

**The Internal Revenue Service Can Improve
Treatment of Taxpayers During Examinations**

May 2000

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

May 19, 2000

MEMORANDUM FOR COMMISSIONER ROSSOTTI

A handwritten signature in black ink that reads "Pamela J. Gardiner".

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report - The Internal Revenue Service Can Improve
Treatment of Taxpayers During Examinations

This report presents the results of our review of the Internal Revenue Service's (IRS) controls in the Examination Division to help ensure fair and consistent treatment of taxpayers.

In summary, IRS employees appropriately handled most of the cases we reviewed. Most notably, IRS employees properly limited the use of intrusive, indirect methods to verify income. Some examination cases, however, demonstrated inconsistent or unfair treatment of taxpayers in certain areas. We found that IRS examiners did not assess penalties consistently and that the IRS assessed taxes against taxpayers without taking all available steps to locate them. While controls are in place to verify examination quality, these controls are not always adequate or effective.

This report makes five specific recommendations to help ensure fair and consistent treatment of taxpayers during the examination process. Management's response was due on March 29, 2000. As of May 11, 2000, management had not responded to this draft report.

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 your staff may contact Gordon C. Milbourn III, Associate Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-3837.

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Treatment of Taxpayers During Examinations**

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Executive Summary

This audit was part of our overall review of controls in the Examination Division to help ensure fair and consistent treatment of taxpayers. We evaluated actions examiners took during the examination process that could have added unnecessary burden to taxpayers. In addition, we determined whether the quality review process gave adequate attention to taxpayer burden and rights issues and whether the results of quality reviews were recorded accurately. Other recent reviews have addressed taxpayer rights and burden in the identification, selection, and closing of office and service center audits and in the resolution of unagreed cases.

Results

Internal Revenue Service (IRS) employees appropriately handled most of the cases we reviewed. Most notably, IRS employees properly limited the use of intrusive, indirect methods to verify income. Some examination cases, however, demonstrated inconsistent or unfair treatment of taxpayers in assessing taxes and penalties.

Although controls are in place to verify examination quality, these controls were not always adequate or effective. In addition, we could not validate the reliability of the quality review information used as part of the IRS' Balanced Measurement System.

Examiners Used Indirect Methods to Verify Income When Appropriate

Indirect methods to verify income can involve intrusive requests for detailed personal information and records from taxpayers. The IRS Restructuring and Reform Act of 1998¹ limited the use of intrusive audit methods to situations when the IRS has indications of unreported income. We reviewed a judgmental sample of 350 audited tax returns to evaluate the use of this audit method. Except for one case in our sample, examiners used indirect methods only when there were indications of unreported income.

Examiners Did Not Always Support Their Decisions to Apply Penalties

In Fiscal Year 1998, the Examination Division assessed over \$100 million in penalties for negligence or inaccuracies on over 76,000 tax returns. To help ensure taxpayers are treated fairly, examiners are required to discuss with taxpayers the reasons for assessing penalties and to document these reasons in the case files. Despite this requirement, 75

¹ Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98), Pub. L. No. 105-206, 112 Stat. 685.

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(42 percent) of the 180 examination case files in our sample did not contain adequate documentation to support the reasons why penalties were or were not assessed. Without adequate documentation, there is no assurance that examiners were fair and consistent in their decisions to assess or not assess penalties. Based on the facts and circumstances contained in the case files we reviewed, it appears that penalties were not assessed consistently.

Examiners Did Not Take Sufficient Actions to Locate Taxpayers Before Assessing Additional Tax

When taxpayers do not respond to an IRS notice of audit, examiners should take additional steps to contact or locate the taxpayer. Otherwise, the taxpayer may be assessed additional tax and penalties without knowing about it. This can cause additional burden to the taxpayer and administrative problems for the IRS to resolve the issue after tax, penalties, and interest have already been assessed. Unfortunately, examiners did not use available resources to locate and contact taxpayers in 112 (91 percent) of 123 sample cases before assessing taxes and penalties. Using the IRS locator services and the Internet, we were able to find a more current taxpayer address or telephone number in 44 (39 percent) of the 112 cases. We estimate that using available IRS resources would have helped locate taxpayers before assessing additional tax on approximately 5,600 tax returns.

Examiners Need to Ensure Adjustments Are Carried Forward to Subsequent Tax Years When the Adjustments Would Result in Lower Tax

Examiners sometimes make assessments in the year under audit which should result in a refund the subsequent year. In a limited number of cases, examiners did not make adjustments for the subsequent year. As a result, taxpayers had to file amended tax returns to obtain refunds. Nationwide, approximately 290 taxpayers had to file claims because examiners did not properly address all affected tax years.

The Examination Quality Measurement System Needs Improvement to Ensure It Provides Reliable Data to Management

The Examination Quality Measurement System (EQMS) is an important control the IRS uses to ensure examinations are performed according to standards. The IRS is currently reorganizing its EQMS to emphasize new quality review standards that address customer relations, professionalism, communication, the reduction of taxpayer burden, and the protection of taxpayer rights. The quality measures reported by the EQMS are an important aspect in the new IRS Balanced Measurement System which is designed to help ensure that taxpayers are treated fairly. While the IRS has made improvements to

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the EQMS, cases reviewed by the EQMS were not adequately identified in the database to assist in validating system reports.

Summary of Recommendations

To help ensure fair and consistent treatment for taxpayers, Examination Division managers need to ensure that examiners follow IRS guidelines which require them to document the reasons for applying or not applying penalties. Additionally, the Examination Division should be required to use IRS locator resources early in the process to locate and contact taxpayers who do not respond to a notice of audit.

Improvements in the EQMS are also needed to help the IRS identify problems that could lead to unfair treatment of taxpayers. The EQMS quality rating criteria should be re-evaluated to ensure that the documentation and application of penalties is given adequate consideration when determining whether cases meet quality standards. Cases should be included for quality review if the tax assessment was made without locating the taxpayer. Finally, to help ensure that EQMS reports to IRS management are reliable, important additional data should be recorded in the EQMS database.

Management's Response: Management's response was due on March 29, 2000. As of May 11, 2000, management had not responded to this draft report.

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Objectives and Scope

This audit determined whether taxpayers' rights and burden were considered in the examination process and whether quality review results were adequately recorded.

This audit was part of our overall review of controls in the Examination Division to help ensure fair and consistent treatment of taxpayers. We evaluated actions examiners took during the examination process that could have added unnecessary burden to taxpayers. In addition, we determined whether the quality review process gave adequate attention to taxpayer burden and rights issues and whether the results of quality reviews were recorded accurately. Other recent reviews have addressed taxpayer rights and burden in the identification, selection, and closing of office and service center audits and in the resolution of unagreed cases.

Fieldwork was performed from December 1, 1998, through July 31, 1999, using a nationwide sample of Internal Revenue Service (IRS) examination cases. We also reviewed the revised national IRS Examination Quality Standards and process. This audit was performed in accordance with *Government Auditing Standards*.

Details of our audit objectives, scope, and methodology are presented in Appendix I. Major contributors to this report are listed in Appendix II.

Background

The objective of the IRS' examination process is to determine whether taxpayers properly reported income and expenses as required by federal tax laws.

The objective of the IRS' examination process is to determine whether taxpayers properly reported income and expenses as required by federal tax laws. The IRS must correctly apply the tax laws while taking steps to minimize the burden that the audit process imposes on taxpayers.

There are several steps involved in the examination process, including:

- Notifying the taxpayer of the tax returns under audit and scheduling an audit appointment.

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- Requesting information to substantiate expenses and deductions on the tax returns.
- Requesting information to determine the extent of the taxpayer's income but only if there are indications of unreported income.
- Assessing or abating taxes depending on the results of the audit.
- Assessing penalties if the IRS determines that the taxes owed were underreported due to taxpayer negligence or intentional disregard of the law.
- Notifying the taxpayer of the audit results.

One of the methods the IRS uses to minimize the burden imposed on taxpayers and to ensure the law is properly applied to each case is the Examination Quality Measurement System (EQMS), which determines the overall quality of examinations.

Results

The IRS needs to take additional steps to ensure taxpayers are treated fairly.

IRS employees appropriately handled most of the cases we reviewed. Most notably, employees properly limited the use of intrusive, indirect methods to verify income. Some examination cases, however, demonstrated inconsistent or unfair treatment of taxpayers in assessing taxes and penalties.

Although controls are in place to verify examination quality, these controls were not always adequate or effective. In addition, we could not validate the reliability of the quality review information used as part of the IRS' Balanced Measurement System. This system is designed to promote fair and consistent treatment of taxpayers by emphasizing quality as an important measure of effectiveness.

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Examiners Used Indirect Methods to Verify Income When Appropriate

Before the Congress passed the IRS Restructuring and Reform Act of 1998 (RRA 98),¹ the Internal Revenue Code did not restrict the IRS from using indirect methods to verify income on any return. Indirect methods often involve evaluating a taxpayer's lifestyle and personal living expenses to identify possible unreported income. Because of the intrusive nature of these audit methods, the RRA 98 limited their use to situations in which the IRS has indications of unreported income.

We reviewed a judgmental sample of 350 audited tax returns to evaluate the use of intrusive audit techniques after July 22, 1998 (the effective date of the RRA 98). We sampled from the following three categories of closed Examination audits:

- Cases in which IRS management information indicated that an indirect method of income probe had been used.
- Cases in which examiners were likely to have used indirect methods because the tax returns showed negative taxable incomes.
- Cases in which examiners were not likely to have used indirect methods because the tax returns showed high taxable incomes.

Overall, indirect audit methods were properly limited to cases in which there were indications of unreported income.

Except for one case in our sample, examiners used indirect methods only when there were indications of unreported income.

¹ Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98), Pub. L. No. 105-206, 112 Stat. 685.

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Examiners Did Not Always Support Their Decisions to Apply Penalties

During FY 1998, the IRS assessed over \$100 million in penalties on over 76,000 individual tax returns for negligence or intentional disregard of rules or regulations.

Examiners did not always document an explanation for asserting or for not asserting a penalty.

During Fiscal Year (FY) 1998, the Examination Division assessed over \$100 million in penalties on over 76,000 individual tax returns for negligence or intentional disregard of rules or regulations. According to IRS guidelines, examiners should make every effort to apply penalties in a fair and consistent manner. Examiners are required to solicit the taxpayer's explanation for errors and omissions and document the reasons for asserting or not asserting penalties in the examination workpapers.

To evaluate whether the IRS properly and consistently applied penalties, we selected a national random sample of 180 closed cases. In 75 (42 percent) of the 180 cases reviewed, examiners did not fully document an explanation for asserting a penalty (40 cases) or not asserting a penalty (35 cases) when the case history indicated that an explanation was necessary.

In many of these cases, penalties did not appear to be consistently applied or considered when the issues, dollar amounts, and tax assessments were similar. For example:

- In 19 cases with additional tax assessments due to inappropriate business deductions, 11 taxpayers (with assessments averaging \$4,800) had a penalty applied and 8 taxpayers (with assessments averaging \$5,600) did not.
- In 15 cases with additional tax assessments due to underreported income, 10 taxpayers (with assessments averaging \$12,100) had a penalty applied and 5 taxpayers (with assessments averaging \$10,300) did not.
- In 13 cases with additional tax assessments due to inappropriately filed exemptions or standard deductions or Earned Income Tax Credit,

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5 taxpayers (with assessments averaging \$2,400) had a penalty applied and 8 taxpayers (with assessments averaging \$2,200) did not.

The Internal Revenue Manual (IRM) is clear that the consideration and application of penalties requires adequate documentation in the case files to support the examiner's conclusion. However, examiners and managers did not always follow this guidance and adequately document the penalties. For the cases in our sample, examiners assessed approximately \$42,000 in penalties that they did not support. Without adequate documentation, there is no assurance that examiners were fair and consistent in their decision to assess or not assess penalties. As noted above, based on the facts and circumstances contained in the case files we reviewed, it appears that penalties were not assessed consistently.

A case can be rated low in the penalty area and still meet the overall quality standard related to the proper application of law.

Additionally, the EQMS method for rating the quality of examination cases may not be adequate to ensure improvement in the area of penalties. While the EQMS does evaluate examination cases for penalty determinations and documentation, a case can be rated low in this area and still meet the overall quality standard related to the proper application of law on each case. The EQMS needs to ensure that the lack of documentation for penalties is properly addressed.

Recommendations

1. The Assistant Commissioner (Examination) should require that group manager reviews include an assessment of penalty documentation and the fairness of penalty assertions.
2. The EQMS Office Director should re-evaluate the EQMS rating criteria to ensure that the application and documentation of penalties is given adequate consideration when determining whether cases meet quality standards.

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Management's Response: Management's response was due on March 29, 2000. As of May 11, 2000, management had not responded to this draft report.

Examiners Did Not Take Sufficient Actions to Locate Taxpayers Before Assessing Additional Taxes

When taxpayers do not respond to an IRS notice of audit, examiners are to take additional steps to locate and contact the taxpayer.

When taxpayers do not respond to an IRS notice of audit, IRS procedures require examiners to make an attempt to contact the taxpayer. If the notice is returned by the Postal Service as undeliverable, the Examination Division is required to use information sources including IRS computer records, case files, United States Postal data, employer data, and telephone directory information to establish contact with the taxpayer.

If examiners are not able to contact or locate a taxpayer, they may still make an assessment of tax and penalties on tax issues that are in question. In these instances, the taxpayer may be assessed additional tax and penalties without knowing about it. This can cause significant burden to the taxpayer and administrative problems for the IRS to resolve issues after tax, penalties, and interest have already been assessed.

In FY 1998, additional taxes were assessed or credits disallowed on 25,700 tax returns in cases where taxpayers did not respond or show up for an audit appointment.

To determine whether the IRS is taking the steps needed to locate taxpayers early in the examination process, we selected and reviewed a random sample of cases closed in FY 1998. In that year, 25,700 tax returns were assessed taxes or disallowed credits in cases where taxpayers did not respond or did not keep their audit appointments. We reviewed 200 of these returns. In 123 of these cases, taxpayers either did not receive the notice or chose not to respond to the notice; in the rest of the cases, taxpayers established contact with the IRS but did not keep their appointments.

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Examiners could have taken additional steps to contact or locate taxpayers before assessing taxes and penalties.

Examiners did not use the resources that were available to locate and contact taxpayers in 112 (91 percent) of 123 cases before assessing taxes. In 92 of the cases, there was no evidence in the case files that an examiner had called the taxpayer to determine why he/she had not responded to the notice of audit. While examiners may not have been able to contact all of these taxpayers, it is likely that additional efforts would have helped contact some. For example, in 44 (39 percent) of 112 cases, we identified addresses or telephone numbers that were more current by using IRS locator services and public Internet resources. The Examination Division assessed \$276,000 in tax, penalties, and interest on these 44 taxpayers. Of the 25,700 tax returns that were assessed taxes or disallowed credits when taxpayers did not respond or did not keep their audit appointments, we estimate that using available IRS resources would have helped locate taxpayers in approximately 5,600 cases before taxes were assessed.

The practice of assessing tax without taking adequate steps to locate taxpayers adds burden to taxpayers. Taxpayers may have to request an audit reconsideration so that they can present information for the examiner to consider or take additional steps to resolve the case through the IRS problem resolution program. Both require significant taxpayer time and increased administrative costs for the IRS.

The Examination Division procedures do not require examiners to consistently use all relevant IRS resources to locate taxpayers before proposing additional taxes. In addition, the EQMS does not review these types of cases because many of the quality standards do not apply when taxpayers fail to respond or provide requested tax information. However, since these assessments are made without the taxpayers' knowledge, the EQMS should review them to determine whether adequate steps were taken to locate the taxpayer.

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Examination procedures should require examiners to use IRS resources to locate and contact taxpayers early in the examination process.

Recommendations

3. The Assistant Commissioner (Examination) should require examiners or support personnel to use IRS locator services and the Internet early in the examination process to locate and contact taxpayers who do not respond to the notice of audit. These steps should be taken before examiners propose audit assessments. In addition, the steps taken to locate and contact taxpayers should be documented in the case file.
4. The EQMS Office Director should periodically assess whether examiners are taking the necessary actions to contact taxpayers. This could be accomplished by annually reviewing a national sample of cases in which taxpayers have not responded to a notice of audit.

Examiners Need to Ensure Adjustments Are Carried Forward to Subsequent Tax Years When the Adjustments Would Result in Lower Tax

When adjustments affect returns filed for other years open under the statute of limitations, the IRM requires examiners to ensure appropriate adjustments are made for those years. These adjustments can be necessary when timing issues are present, such as depreciation, capital loss carry-forwards, and passive activity carry-forwards. In a limited number of cases, examiners did not make adjustments to subsequent years that would have resulted in lower tax. As a result, taxpayers had to file amended tax returns to obtain refunds.

In a small number of cases, taxpayers had to file amended returns because examiners did not carry adjustments over to the subsequent year.

From cases closed in FY 1998, we identified 962 in which taxpayers filed an amended tax return for the subsequent year. We selected a random sample of 194 of these cases to review.

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Of this sample, 58 (30 percent) of the amended returns were necessary because the examiner did not make the proper adjustments to all affected tax years. The 58 cases had tax assessments totaling \$346,000 for the tax years audited. Amended tax returns filed for the subsequent tax years resulted in a total of \$226,000 in refunds or abatements. Based on this sample, we estimate that nationwide, approximately 290 taxpayers had to file amended tax returns because all of the affected tax years were not properly addressed by examiners. However, the limited number of taxpayers affected indicates that this is not a pervasive problem for the IRS.

The Examination Quality Measurement System Needs Improvement to Ensure It Provides Reliable Data to Management

The EQMS performs analysis on a statistical sample of cases to provide management information on certain characteristics of all closed examination cases.

The EQMS is an important control the IRS uses to help ensure examinations are performed according to standards. The EQMS performs analysis on a statistical sample of cases to provide management information on certain characteristics of all closed examination cases. This management information is an essential element in compiling the IRS' balanced measures.

The IRS is currently reorganizing its EQMS to emphasize new quality review standards that address customer relations, professionalism, communication, the reduction of taxpayer burden, and the protection of taxpayer rights. The quality measures reported by the EQMS are an important component of the new IRS Balanced Measurement System. This system is designed to promote fair and consistent treatment of taxpayers by emphasizing quality as an important measure of effectiveness.

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Inconsistent interpretation or application of quality standards reduces the reliability of information provided to IRS management through EQMS reports.

Because EQMS data are used in compiling the IRS' balanced measures, the data captured and provided to IRS management must be reliable. IRS managers and EQMS officials have expressed concerns that EQMS review results are inconsistent among different reviewers and different review locations. Inconsistent interpretation or application of quality standards reduces the reliability of information provided to IRS management through EQMS reports.

Because the EQMS database still does not identify which cases have been reviewed, we were not able to evaluate the reliability of EQMS reports.

EQMS officials have made attempts to ensure consistency through training and discussions within EQMS groups. However, the EQMS database still does not have enough data to identify which cases have been reviewed. Because of this, we were not able to evaluate the reliability of EQMS reports.

Recommendation

5. The EQMS Office Director should update the EQMS database to include necessary information to identify which cases have been reviewed, and implement a review process to ensure consistency and reliability of EQMS reports.

Conclusion

Except for one case in our sample, examiners used indirect methods only when there were indications of unreported income. However, the IRS can take further action to improve its treatment of taxpayers during the examination process. Examiners did not document and assess penalties consistently, nor did they take adequate steps to locate taxpayers before assessing tax.

Although controls are in place to verify examination quality, these controls were not always adequate or effective. The Examination Division should ensure that the EQMS provides reliable information for its Balanced Measurement System. This will help to ensure fair and consistent treatment of taxpayers.

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Appendix I

Detailed Objectives, Scope, and Methodology

This audit was part of our overall review of controls in the Examination Division to help ensure fair and consistent treatment of taxpayers. We evaluated actions examiners took during the examination process that could have added unnecessary burden to taxpayers. In addition, we determined whether the quality review process gave adequate attention to taxpayer burden and rights issues and whether the results of quality reviews were recorded accurately. To meet these objectives, we performed the following tests:

- I. Determined whether revenue agents and tax auditors used intrusive, indirect audit methods to probe for unreported income only when there was an indication of unreported income.
 - A. Reviewed the current laws, procedures, and guidelines on the use of intrusive, indirect audit methods.
 - B. Obtained a download of the November 30, 1998, Examination Operational Automated Database (EOAD) and reviewed indirect techniques used in samples of field and office audit examination cases that were closed after July 22, 1998. The following categories of judgmental samples were selected from the EOAD:
 - Cases in which Internal Revenue Service (IRS) management information indicated that an indirect method of income probe had been used (97 cases reviewed).
 - Cases in which examiners were not likely to have used indirect methods because the tax returns showed high taxable incomes (161 cases reviewed).
 - Cases in which examiners were not likely to have used indirect methods because the tax returns showed negative taxable incomes (92 cases reviewed).
- II. Determined if IRS examiners properly considered, documented, and assessed penalties when auditing individual taxpayers.
 - A. Reviewed the IRS guidelines to determine the procedures and guidance for documenting and assessing penalties.
 - B. Determined the population of cases in which examiners assessed taxes and penalties on individual taxpayers. These cases were identified from the

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Fiscal Year (FY) 1998 Audit Information Management System (AIMS). A total of 76,378 tax returns met the above criteria.

- C. Analyzed a random sample of 180 cases nationwide to determine if the examiners properly considered, documented, and assessed accuracy-related penalties.
- III. Determined if IRS examiners were taking adequate steps to locate or contact taxpayers who did not respond to notices before assessing taxes and penalties.
- A. Reviewed the IRS guidelines (Internal Revenue Manual (IRM) and Examiners Officers Guide (EOG)) for procedures which define examiners' responsibility to locate taxpayers who do not respond to a notice of audit.
 - B. Determined the population of cases closed as "no show or no response" in which examiners assessed taxes or disallowed credits. These cases were identified from the FY 1998 AIMS database. A total of 25,700 tax returns met the above criteria. We selected a statistical sample of 200 cases to review.
 - C. For the 123 cases in our sample in which taxpayers did not respond to the IRS notice of audit, we determined whether examiners took the steps outlined in the IRS guidelines to locate the taxpayers.
 - D. Determined whether IRS employees could have identified better addresses to locate or contact taxpayers by requesting locator services and/or researching Internet address sites for the 123 cases.
- IV. Determined whether examiners correctly assessed and adjusted subsequent year tax returns when timing issues were present, such as depreciation, capital loss carry-forwards, and passive activity carry-forwards.
- A. Reviewed the IRS guidelines (the IRM, EOG, and Examination Quality Measurement Standards) for procedures which define examiners' responsibilities during audits to address issues which favorably affect taxpayers' subsequent year tax returns.
 - B. Determined the population of cases in which taxpayers filed a claim for refund for a subsequent year after an audit had been performed. These cases were identified from the FY 1998 AIMS closed case database and the FY 1998 Masterfile. We included only agreed cases and cases in which there were no changes in the tax liability; we did not include cases with missing or delinquent returns. A total population of 962 returns met the above criteria. A random statistical sample of 194 returns was selected for review using a 90 percent confidence level, 3 percent precision, and anticipated error rate of 10 percent.

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- C. Reviewed the sample of 194 returns (82 Revenue Agent and 112 Tax Auditor cases) to determine if examiners were expanding the scope of their audit to subsequent years to address timing issues in the favor of the taxpayer.

- V. Determined whether revised the Examination Quality Measurement System (EQMS) procedures would identify case problems that were not consistent with taxpayer rights or would cause undue burden.
 - A. Obtained and reviewed the most current revised EQMS process, standards, input sheets, reviewer guidelines, and measures to determine:
 - Whether cases would pass the overall standard related to the proper application of tax law if penalties were not properly considered, documented, and assessed.
 - Whether reviews were performed on cases in which the IRS was unable to contact the taxpayer but still assessed additional taxes.

 - B. Contacted National Office, regional, and district EQMS officials involved in the process to revise and administrate the EQMS standards and process to determine what steps were in place to ensure that EQMS reports provide accurate data to IRS managers.

Major Contributors to This Report

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Appendix III

Report Distribution List

Deputy Commissioner Operations C:DO
Commissioner, Large and Mid-Size Business Division LM
Commissioner, Small Business/Self-Employed Division S
Chief Operations Officer OP
Assistant Commissioner (Examination) OP:EX
Director, Office of Program Evaluation and Risk Analysis M:O
National Director, Compliance Specialization OP:EX:CS
Examination Quality Measurement System Office Director OP:EX:CS:Q
National Director for Legislative Affairs CL:LA
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Office of the Chief Counsel CC
Audit Liaisons:
 Deputy Commissioner Operations C:DO
 Chief Operations Officer OP
 Assistant Commissioner (Examination) OP:EX

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Appendix IV

Outcome Measures

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

Finding and recommendation:

Examiners did not properly document the reasons used to determine whether to apply penalties. We recommended that the Examination Division require group managers to review penalty determinations during workload reviews. We also recommended that the Examination Quality Measurement System (EQMS) Office Director re-evaluate the EQMS rating criteria to ensure that the application and documentation of penalties is given adequate consideration when determining whether cases meet overall quality standards. (See page 4 for details.)

Type of Outcome Measures:

Taxpayer rights and entitlements

Value of the Benefit:

The Internal Revenue Service (IRS) assessed penalties on over 76,000 individual tax returns related to accuracy during Fiscal Year (FY) 1998. In 75 (42 percent) of the 180 cases reviewed, examiners did not fully document an explanation for asserting a penalty (40 cases) or not asserting a penalty (35 cases) when the case history indicated that an explanation was necessary. For the cases in our sample, examiners assessed approximately \$42,000 in penalties that they did not support. Properly considering, documenting, and assessing penalties will help ensure that the taxpayers who are assessed penalties are treated fairly.

Methodology Used to Measure the Reported Benefit:

The approximately 76,000 individual tax returns with penalties assessed during FY 1998 were identified from the IRS closed examination case Audit Information Management System (AIMS) database for FY 1998.

Finding and recommendation:

IRS examiners did not use IRS resources to locate taxpayers before assessing additional taxes and penalties. We recommended that the IRS update examination procedures to require the Examination Division to use IRS resources (including IRS locator services and the Internet) early in the examination process to locate and contact taxpayers who do not respond to a notice of audit. We also recommended that the IRS include cases for

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EQMS review in which taxpayers have not responded to a notice of audit. (See page 6 for details.)

Type of Outcome Measure:

Taxpayer burden

Value of the Benefit:

Taking additional steps to locate taxpayers will help IRS examiners locate taxpayers in an estimated 5,600 additional cases so that they will not be assessed taxes or disallowed credits and penalties without being contacted. This will help avoid the need for taxpayers to take additional steps to have the taxes corrected. It will also help ensure that assessments shown on IRS information systems are correct.

Methodology Used to Measure the Reported Benefit:

Based on an analysis of the AIMS database, there were approximately 25,700 tax returns in which taxpayers were assessed additional taxes or disallowed credits where the taxpayer did not respond or did not keep their audit appointments. Based on the ratio in our sample (112 out of 200, or 56 percent), additional steps could have been taken to locate the taxpayers in approximately 14,400 of these cases. In 44 (39 percent) out of 112 cases, we were able to find a more current address using IRS locator services or public resources on the Internet. We used this ratio to estimate that in approximately 5,600 cases, taking additional steps would have helped the IRS locate these taxpayers before tax was assessed. The sample consisted only of cases that were assessed penalties in addition to tax; therefore, this estimate relies on the assumption that examiners' efforts to locate taxpayers are not correlated with whether penalties were assessed.

Finding and recommendation:

The EQMS needs improvement to ensure it provides reliable data to management. We recommended that the IRS update the EQMS database to include necessary information to identify which cases have been reviewed, and implement a review process to ensure consistency and reliability of EQMS reports. (See page 9 for details.)

Type of Outcome Measure:

Reliability of information

Value of the Benefit:

The EQMS is tasked with providing a statistical measure of quality for approximately 550,000 examined tax returns annually. Recording the information needed for EQMS reports to be validated and taking steps to ensure consistency and reliability will help ensure that the quality measures for these tax returns are accurate. This is important if the IRS is to effectively implement its Balanced Measurement System in the Examination

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Division. This system is designed to promote fair and consistent treatment of taxpayers by emphasizing quality as an important measure of effectiveness.

Methodology Used to Measure the Reported Benefit:

The 550,000 tax returns examined annually for individual taxpayers were identified from the AIMS database. The AIMS database provides quantitative data on these examinations. The EQMS provides a statistical measure of the quality of these examinations.