field examiners may need to conduct a detailed comparative analysis for individual non-business returns.

IMPLEMENTATION DATE:

October 15, 2019

RESPONSIBLE OFFICIAL:

Director, SB/SE Examination Field and Campus Policy

CORRECTIVE ACTION MONITORING PLAN:

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

RECOMMENDATION 4:

The Director, Examination, SB/SE Division should provide additional training to field examiners and managers to ensure that the Lead Sheet 130 includes an adequate explanation for not expanding to prior and/or subsequent returns.

CORRECTIVE ACTION:

We agree with this recommendation. We will create a training presentation for Field Examination managers and examiners that emphasizes proper documentation of required filing checks. It will also explain related IRM updates clarifying examination cycle exceptions and when it is appropriate to start an audit with less than 12 months remaining on the assessment statute of limitations.

IMPLEMENTATION DATE:

January 15, 2020



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RESPONSIBLE OFFICIAL:

Director, SB/SE Examination Field and Campus Policy

CORRECTIVE ACTION MONITORING PLAN:

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

RECOMMENDATION 5:

The Director, Examination, SB/SE Division should update the IRM to require that the Form 5345-D, *Examination Request-ERCS (Examination Returns Control System) Users*, include the manager's signature and update the form with a manager signature line. In addition, field examiners should be reminded of the need to retain the Form 5345-D in the case files of all years examined.

CORRECTIVE ACTION:

We partially agree with the recommendation. We will publish an article in the Technical Digest reminding Field examiners and managers of the need to retain Form 5345-D in the administrative case file. However, Form 5345-D will not be updated to include a manager's signature line. Managerial approval is completed in the Examination Returns Control System and an audit trail is maintained showing who approved the opening of a return.

IMPLEMENTATION DATE:

March 15, 2019

RESPONSIBLE OFFICIAL:

Director, SB/SE Examination Field and Campus Policy

CORRECTIVE ACTION MONITORING PLAN:

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