Interest Paid to Large Corporations Could Significantly Increase Under a Proposed New Revenue Procedure

August 2003

Reference Number: 2003-30-176

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.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

August 27, 2003

MEMORANDUM FOR COMMISSIONER, LARGE AND MID-SIZE BUSINESS DIVISION

FROM: for Gordon C. Milbourn III
Assistant Inspector General for Audit (Small Business and Corporate Programs)

SUBJECT: Final Audit Report - Interest Paid to Large Corporations Could Significantly Increase Under a Proposed New Revenue Procedure (Audit # 200230044)

This report presents the results of our review of claims filed during examinations of Coordinated Industry Cases (CIC) in the Large and Mid-Size Business (LMSB) Division.[1] The overall objective of this review was to determine the impact claims are having on the effectiveness and efficiency of tax administration.

In summary, claims filed during examinations in the LMSB Division have been identified as a risk that could hamper efforts to meet performance goals because, among other things, they are believed to be a significant factor in extending the length of and time spent on examinations. Since 2000, the LMSB Division has chartered numerous design teams that have revamped decades-old business processes and practices to meet expectations for a more efficient examination process in the Division's CIC and Industry Case programs. One recent design team was chartered in 2002 to design a new process for dealing with the risk that is believed to be associated with claims filed during CIC examinations.

[1] As discussed in the report, claims consist of additional deductions, credits, and/or other adjustments to taxable income that were not included on the original return when it was filed. In examinations, the LMSB Division divides claims into two categories, formal and informal. Formal claims are generally defined as amended returns filed by taxpayers, either with examiners or through an Internal Revenue Service Submission Processing Site, requesting a refund. Informal claims can request refunds but are submitted only to examiners during an examination. It is also important to note that claims in the context of this report do not include requests for refunds on net operating losses.

Based on the design team's proposal, the LMSB Division is considering issuing a new revenue procedure. The procedure would provide special treatment for CIC taxpayers that file claims during examinations by allowing examiners to delay the claim evaluation process until after the ongoing examination is completed. A second study is nearing completion in the LMSB Division's Office of Strategy, Research, and Program Planning (SRPP); LMSB Division management anticipates the results will provide the basis for an overall strategy to address claims issues in the Division's examinations. However, both studies contained technical and procedural shortcomings that diminish their usefulness. More significantly, we found that claims had relatively little effect on the length of CIC examinations and that the proposed new revenue procedure could significantly increase the interest the Internal Revenue Service (IRS) must pay on claims.

When a claim is filed on a CIC return that is under examination, the IRS incorporates the claim into the ongoing examination, and any refund that may be due the taxpayer is issued at the end of the examination. While this practice guards against taxpayers receiving refunds for more than they are entitled to, the interest that may be owed taxpayers continues to increase during examinations.

Between Fiscal Years 1998 and 2002, the IRS processed, on average, 382 CIC examinations containing claims activity per year, with examiners allowing an average of $10 million in claims per examination. We estimate that during this 5-year period approximately $637.6 million of interest accrued[2] each year. However, if the claims were not considered until after the examinations were completed, as proposed by the new revenue procedure, we estimate that during this 5-year period slightly more than $1 billion of interest would have accrued per year. This would have increased interest costs by over 57 percent ($367.7 million) each year, or $1.839 billion over 5 years.

In view of this substantial cost, we recommended that the Commissioner, LMSB Division, (1) direct that the design team's study no longer be represented as the basis for changing the process to manage claims that are filed during CIC examinations and (2) conduct a pilot program to gather pertinent information concerning the effect the proposed procedure will have on reducing the length of examinations and interest costs. Also, survey results from the second study that is nearing completion should not be represented as being statistically valid in determining the characteristics of formal claims filed in examinations or the amount of revenue protected from examining claims.

In our discussions with LMSB Division management on the issues contained in this report, the managers stated our analysis did not consider that the proposed new revenue procedure would enhance their ability to plan and control examinations. According to the managers, this will make it easier for them to shorten the length of examinations and thereby minimize additional interest that may accrue by not addressing claims filed during ongoing examinations. However, the evidence needed to show that the proposed new revenue procedure would shorten examinations and minimize additional interest costs has yet to be developed. We clarified this point in footnotes to our analysis in Appendix IV.

---

[2] The term accrued is a financial accounting term that means amounts owed but not yet paid.

Management's Response: The Commissioner, LMSB Division, agreed with all our recommendations and responded that the Claims Implementation Team has been asked to no longer use the claims study as the basis for changing the process to manage claims filed during CIC examinations and to conduct a pilot program to collect pertinent information about the effects of the proposed revenue procedure on the length of examinations and interest costs. In addition, when the LMSB Division's Office of SRPP completes its research project, a cautionary note against using the data from the survey to reach conclusions about the LMSB Division population will be included in references to the claims survey and references to "Revenue Protected" in the survey data will be corrected to "Amount of Claims Disallowed."

Even though actions are being taken to implement all our recommendations, the Commissioner, LMSB Division, believes that several conclusions in the report were not fully supported by actual facts and requested that we reconsider some of the statements in the report. Management's complete response to the draft report is included as Appendix V.

Office of Audit Comment: We are encouraged that the Commissioner is implementing all of our recommendations. We understand that the purpose of delaying the examination of certain claims is to assist in managing the examination process. However, we respectfully disagree that our conclusions are not supported by actual facts. We made appropriate revisions to a draft of this report to clarify the basis for our conclusions and recommendations but believe further clarification and explanation may be helpful for three areas that remain a particular source of concern in IRS management's response.

First, the LMSB Division does not concur with our statement that, as proposed, the new revenue procedure would increase interest costs by over 57 percent ($367.7 million) each year, or $1.839 billion over 5 years, and did not agree with the use of data from formal claims in our computation. We agree that we used the average time spent on examinations that were initiated by a formal claim. Our report explained that we had to use the average time spent on these examinations because the IRS does not track the time spent examining claims that are filed during ongoing examinations of originally filed returns. In computing the interest costs, our intent was, and still is, to show the risk posed by the claims process. Our computation relied on IRS data that recognized the actual number and average amount, allowed by examiners, of formal and informal claims that were filed during CIC examinations.

Second, we were asked to reconsider the statement "…we found that claims had relatively little effect on the length of CIC examinations…" because the LMSB Division considers 3.7 months significant when considering the length of examinations. As noted in the report, we considered and recognized the 3.7 months (111 days) in computing the potential increase in interest costs. Further, the report notes that revisions to planned examination completion dates were made nearly as often in examinations not containing a claim as in those with one, which suggests that factors other than claims are affecting the length of examinations.

Third, the LMSB Division disagreed with the statement “By not accurately identifying the formal claims universe, all statistical uses of the data were problematic” and the related discussion in the report. The Commissioner, LMSB Division, believes the sample was valid. We do not agree with the LMSB Division’s position. As explained in the report, when appropriately selected, statistically valid samples allow researchers to determine the characteristics of some larger group (universe) by studying the characteristics in a much smaller portion (sample) of the universe. To allow the results of statistically valid sample measurements to be extended or generalized to the universe, researchers need to ensure the sample selected accurately represents the universe to be studied. In this instance, the sample did not accurately represent the universe of accounts with formal claims because accounts that did not have formal claims were included in the sample. As a result, we continue to believe that statistical uses of the data are problematic since it be will very difficult, if not impossible, to allow the results of the sample measurements to be extended or generalized to the universe of formal claims.

Copies of this report are also being sent to the IRS managers who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Parker F. Pearson, Director (Small Business Compliance), at (410) 962-9637.

Table of Contents

Background

Since 2000, the Large and Mid-Size Business (LMSB) Division has chartered numerous design teams that have revamped decades-old business processes and practices to meet expectations for a more efficient examination process in the Coordinated Industry Case (CIC) and Industry Case (IC) programs.[1] Both the Division and large corporate taxpayers believe that examinations take too long, particularly those in the CIC program.

In response to concerns over claims[2] filed during CIC examinations, a design team was chartered in 2002 to develop a new process for dealing with the risk that is believed to be associated with claims filed during CIC examinations. The team surveyed LMSB Division field managers and validated that field managers believed claims extend the length of examinations because they increase the number of tax issues that need to be examined. Additionally, these managers believed that claims disrupted their planned examination coverage and hampered their ability to meet completion date goals.

A second study on claims is nearing completion in the LMSB Division's Office of Strategy, Research, and Program Planning (SRPP). Among other responsibilities, the Research Unit in the Office of SRPP provides the LMSB Division with research expertise for assessing emerging issues and trends. To assess the issues and trends in claims, the unit has surveyed team managers and analyzed historical

---

[1] The LMSB Division serves corporations, sub-chapter S corporations, and partnerships with assets greater than $10 million. For examination purposes, the Division divides taxpayers into two categories, CIC and IC. CIC cases generally involve the nation's largest taxpayers and are examined by teams of examiners. IC cases are generally assigned to one examiner.

[2] As discussed in the report, claims consist of additional deductions, credits, and/or other adjustments to taxable income that were not included on the original return when it was filed. In examinations, the LMSB Division divides claims into two categories, formal and informal. Formal claims are generally defined as amended returns filed by taxpayers, either with examiners or though an Internal Revenue Service Submission Processing Site, requesting a refund. Informal claims can request refunds but are submitted only to examiners during an examination. It is also important to note that claims in the context of this report do not include requests for refunds on net operating losses.

Internal Revenue Service (IRS) tax data. Although at the time we completed our audit work the Research Unit had not issued a final report, LMSB Division management anticipates the results will provide the basis for an overall strategy to address claims issues in the Division's examinations.

When a claim is filed on a CIC return that is under examination, the IRS incorporates the claim into the ongoing examination, and any refund that may be due the taxpayer is issued at the end of the examination. While this practice guards against taxpayers receiving refunds for more than they are entitled to, the interest that may be owed taxpayers continues to increase during examinations. This is because under the Internal Revenue Code (I.R.C.), the IRS must generally pay interest on overpaid taxes from the later of the due date of the return or the date the return is filed. Since taxpayers have up to 3 years to file a claim and interest must be paid back to the overpayment date of the original return, the IRS may ultimately pay several years of interest on any refund due the taxpayer.

This review was performed in accordance with *Government Auditing Standards* between August 2002 and February 2003. To meet our objective, we relied on the IRS' internal management databases and reports. We did not establish the reliability of these data because extensive data validation tests were outside the scope of this audit and would have required extensive resources and time. Onsite work was performed in the IRS Submission Processing Site in Ogden, Utah, and the LMSB Division offices in Oakland, California, and Chicago, Illinois. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

Design and Research Teams Are Revamping Old Business Practices to Benefit Both Taxpayers and the Internal Revenue Service

The IRS Restructuring and Reform Act of 1998 (RRA 98)[3] required the agency to significantly improve the way it provides service and ensures compliance. To assist the IRS in meeting its mandate, the LMSB Division has chartered numerous design and research teams that are revamping decades-old business practices. According to LMSB Division customer satisfaction surveys, taxpayers reported high levels of satisfaction in their experiences with these changed business practices.

One of the focuses to increase LMSB Division taxpayer satisfaction was to reduce the length and contentious nature of the examination process. In response, a design team successfully developed, tested, and implemented the Industry Issue Resolution (IIR) Program to address contentious issues in a more "preemptive" and less intrusive manner than in an examination. Under the IIR Program, taxpayers can submit frequently disputed tax issues to the IRS for guidance. The benefit is that broad groups of taxpayers rely on the guidance and avoid spending time and resources resolving the issues in an examination.

To reduce the length of examinations, a Limited Issue Focused Examination process, which is an alternative to the traditional broad-based examination process, has also been introduced to examiners. The process encourages examiners to use risk analysis and materiality considerations to limit examinations to a few critical issues on a tax return. As shown in Table 1, numerous other strategies, initiatives, and research projects are underway to replace outdated practices. If these efforts are successful, both taxpayers and the IRS should benefit.

[3] IRS Restructuring and Reform Act of 1998, Pub. L. No. 105-206, 112 Stat. 685 (codified as amended in scattered sections of 2 U.S.C., 5 U.S.C. app., 16 U.S.C., 19 U.S.C., 22 U.S.C., 23 U.S.C., 26 U.S.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.).

Table 1: Selected LMSB Division Strategies, Initiatives, and Research Projects

Title	Description
Issue Management Strategy	A group of initiatives focused on early issue resolution.
Compliance Risk Strategy	A group of initiatives aimed at ensuring the most high-risk returns are examined.
Information Document Request Management Process	A process for obtaining complete, timely information during examinations.
Fast Track Dispute Resolution Program	An opportunity for taxpayers to appeal issues earlier in the dispute resolution process.
Risk Analysis Process	A process focused on shortening examinations by targeting high-risk issues.
Issue-Based Scoring	A research project that is studying dollar values and other criteria to identify issues in need of examination.
Trends in Book-Tax Reporting and Off-Balance Sheet Financing	A research project studying potential noncompliance in gaps between financial statement income and taxable income.

Source: The LMSB Division.

Building on efforts to improve the examination process, a new revenue procedure[4] is being considered as a result of the design team's study. The procedure would provide special treatment for CIC taxpayers that file claims during examinations by allowing examiners to delay the claim evaluation process until after the ongoing examination is completed. A second study to determine if additional changes may be warranted to better manage claims filed during LMSB Division examinations is nearing completion.

However, both studies contained technical and procedural shortcomings that diminish their usefulness. More substantially, we found that claims had relatively little effect on the length of CIC examinations and that the proposed new revenue procedure could significantly increase the interest the IRS must pay on claims.

[4] A revenue procedure is an official statement of procedure that, among other things, affects the rights or duties of taxpayers under the I.R.C.

Sufficient and Competent Evidence Is Needed to Support the Proposed New Revenue Procedure

The General Accounting Office's (GAO) *Business Process Reengineering Assessment Guide* provides key concepts that can be applied to designing new business processes in the LMSB Division. The concepts include (1) justifying in sufficient detail the need for proposed changes, (2) securing sufficient stakeholder support, and (3) performing adequate cost-benefit analysis.

We found that, due to time and resource constraints, the design team's approach for revamping the process for handling claims during examinations did not include some key concepts recommended in the GAO *Guide*. As a result, we identified enough technical and procedural shortcomings in the design team's study for us to conclude that it should not be used as the basis for the proposed new revenue procedure.

<u>Justifying the need for the proposed change</u>

In justifying the need for changing the way claims are handled, the design team did not adequately consider important data on the claims filed during CIC examinations from Fiscal Years (FY) 1993 through 2002. The need for the new proposed revenue procedure was not supported since there was no correlation analysis of the relationship that a claim filed during an examination has with the length of the examination.

We analyzed the IRS' Coordinated Examination Management Information System (CEMIS), which contained results from 4,971 CIC examinations closed from FYs 1993 through 2002, and found that claims had relatively little impact on the length of examinations. For example, we found that revisions to planned completion dates were made nearly as often in the examinations not containing a claim as in those with one. Also, over the 10-year period, the CIC examinations that contained claims extended the length of examinations, on average, only about 111 days (3.7 months). Taking these two facts into consideration suggests that factors other than claims are affecting the length of CIC examinations.

Securing sufficient stakeholder support

In securing stakeholders' support for the new process, tax professionals in 3 leading organizations[5] and approximately 5,000 LMSB Division examiners and managers were surveyed. However, only 195 of those targeted for the survey responded. According to the IRS' own internal criteria,[6] this relatively small number of respondents (less than 5 percent) would be of little or no value in measuring the level of support for the new process.

Performing adequate cost-benefit analysis

In analyzing the costs and benefits of the new process, the design team did not sufficiently consider interest the IRS must pay on refunds. When a claim is filed on a CIC return that is under examination, the IRS currently incorporates the claim into the ongoing examination, and any refund that may be due the taxpayer is issued at the end of the examination.

The proposed new revenue procedure changes this long-standing practice by allowing examiners to delay the CIC examination of the claim until after the examination of the original return is completed. With FY 2002 CIC examinations taking, on average, 1,182 days (38.9 months) to complete, the new revenue procedure would significantly risk increasing the interest the IRS must pay on any claims that are allowed by examiners.

To determine the potential additional cost, we estimated the amount of additional interest that would be paid under the proposed new revenue procedure. Our analysis covered a 5-year period beginning in FY 1998 and is based on the number and dollar amounts of claims filed in CIC examinations that were allowed by examiners.

Table 2 shows that, between FYs 1998 and 2002, the IRS processed, on average, 382 CIC examinations containing claims activity per year, with examiners allowing an average

[5] The organizations included the American Bar Association, Tax Executives Institute, and American Institute of Certified Public Accountants.
[6] As described by the IRS' Service-Wide Research Assurance Council.

of $10 million in claims per examination. We estimate that during this 5-year period approximately $637.6 million of interest accrued[7] each year.

Table 2: Increase in Interest Costs By Addressing Claims After Examinations Are Completed

Dollars in Millions

Fiscal Year	Number of CIC Exams With Claims	Average Dollar Amount of Claims Allowed	Interest Accrued on Claims During Exams	Average Days Spent to Examine Claims	Interest Accrued on Claims If Addressed After Exams Are Completed
1998	438	$9.1	$700.6	575	$1,153.1
1999	405	$6.0	$407.4	499	$620.3
2000	322	$10.1	$519.7	530	$864.3
2001	349	$11.5	$606.5	585	$1,024.2
2002	394	$13.5	$953.6	769	$1,364.2
Averages	382	$10.0	$637.6	592	$1,005.2

Due to rounding, numbers may not add or subtract precisely.

Source: The Treasury Inspector General for Tax Administration's combined analysis of the IRS' CEMIS, Audit Information Management System (AIMS),[8] and Integrated Data Retrieval System (IDRS).[9]

The analysis in Table 2 also shows that if the claims were not considered until after the examinations were completed, as proposed by the new revenue procedure, during this 5-year period slightly more than $1 billion of interest would have accrued each year. This would increase interest costs by over 57 percent ($367.7 million)[10] each year, or

---

[7] The term accrued is a financial accounting term that means amounts owed but not yet paid.
[8] The AIMS is a management information system that contains data on open and closed examinations.
[9] The IDRS is a computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer's account records.
[10] The more precise number, $367.66 million, has been rounded.

$1.839 billion over 5 years. Thus, the cost may far exceed the benefits that would be achieved under the new proposed revenue procedure. Additional detail on the analysis is provided in Appendix IV.

In our discussions with LMSB Division management on the issues contained in this report, the managers stated our analysis did not consider that the proposed new revenue procedure would enhance their ability to plan and control examinations. According to the managers, this will make it easier for them to shorten the length of examinations and thereby minimize additional interest costs that may accrue by not addressing claims filed during ongoing examinations. However, the evidence needed to show that the proposed new revenue procedure would shorten examinations and minimize interest costs has yet to be developed. We clarified this point in footnotes to our analysis in Appendix IV.

Recommendations

Because of the study's shortcomings and the uncertainties about whether the proposed new revenue procedure would shorten the length of CIC examinations and not increase interest costs, we recommend that the Commissioner, LMSB Division:

1. Direct that the study no longer be represented as the basis for changing the process to manage claims that are filed during CIC examinations.

   Management's Response: The Commissioner, LMSB Division, asked the Claims Implementation Team to no longer use the claims study as the basis for changing the process to manage claims filed during CIC examinations.

2. Gather pertinent information concerning the effect the proposed procedure will have on reducing the length of examinations and interest costs by conducting a pilot program to demonstrate the actual benefits that could be achieved.

Management's Response: The Commissioner, LMSB Division, responded that the Claims Implementation Team will conduct a pilot program to collect pertinent information about the effects of the proposed revenue procedure on the length of examinations and interest costs. The team will also evaluate other cost and benefit aspects of the process.

Even though actions are being taken to implement the two recommendations discussed above, the Commissioner, LMSB Division, believes that several conclusions in the report related to these two recommendations were not fully support by actual facts. In addition, the Commissioner, LMSB Division, requested that we reconsider some of the statements in the report related to these two recommendations.

Office of Audit Comment: We are encouraged that the Commissioner is implementing all of our recommendations. We understand that the purpose of delaying the examination of certain claims is to assist in managing the examination process. However, we respectfully disagree that our conclusions are not supported by actual facts. We made appropriate revisions to a draft of this report to clarify the basis for our conclusions and recommendations but believe further clarification and explanation may be helpful for the following two areas that remain a particular source of concern in IRS management's response.

First, the LMSB Division does not concur with our statement that, as proposed, the new revenue procedure would increase interest costs by over 57 percent ($367.7 million) each year, or $1.839 billion over 5 years, and did not agree with the use of data from formal claims in our computation. We agree that we used the average time spent on examinations that were initiated by a formal claim. Our report explained that we had to use the average time spent on these examinations because the IRS does not track the time spent examining claims that are filed during ongoing examinations of originally filed returns. In computing the interest costs, our intent was, and still is, to show the risk posed by the claims process. Our computation relied on IRS data that recognized the actual number and average amount, allowed by examiners, of formal and informal claims that were filed during CIC examinations.

Second, we were asked to reconsider the statement "…we found that claims had relatively little effect on the length of CIC examinations…" because the LMSB Division considers 3.7 months significant when considering the length of examinations. As noted in the report, we considered and recognized the 3.7 months (111 days) in computing the potential increase in interest costs by delaying the examination of claims as proposed by the LMSB Division. Further, the report notes that revisions to planned examination completion dates were made nearly as often in examinations not containing a claim as in those with one, which suggests that factors other than claims are affecting the length of examinations.

Data Reliability and Technical and Procedural Problems Diminish the Usefulness of a Second Claims Study

Despite a good faith effort, the combination of data limitations and technical and procedural problems diminish the usefulness of a second claims study that is underway in the LMSB Division's Office of SRPP. In summary, the results from a survey on formal claims[11] conducted during the study are not reliable since the Office of SRPP did not have the accurate universe of formal claims to allow statistically reliable inferences about the characteristics of formal claims filed in open examinations. In addition, the amount of revenue protected[12] as measured by the survey is not accurate.

An initial technical error in identifying the universe of claims has caused problems. The IRS does not have readily available data on the number of claims filed by taxpayers served by the LMSB Division. To overcome this data

---

[11] As discussed in this report, formal claims are generally defined as amended returns filed by taxpayers, either with examiners or though an IRS Submission Processing Site, requesting a refund.

[12] Among other things, revenue protection measures work performed by examiners in disallowing claims for refund, which prevents the release of money from the Department of the Treasury to the taxpayer.

limitation, the research team matched two databases intending to produce a universe of formal claims filed in open examinations. However, we found that because the match contained incorrect criteria, the team was not able to accurately identify the universe of formal claims in open examinations. To validate this, we reviewed information from 68 taxpayer accounts included in the research team's universe of formal claims and found that 19 of the accounts contained no evidence that a formal claim was filed during an open examination.

By not accurately identifying the formal claims universe, all statistical uses of the data were problematic. For example, the team decided to survey a statistically valid sample[13] of all LMSB Division managers with formal claims in open examinations. The incorrect criteria led to surveying 33 managers who should not have been selected for the survey because they were not involved with formal claims in open examinations. Because the 33 managers were included in the sample, conclusions determined from the sample cannot be statistically projected or generalized to the universe of managers involved with formal claims in examinations.

A conventional requirement for data collection instruments, such as surveys, is that questions be clear and understandable so that complete and accurate responses are received. To find out what may be confusing about survey questions, researchers will often "try out" the survey on a number of likely respondents and then clarify the questions or instructions as needed.

Although efforts were made to test the survey on likely respondents, our discussions with 13 managers that responded to the survey suggested that more could have been done to ensure questions were answered accurately. The survey contained at least 42 items and as many as 522 items for special cases, and several of the managers told

---

[13] When appropriately selected, statistically valid samples allow researchers and others to determine the characteristics of some larger group (universe) by studying the characteristics in a much smaller portion (sample) of the universe.

us they had difficulty understanding the instructions and some of the survey questions. This helps explain why we found numerous inaccuracies in their responses, including a claim that was misstated by $107 million.

From a procedural standpoint, the research team also encountered problems. An important output measure that the survey attempted to quantify is the amount of revenue protected as a result of examinations. In examinations, revenue protection measures examiner efforts in preventing taxpayers from receiving refunds larger than they are entitled to on the claims they file.

According to the IRS Internal Revenue Manual (IRM),[14] at least eight factors need to be considered in calculating the measurement. However, most of factors needed for the calculation were not collected in the survey, which will make it impossible to accurately measure the revenue protected from the survey.[15]

Recommendations

Due to the shortcomings in the survey, we recommend that the Director, SRPP, ensure:

3. The survey results are not represented as being statistically valid in determining the population or the characteristics of formal claims filed in open examinations. This qualification needs to be considered in any decision-making process concerning the results.

[14] The IRM serves as the official compilation of policies, procedures, delegated authorities, instructions, and guidelines relating to the organization, functions, administration, and operations of the IRS.
[15] Among the factors that were not considered were (1) outstanding amounts the taxpayer owed, (2) claims referred to the Appeals function because of disagreements, (3) claims allowed that were equal to other tax adjustments, (4) claims allowed that were greater than other tax adjustments, and (5) claims allowed that were less than other tax adjustments.

Management's Response: The Commissioner, LMSB Division, responded that when the Office of SRPP completes the Claims Research Project a cautionary note against using the data from the survey to reach conclusions about the LMSB Division's population would be included in references to the claims survey. The LMSB Division will also revise all existing material about the survey to provide a similar caution.

4. The amount of revenue protected from examining claims as determined by the survey is not represented as an accurate measurement.

Management's Response: The Commissioner, LMSB Division, responded that references to "Revenue Protected" in the survey data will be corrected to "Amount of Claims Disallowed" when the Claims Research Project is completed.

Even though actions are being taken to implement the two recommendations discussed above, the LMSB Division disagreed with the statement "By not accurately identifying the formal claims universe, all statistical uses of the data were problematic" and the related discussion in the report. The Commissioner, LMSB Division, believes the sample was valid.

Office of Audit Comment: We are encouraged that the Commissioner is implementing all of our recommendations. However, we do not agree with the Commissioner's position and believe that further clarification and explanation may be helpful for this third area that remains a particular source of concern in IRS management's response. As explained in the report, when appropriately selected, statistically valid samples allow researchers to determine the characteristics of some larger group (universe) by studying the characteristics in a much smaller portion (sample) of the universe. To allow the results of statistically valid sample measurements to be extended or generalized to the universe, researchers need to ensure the sample selected accurately represents the universe to be studied.

In this instance, the sample did not accurately represent the universe of accounts with formal claims because accounts that did not have formal claims were included in the sample. As a result, we continue to believe that statistical uses of the data are problematic since it will be very difficult, if not impossible, to allow the results of the sample measurements to be extended or generalized to the universe of formal claims.

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine the impact claims are having on the effectiveness and efficiency of tax administration. To meet our objective, we relied on the Internal Revenue Service's (IRS) internal management databases and reports. We did not establish the reliability of these data because extensive data validation tests were outside the scope of this audit and would have required extensive resources and time. The specific audit tests included the following:

I. Performed a walk-through of the appropriate operations in the Ogden Submission Processing Site to determine how formal claims are received, controlled, and posted to accounts.

II. Reviewed work plans, status reports, and, if available, final reports of the LMSB Division design and research team to determine its goals, scope, methodology, and recommendations.

III. Interviewed officials from the LMSB Division design and research team and reviewed pertinent documents to learn about the various LMSB Division strategies, initiatives, and research projects that are changing work processes to improve service to taxpayers and ensure compliance.

IV. Used the General Accounting Office's (GAO) *Business Process Reengineering Assessment Guide* in assessing how well the LMSB Division design team applied "best practices" outlined in the GAO *Guide* to its study.

V. Analyzed the Coordinated Examination Management Information System (CEMIS) and the Audit Information Management System (AIMS)[1] in assessing the length of Coordinated Industry Case (CIC) examinations, number and amount of claims filed in CIC examinations, how claims were resolved in CIC examinations, and the impact claims had on timely completing CIC examinations.

VI. Used the IRS' Integrated Data Retrieval System (IDRS)[2] to compute the applicable rate of Federal interest under Internal Revenue Code Section 6621 on claims analyzed during the review.

---

[1] The CEMIS and AIMS are management information systems that contain data on open and closed examinations.
[2] The IDRS is a computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer's account records.

VII. Evaluated the criteria used by the LMSB Division research team in determining the population of examinations containing claims and assessed whether the criteria would yield intended results.

VIII. Used the American Statistical Association's Guide on *Judging the Quality of a Survey* in assessing how well the LMSB Division research team applied "best practices" outlined in the Guide to its survey.

IX. Used the IRS Internal Revenue Manual[3] to determine whether the LMSB Division's research team considered required factors in computing revenue protection amounts.

[3] The IRM serves as the official compilation of policies, procedures, delegated authorities, instructions, and guidelines relating to the organization, functions, administration, and operations of the IRS.

Appendix II

Major Contributors to This Report

Parker Pearson, Director (Small Business Compliance)
Philip Shropshire, Director
Frank Dunleavy, Audit Manager
Stanley Pinkston, Senior Auditor
Lisa Stoy, Senior Auditor
William Tran, Senior Auditor
Debra Mason, Auditor

Appendix III

Report Distribution List

Commissioner N:C
Deputy Commissioner for Services and Enforcement N:SE
Acting Deputy Commissioner, Large and Mid-Size Business Division LM
Director, Retailers, Food, Pharmaceuticals, and Healthcare Industry, Large and Mid-Size Business Division LM:RFP
Director, Strategy, Research, and Program Planning, Large and Mid-Size Business Division LM:SR
Chief Counsel CC
National Taxpayer Advocate TA
Director, Office of Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis N:ADC:R:O
Office of Management Controls N:CFO:AR:M
Audit Liaison: Commissioner, Large and Mid-Size Business Division LM:CL

Appendix IV

Outcome Measures

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 the Congress.

Type and Value of Outcome Measure:

- Funds Put to Better Use – Potential; an average of $367.7[1] million per year; $1.839 billion over 5 years. This represents the interest that could be avoided by continuing to incorporate claims into ongoing Coordinated Industry Case (CIC) examinations rather than delaying the examination of claim issues until after ongoing examinations are completed (see page 5).

Methodology Used to Measure the Reported Benefit:

To estimate the potential funds that could be put to better use, we analyzed three of the Internal Revenue Service's (IRS) automated information systems. The first system, the Coordinated Examination Management Information System (CEMIS), contains information on the length of CIC examinations, the number and amount of claims filed by taxpayers during CIC examinations, and the number and amount of claims that examiners allowed during CIC examinations. The second system, the Audit Information Management System (AIMS), contains information on the time span of CIC examinations that involved only claims for refunds on amended returns. The third system, the Integrated Data Retrieval System (IDRS), contains a computer program that calculates the applicable amount of Federal interest on tax overpayments and underpayments.

Based on the analysis in Table 1, between Fiscal Years 1998 and 2002, the IRS processed, on average, 382 CIC examinations with claims activity per year, with examiners allowing an average of $10 million in claims per examination. We used the IDRS and determined that during this 5-year period, approximately $637.6 million of interest accrued each year. The analysis in Table 1 also shows that delaying the examination of the claims as currently proposed would risk increasing interest costs from $637.6 million to slightly over $1 billion each year. This is an increase of approximately $367.7 million each year, or a $1.839 billion increase over 5 years.

[1] The more precise number, $367.66 million, has been rounded.

Table 1: Increase in Interest Costs by Addressing Claims After Examinations Are Completed

Dollars in Millions

A	B	C	D	E	F	G	H
Fiscal Year	**Number of CIC Exams With Claims**	**Average Dollar Amount of Claims Allowed**	**Average Length of Exams in Days (†) (✳)**	**Interest Accrued on Claims During Exams**	**Average Days Spent to Examine Claims (✓) (×)**	**Interest Accrued on Claims If Addressed After Exams Are Completed**	**Additional Accrued Interest (G less E)**
1998	438	$9.1	914	$700.6	575	$1,153.1	$452.5
1999	405	$6.0	906	$407.4	499	$620.3	$212.9
2000	322	$10.1	918	$519.7	530	$864.3	$344.6
2001	349	$11.5	919	$606.5	585	$1,024.2	$417.7
2002	394	$13.5	1,071	$953.6	769	$1,364.2	$410.6
Averages ⌿	382	$10.0	946.9	$637.6	592	$1,005.2	$367.7

(†) We found that CIC examinations containing claims over a 10-year period may have been a factor in extending the length of examinations by an average of 111 days. Consequently, we reduced the average length of the examinations as shown in the table by the 111 days.

(✳) We did not consider the impact that the proposed new revenue procedure could have on reducing the length of examinations or on the number of claims that would be addressed after examinations are completed because the data were not available. According to Large and Mid-Size Business Division managers, the proposed revenue procedure would enhance their ability to plan and control examinations. This, according to the managers, will make it easier for them to shorten the length of examinations and thereby minimize additional interest that may accrue by not addressing claims during ongoing examinations.

(✓) We used the average time spent on examinations that were initiated by a claim for refund on an amended return because the IRS does not track the time spent on claims that are filed during ongoing examinations of originally filed returns. The time spent on claims filed during ongoing examinations of originally filed returns could be less because, among other things, taxpayer records are readily available to examine.

(×) We excluded the time spent examining claims that are subject to review by the Joint Committee on Taxation. Generally, these claims involve requests for refunds of $2 million or more and can take additional time to process because of a special review process.

(⌿) Due to rounding, numbers may not add or subtract precisely.

Source: The Treasury Inspector General for Tax Administration's combined analysis of examination results from the IRS' CEMIS, AIMS, and IDRS.

Appendix V

Management's Response to the Draft Report

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

COMMISSIONER
LARGE AND MID-SIZE
BUSINESS DIVISION

August 8, 2003

RECEIVED
AUG 14 2003

MEMORANDUM FOR TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

FROM: Deborah M. Nolan
Commissioner, Large and Mid-Size Business Division

SUBJECT: Draft Audit Report – Interest Paid to Large Corporations Could Significantly Increase Under a Proposed New Revenue Procedure (Audit # 2002-30-044)

While I agree with your audit recommendations, I believe several conclusions in your audit report were not fully supported by actual facts. To share these concerns and increase your understanding of the claims process (current and proposed) and the role and activities of the Claims Design and the Research teams, my staff provided and discussed with you a comprehensive list of concerns with the report. I appreciate the time you spent with them before and during the closing conference to discuss these concerns. I also appreciate the fact that you made some revisions to your earlier draft report based on the comments we provided. However, I would like you to reconsider some statements in your draft audit report, as explained in Attachment 1.

Although I do not believe that the proposed revenue procedure will have a significant negative impact on the claims process or interest payments, I will consider its potential impact and make every effort to ensure that the new process does not increase the length of examinations or interest costs to the IRS.

The Coordinated Industry Case (CIC) Program has experienced a long-standing problem with claims[1] filed late in the examination cycles. Late claims disrupt planned examination activities and often extend closing dates of examinations. The recent influx of marketed claims[2] has only worsened this situation. Sometimes, team managers find it difficult to work effectively on their planned examinations when reviewing the many claims we receive. Many revenue agents said that late claims were the most significant problems they encountered during their examinations.

[1] Claims consist of additional deductions, credits, and/or other adjustments to taxable income that were not included in the original return when it was filed. In examinations, the LMSB Division divides claims into two categories, formal and informal. Formal claims are generally defined as amended returns filed by taxpayers either with examiners or through an IRS Submission Processing Site requesting a refund. Informal claims can request refunds, but are submitted only to examiners during an examination.

[2] A marketed claim is one advertised by a promoter who is willing to file a claim for a contingent fee. These claims are often based on estimates and many times do not include adequate documentation.

2

To address the claims problem, we formed a design team last year consisting of revenue agents, LMSB managers, and personnel from Appeals and Chief Counsel. The team's objectives were to: 1) design a claims process that would ensure consistent and timely processing, 2) identify recurring and emerging issues, and 3) issue timely technical guidance to the field. The team recommended that we:

- Issue a revenue procedure to establish a new process to manage claims. We have delayed this recommendation pending the results of a planned pilot program to collect pertinent information about the effect the proposed revenue procedure would have on the length of examinations and interest costs.
- Establish separate examinations for large claims (those over $2 million) that taxpayers file more than 90 days after the examination opening conference.
- Complete the claim examination simultaneously with the regular examination, but allow a delay, if necessary, until the regular examination is completed.
- Assign additional personnel to review claim issues to lessen the impact of any necessary claim examination delays.
- Forward unagreed issues from the regular examination to Appeals under the Early Referral procedures.

We would like to point out that the Claims Design Team did not rely on the preliminary claims research survey from the Strategy, Research, and Program Planning (SRPP) office when making these recommendations.

The proposed new claims process would:

- Allow audit teams to complete examinations as planned without claim interruptions.
- Help identify emerging and recurring claim issues and ensure that we issue timely guidance to the field.
- Save research time for agents examining similar issues.
- Ensure consistent treatment of taxpayers.

Attachment 2 contains a detailed response on the corrective actions we will take to address your recommendations. If you have any questions, please contact Richard Teed, Director, Strategy, Research, and Program Planning at (202) 283-8335 or Robert Brazzil, Industry Director, Retailers, Food, Pharmaceutical, and Healthcare at (630) 493-5900.

Attachment 1

Other Significant Report Concerns for TIGTA's Reconsideration

We ask that TIGTA reconsider the following statements in the draft report:

- **"The Claims Process *would have increased interest costs by over 57 percent ($367.7 million) each year, or $1.839 billion over 5 years.*" [p. 7]**
  - To produce these figures, you took the data from cases initiated as a result of formal claims filed. We base the claims process largely on informal claims taxpayers file during open examination cycles. The table in the report compares two very different things and does not represent the cases the claims process addresses.
  - The table assumes that, before we address them, we hold claims filed by the taxpayers until after we close the regular cases. Taxpayers file many claims during the first 90 days of the examination, which we include in the examination plan for the current cycle. Additionally, we would address many claims filed after 90 days during the current cycle, including all those that fall under the $2 million threshold, and those claims that we have resources to work.
  - In fact, we would work very few claims after the regular cycle closes. Of those, we would complete many during the 90 days taxpayers have to file their protests, and during the time it takes for Appeals to assign the case and contact the taxpayer.
  - You should consider "lost opportunity cost" of examining claims (versus selected issues in the examination plan) when computing costs.
  - Your savings computation should take into account the present value of money and interest offset factors.

- ***"...we found that claims had relatively little effect on the length of CIC examinations..."* [p. 5]**
  - The TIGTA study acknowledges that cases with claims extended the examinations by 3.7 months. LMSB considers 3.7 months significant when considering the length of our examinations.
  - A 1997 Coordinated Examination Case study on claims states, in part, "In several examinations, the taxpayer submitted claims late in the examination and, as a result, the planned completion date had to be delayed and significant examination resources had to be expended to address the claim issues."

2

- ***"In securing stakeholder' support for the new process... approximately 5,000 LMSB Division examiners and managers were surveyed. However, only 195 of those targeted for the survey responded."*** **[p. 6]**
  - The Claims Team did not conduct a survey, but sent a request for informal feedback to 77 managers consisting of Directors of Field Operations and Territory Managers, with a 10-day turn around time. We did not request feedback from bargaining unit employees, but some managers submitted responses from them. We thought the results (195 responses) were outstanding. Many of those responding stated that late claims were the most significant problem they encountered on their cases.

- ***"By not accurately identifying the formal claims universe, all statistical uses of the data were problematic."*** **[p. 9]**
  - We disagree with this statement and the related discussion in the report. Despite a great deal of work by TIGTA and IRS Research personnel, we have not reached a common understanding about the sampling methodology we used to conduct the survey or the impact of the sample design on survey validity. We believe the sample was valid, but could reconsider the sample design to correct any sampling errors to remove bias.

- ***"Although efforts were made to test the survey on likely respondents, our discussions with 13 managers that responded to the survey suggest that more could have been done to ensure questions were answered accurately."*** **[p. 10]**
  - We think your report substantially understates the extent of work that went into the design, testing, and review of the survey instrument and field responses. We have not been able to validate the errors you reported However, given the complexity of the questionnaire and our experience with other field surveys, we agree that respondent error is probable. Therefore, we have not disputed your recommendation not to use the survey to project assumptions to the entire LMSB population.

Attachment 2

IDENTITY OF FINDINGS/RECOMMENDATIONS

FINDINGS:

- Design and research teams are revamping old business practices to benefit both taxpayers and the IRS.
- Sufficient and competent evidence is needed to support the proposed new revenue procedure:
  - Justification for proposed change
  - Sufficient stakeholder support
  - Adequate cost-benefit analysis

RECOMMENDATIONS:

Because of the study's shortcomings and the uncertainties about whether the proposed new revenue procedure would shorten the length of CIC examinations and not increase interest costs, the Treasury Inspector General for Tax Administration (TIGTA) recommends that the Commissioner, LMSB Division:

RECOMMENDATION 1

Direct that the Claims study no longer be represented as the basis for changing the process to manage claims that are filed during CIC examinations.

CORRECTIVE ACTION:

The Commissioner, LMSB Division asked the Claims Implementation Team to no longer use the Claims study as the basis for changing the process to manage claims that taxpayers file during CIC examinations.

IMPLEMENTATION DATE:

COMPLETED: July 31, 2003

CORRECTIVE ACTION(S) MONITORING PLAN: Not applicable.

2

RECOMMENDATION 2

Gather pertinent information about the effect of the proposed procedure on reducing the length of examinations and interest costs by conducting a pilot program to demonstrate the actual benefits that could be achieved.

CORRECTIVE ACTION(S):

The Claims Implementation Team will conduct a pilot program to collect pertinent information about the effects of the proposed revenue procedure on the length of examinations and interest costs. The team will also evaluate other cost and benefit aspects of the process.

IMPLEMENTATION DATE:

PROPOSED: November 15, 2005

RESPONSIBLE OFFICIAL:

Industry Director, Retailers, Food, Pharmaceutical, and Healthcare

CORRECTIVE ACTION(S) MONITORING PLAN:

A Claims Implementation Team will:

- Select a group of representative cases for the pilot program.
- Have each team complete a check sheet regularly to capture pertinent data for each of these cases.
- Compare results with other CIC closures during the pilot period.

Because CIC cases take a long time to complete, we might have to extend the pilot period. For cases that close with unagreed issues, we will continue to measure results throughout the Appeals process.

TIGTA also recommends that the Director, SRPP office ensure:

RECOMMENDATION 3

The survey results from the second claims study are not represented as being statistically valid in determining the population or the characteristics of formal claims filed in open examinations. This qualification needs to be considered in any decision making process concerning the results.

CORRECTIVE ACTION(S):

When the SRPP office completes the Claims Research Project, we will have them include a cautionary note in references to the Claims Survey against using the data from the survey to reach conclusions about the LMSB population. We will revise all existing material about the survey to provide a similar caution.

IMPLEMENTATION DATE:

PROPOSED: November 15, 2003

RESPONSIBLE OFFICIAL:

Director, SRPP

CORRECTIVE ACTION(S) MONITORING PLAN: Not applicable.

RECOMMENDATION 4

The amount of revenue protected from examining claims as determined by the survey is not represented as an accurate measurement.

CORRECTIVE ACTION:

We will correct references to "Revenue Protected" in the survey data to "Amount of Claims Disallowed" when the SRPP office completes the Claims Research Project.

IMPLEMENTATION DATE:

PROPOSED: November 15, 2003

RESPONSIBLE OFFICIAL:

Director, SRPP

CORRECTIVE ACTION(S) MONITORING PLAN:

The Servicewide Research Council's Quality Assurance Review Team will independently review the final Claims Research Project report. We will provide a copy of the TIGTA report to the reviewers to ensure that any references to "Revenue Protected" are accurate.

OUTCOME MEASURES:

We disagree with the benefits described in Appendix IV and believe that an accurate assessment of benefits is not possible with the current data. The benefits computation assumes that under the proposed system we would not start CIC claims until the regular cycle ends. The benefits computation assumes that cycle time for claims would be the same as the cycle time for examinations initiated because they contained a claim. Both of these assumptions are incorrect, and as a result, the computed benefits are exaggerated. Until a study of the revised procedures is complete, we cannot determine the costs or benefits of the process or the TIGTA recommendations.