
TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION



***Opportunities Exist to Improve the
Correspondence Examination Process for
High-Income Nonfilers***

September 16, 2008

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TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

September 16, 2008

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/
SELF-EMPLOYED DIVISION

Michael R. Phillips
FROM: Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Opportunities Exist to Improve the
Correspondence Examination Process for High-Income Nonfilers
(Audit # 200630031)

This report presents the results of our review to evaluate examination cases closed with no taxpayer response. The overall objective of this review was to determine whether the Internal Revenue Service (IRS) can improve its processes to minimize the large number of cases closed with assessments for which taxpayers were not responsive to IRS contact letters. We conducted this review as part of our planned Fiscal Year (FY) 2007 audit coverage.

Impact on the Taxpayer

The IRS identifies billions of dollars in additional taxes owed from examinations of high-income nonfilers in which it estimates the taxes owed and prepares "substitute" returns after not receiving a response to contact letters. While billions of dollars are assessed, the amount ultimately collected is considerably lower [REDACTED]

[REDACTED] Ensuring that these delinquent returns receive greater scrutiny might discourage those who believe that they can avoid paying taxes and not get caught by [REDACTED]

Synopsis

Correspondence examination assessments are substantial, and those involving individuals with incomes of \$100,000 or more (high-income taxpayers) are increasing. A significant number of assessments from high-income taxpayers involve nonfiling situations in which the IRS estimates the taxes owed and prepares "substitute" returns after not receiving a response to contact letters.

[REDACTED]



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While billions of dollars in assessments are generated from high-income substitute for return (SFR) examinations, (b)(7)(E)

We previously reported¹ working with IRS data to estimate a collection rate and found a 14 percent collection rate based on a statistically valid sample of SFR assessments involving high-income individuals. Admittedly, we do not know how much should be collected from these examinations. However, we do know that collecting 14 cents out of every dollar suggests that there are opportunities for improvement.

One improvement opportunity that needs exploration, at least on a test basis, involves using locator services to ensure that contact letters are sent to the most current addresses available for taxpayers. Locator services are made available commercially by credit bureaus and are routinely used and relied upon by the IRS to locate taxpayers and their assets once taxes are assessed and collection actions are started. We compared the addresses listed in a locator service for SFR assessments from a sample of 97 high-income taxpayers to those on IRS contact letters and on the IRS Master File.² Although all addresses listed on the contact letters matched those on the IRS Master File, we identified more current addresses for 32 (33 percent) of the 97 cases.

The majority (27) of the 32 taxpayers requested and worked with the IRS in reconsidering the SFR assessments after IRS collection actions had started. We recognize that some individuals might never respond to IRS contact letters. In these cases, the IRS has no option other than assessing taxes based on the information it has available so collection actions can begin. However, we found that a better address was available from a locator service in 18 cases for which the initial contact letters were returned to the IRS by the United States Postal Service as undeliverable. Using a locator service in these instances to find better addresses might be a more cost-effective alternative to reworking examinations long after the SFRs are prepared and the taxes are assessed. Also, using a locator service to find better addresses when initial contact letters are returned as undeliverable might reduce the number of examinations closed with no response.

The second improvement opportunity involves more closely scrutinizing the delinquent returns submitted by high-income nonfilers after the SFRs are prepared and the taxes are assessed. As shown in our SFR case reviews, more than one-half of the high-income nonfilers (53 of 97) who did not respond during the original correspondence examinations later submitted delinquent returns (b)(7)(E) on the 53 returns. Although IRS procedures require delinquent returns to be manually screened for indications of noncompliance, we noted significant compliance issues on 4 of the 53 delinquent returns we

¹ *While Examinations of High-Income Taxpayers Have Increased, the Impact on Compliance May Be Limited* (Reference Number 2006-30-105, dated July 25, 2006).

² The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.



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reviewed. For the most part, the issues were complex enough to warrant face-to-face examinations.

(b)(3), 26 U.S.C. 6103, (b)(7)(C)

Because personal living expenses, such as food and clothing, are not reported on tax returns, the gap between expenditures and income is likely much greater than that reflected on the delinquent tax return.

(b)(3), 26 U.S.C. 6103, (b)(7)(C)

Given the significant amount of abatements associated with the relatively small number of high-income nonfilers, we believe that all the delinquent returns they submit to have SFR assessments abated need to be referred to experienced examiners in an IRS field office.

Recommendations

We recommended that the Director, Campus Compliance Services, Small Business/Self-Employed Division, determine the costs and benefits of using locator services to find better addresses when initial contact letters involving high-income taxpayers are returned as undeliverable. We also recommended that the Director, Campus Compliance Services, work with the Director, Examination, Small Business/Self-Employed Division, in revising the IRS field office selection criteria for the high-income nonfiler cases to better ensure that appropriate delinquent returns submitted by high-income nonfilers in response to SFR assessments are considered for face-to-face examinations.

Response

IRS officials agreed with the recommendations and provided corrective actions to address them. The Director, Campus Compliance Services, will ensure that a cost-benefit analysis of using locator services to find current addresses for undeliverable letters on cases involving high-income taxpayers is performed. The Director, Campus Compliance Services, and the Director, Examination, will review the return selection process and revise the criteria as necessary. In addition, the Director, Campus Compliance Services, will prepare a memorandum to examiners that reinforces the criteria and procedures for referring cases to classification. The Director, Examination, will issue a reminder regarding when it is appropriate to survey high-income nonfiler delinquent returns selected for examination. Management's complete response to the draft report is included as Appendix VII.



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The Treasury Inspector General for Tax Administration has designated this audit report as Sensitive But Unclassified pursuant to Chapter III, Section 23 of the Treasury Security Manual (TD P 71-15) entitled, "Sensitive But Unclassified Information." Because this document has been designated as Sensitive But Unclassified, it may be made available only to those officials who have a need to know the information contained within this report in the performance of their official duties. This report must be safeguarded and protected from unauthorized disclosure; therefore, all requests for disclosure of this report must be referred to the Disclosure Branch within the Treasury Inspector General for Tax Administration Office of Chief Counsel.

Copies of this report are also being sent to the IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Margaret E. Begg, Acting Assistant Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-8510.

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Abbreviations

FY	Fiscal Year
IRS	Internal Revenue Service
SFR	Substitute for Return

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Opportunities Exist to Improve the Correspondence Examination Process for High-Income Nonfilers

Background

Each year, the Internal Revenue Service (IRS) identifies billions of dollars in additional income taxes owed through examinations of individual income tax returns. Such examinations, which occur in a variety of forms, are critical to the IRS' enforcement strategy for ensuring that individuals are paying the amount of taxes owed.

Examinations identify billions of dollars in additional income taxes and are critical to the IRS' strategy for ensuring that individuals are paying the amount of taxes owed.

Examinations of individual income tax returns range from reviewing tax returns and resolving questionable items by corresponding with taxpayers through the mail to conducting a detailed, face-to-face examination of a taxpayer's financial records at his or her place of business. In contrast to the more labor-intensive face-to-face examination process, the correspondence examination process is less intrusive, more automated, and conducted by examiners who are trained to deal with and focus on less complex tax issues. Correspondence examinations also enable the IRS to reach more taxpayers at a lower cost.

Typically, a correspondence examination begins with the IRS mailing to a taxpayer a computer-generated letter that outlines the examination process, identifies one or more items on the tax return being questioned, and requests support information to resolve the questionable item(s). Once information is returned, an examiner reviews it to determine whether it resolves the questions. If the questions can be answered by the information provided, the examination is closed without any tax changes—if not, the taxpayer is sent a letter requesting more information or indicating a recommended tax change. At this point, the taxpayer can agree with the examiner, provide the examiner with clarifying information, or appeal the decision to the IRS Office of Appeals. When the taxpayer does not respond to IRS letters, the examiner's recommended tax changes are assessed by default, and the taxpayer will generally have to petition the court system to contest the assessment.

This review was performed in the Small Business/Self-Employed Division in the Office of Examination Planning and Delivery and the Campus Compliance Services function in New Carrollton, Maryland, during the period September 2006 through May 2008. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.



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Results of Review

Correspondence examination assessments are substantial, and the contributions the examinations are making to the IRS' compliance efforts will likely continue in the future. However, despite the billions of dollars in assessments generated, correspondence examinations of high-income nonfilers ultimately result in few dollars collected.

The Recommended Additional Taxes From Correspondence Examinations Are Substantial

IRS statistics show that in Fiscal Years (FY) 2003 through 2007, the IRS conducted more than 4.7 million correspondence examinations that recommended approximately \$31 billion in additional taxes. This represents about 62 percent of the estimated \$50 billion in total recommended additional taxes from all examinations of individuals during these years. It also indicates that for each tax return examined, a correspondence examination generated about \$6,600 in recommended additional taxes.

Considering the seemingly high return from the correspondence examination process, it is not too surprising that the number of examinations conducted through correspondence is increasing. As outlined in Figure 1, the number of individual tax returns examined through correspondence increased from 675,637 in FY 2003 to more than 1.1 million in FY 2007 and accounted for the vast majority of individual tax returns examined in each of these years. Appendix V contains additional details about individual examinations for FYs 2003 through 2007.



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Figure 1: Examination Results (FYs 2003-2007)

	2003	2004	2005	2006	2007
Total Examinations	849,296	997,028	1,199,035	1,283,980	1,384,559
Correspondence Examinations	675,637	828,262	1,007,891	1,055,979	1,144,596
Percentage of Total Examinations	80%	83%	84%	82%	83%
Total Assessments	\$4,120,354,090	\$5,660,770,866	\$12,951,625,344	\$12,268,355,545	\$15,017,420,642
Correspondence Examination Assessments	\$2,281,589,175	\$3,638,885,207	\$7,504,412,199	\$7,874,122,225	\$9,620,959,829
Percentage of Total Assessments	55%	64%	58%	64%	64%

Source: Our analysis of the IRS Audit Information Management System¹ closed case data for FYs 2003-2007.

Besides the additional taxes assessed, there are other important reasons why the correspondence examination process will likely continue to have a large compliance role in the future. Most importantly, perhaps, is its contribution toward reducing the tax gap.² Estimated to be costing the Federal Government \$345 billion annually, the tax gap is considered by many to be one of the most serious problems facing tax administration today, and the correspondence examination process is one technique the IRS uses to help remedy the noncompliance that contributes to it.

The number of correspondence examinations will likely continue to increase also because of the focus that the IRS has placed on reversing many of the downward trends in its compliance activities. We noted in our 2007 report³ issued to the IRS Oversight Board⁴ that the overall percentage of tax returns examined (including face-to-face and correspondence examinations) had increased 84 percent since FY 2000, with the largest increase occurring in examinations of individual tax returns reporting income of \$100,000 or more (high-income taxpayers). Figure 2 shows the substantial increase in the number of high-income individual examinations in FY 2006 compared to that in FY 2000. It also shows that tax returns of high-income individuals were much more likely to be examined in FY 2006 than were tax returns of individuals reporting less than \$100,000 of income.

¹ The Audit Information Management System is a computer system used to control tax returns during examinations, input assessments and adjustments to taxpayer accounts, and provide management reports.

² The difference between taxes that are legally owed and taxes that are paid on time.

³ *Trends in Compliance Activities Through Fiscal Year 2006* (Reference Number 2007-30-056, dated March 27, 2007).

⁴ The organization responsible for oversight of the IRS in its administration, management, conduct, direction, and supervision of the execution and application of the internal revenue laws.



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Figure 2: Comparison of Examination Rates for Individual Tax Returns by Income Levels for FYs 2000 and 2006

Fiscal Year	Individual Tax Returns Reporting Income of Less Than \$100,000		Individual Tax Returns Reporting Income of \$100,000 or More	
	Returns Examined	Examination Rate	Returns Examined	Examination Rate
2006	1,035,830	1 of 114 returns filed	257,851	1 of 60 returns filed
2000	518,218	1 of 221 returns filed	99,547	1 of 104 returns filed

Source: IRS Enforcement and Service Statistics and Examination Table 37.

Of the \$8.1 billion in assessments associated with the 257,851 individual high-income returns examined in FY 2006, a significant number (22 percent) involved a nonfiling situation in which the IRS estimated the taxes owed from available information and prepared a “substitute” return after the individual did not respond to IRS contact letters. While the preparation of a substitute for return (SFR) can generate a large assessment, the amount ultimately collected is usually considerably lower because (b)(7)(E)

We previously reported⁵ working with IRS data to estimate a collection rate and found a 14 percent collection rate based on a statistically valid sample of SFR assessments involving high-income individuals. Admittedly, we do not know how much should be collected from these examinations. However, we do know that the number of high-income SFR examinations is trending up, and collecting 14 cents out of every dollar from these examinations suggests that there are opportunities for improvement.

Few Taxes Are Collected From Correspondence Examinations Involving High-Income Nonfilers

In FYs 2003 through 2007, the IRS assessed about \$15 billion during 245,879 SFR correspondence examinations involving high-income taxpayers. As shown in Figure 3, the numbers of and assessments from such examinations are increasing. To identify factors affecting the number of high-income nonfilers who are not responding to IRS contact letters as well as potential improvement opportunities, we analyzed the tax accounts and case files associated with 97 examinations⁶ included in the Figure 3 statistics for FYs 2005 and 2006.

⁵ While Examinations of High-Income Taxpayers Have Increased, the Impact on Compliance May Be Limited (Reference Number 2006-30-105, dated July 25, 2006).

⁶ Appendix IV provides additional details about the 97 cases included in our sample.



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Figure 3: Correspondence Examination Assessments Involving High-Income Taxpayers (FYs 2003-2007)

All Correspondence Examinations of High-Income Taxpayers Except Those Involving an SFR			Correspondence Examinations of High-Income Taxpayers Involving an SFR	
Fiscal Year	Returns Examined	Assessments	Returns Examined	Assessments
2007	91,717	\$410,357,150	70,668	\$5,536,668,297
2006	104,646	\$576,901,052	56,456	\$4,020,353,365
2005	103,461	\$615,390,721	43,920	\$3,714,657,290
2004	69,898	\$367,036,784	58,722	\$1,478,917,679
2003	61,521	\$350,076,878	16,113	\$399,504,113
Totals	431,243	\$2,319,762,585	245,879	\$15,150,100,744

Source: Our analysis of the Audit Information Management System closed case data for FYs 2003-2007.

Our analysis of information in the 97 tax accounts found that \$696 million (80 percent) of the original \$873 million initially assessed was subsequently abated. After subtraction of another \$73 million (8 percent) that the IRS determined was not collectible, about \$104 million (12 percent) of the assessments might eventually generate tax collections. Because we did not use a statistical sampling technique, our results might not be representative of the total population of SFR correspondence examinations of high-income nonfilers. However, the 12 percent of assessments that might be collected is very close to the statistically valid 14 percent collection rate discussed previously.

In evaluating the 97 closed SFR correspondence examination case files, we found documentation indicating that the IRS forwarded to the taxpayers contact letters that informed them of their rights, including their rights to 1) know why the IRS is asking for the information and 2) authorize another person to represent them. We also found that all contact letters were sent to the taxpayers' addresses listed in the IRS Master File.⁷

While many aspects of the correspondence examination process were closely followed, we identified two areas that we believe the IRS needs to explore as potential improvement opportunities. The first area to explore, at least on a test basis, involves using locator services to ensure that contact letters are sent to the most current addresses available for taxpayers. The second area involves more closely scrutinizing the delinquent returns submitted by high-income nonfilers after the SFRs are prepared and the taxes are assessed.

⁷ The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.



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Locator services could be used to find current addresses during correspondence examinations

We believe that it is reasonable to assume that one technique taxpayers use to avoid meeting their Federal tax obligations is to change residences and not leave forwarding addresses. However, if they are using credit to make purchases, their personal information is recorded, maintained, and made available commercially by credit bureaus through locator services. Unlike the IRS Master File on which taxpayer addresses are not always current, the addresses in locator services are constantly updated. As a result, locator services are an important component of the IRS collection process and are routinely used and relied upon to find taxpayers and their assets in collecting delinquent taxes owed.

For our 97 sample cases, we compared the addresses listed in a locator service to those on the IRS contact letters and on the Master File. Although all addresses listed on the contact letters matched those on the Master File, we identified more current addresses for 32 (33 percent) of the sample cases. The majority (27) of the 32 taxpayers requested and worked with the IRS in reconsidering the SFR assessments after the examinations were over and IRS collection actions had started. As result, both the IRS and taxpayers spent additional time reworking the tax issues supporting the SFR assessments.

We recognize that some individuals might never respond to IRS contact letters. For example, taxpayers never responded in 14 of the 32 cases for which we identified more current addresses. In these cases, the IRS has no option other than assessing taxes based on the information it has available so collection actions can begin. However, we found that a better address was available from a locator service in 18 cases for which the initial contact letters sent to the taxpayers were subsequently returned to the IRS by the United States Postal Service as undeliverable. In these instances, using a locator service to find better addresses in the early stages of the examinations might be a more cost-effective alternative to reworking examinations long after the SFRs are prepared and the taxes are assessed.

Also, using a locator service to find better addresses when initial contact letters are returned as undeliverable might reduce the number of examinations closed with no response. We were unable to determine precisely what potential impact this could have on the number of examinations closed with no response after letters were returned as undeliverable because of data reliability problems with the codes used by the IRS to track examinations closed with no response.⁸

⁸ Appendix VI provides additional details on the data reliability problems with the codes used by the IRS to track examinations closed with no response.



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Delinquent returns from high-income nonfilers need greater scrutiny

Under the tax law, the IRS, at its discretion, may abate part or all of tax, interest, and penalty assessments in a variety of situations to promote compliance and tax system fairness. For example, the IRS may abate tax assessments caused by a tax return preparation error, such as when a taxpayer claims on an amended return an additional deduction that was overlooked when the original return was filed. The IRS also abates SFR examination assessments when taxpayers provide information that was not considered during the original examination.

As shown in our SFR case reviews, more than one-half (53 of 97) of the high-income nonfilers who did not respond during the original correspondence examinations later submitted delinquent returns that the IRS used to abate all of the \$696 million assessed on the 53 returns. Because the delinquent returns filed in these situations bypass routine, automated compliance checks, such as the IRS' computerized scoring system and information document matching routines, they are manually screened by examiners in an IRS campus for indications of noncompliance. According to IRS procedures, if indications of noncompliance are identified during screening, the returns should be referred for examination.

The decision to refer a return for an examination, as well as determining whether it warrants a face-to-face examination by an experienced examiner in an IRS field office, is ultimately based on the judgment of the examiner⁹ screening the return. As a result, this process is more subjective than the one the IRS uses to identify and select for examination those individual tax returns that were filed on time and might be providing high-income nonfilers with a way to significantly understate their tax liabilities and avoid examinations.

Although we reviewed only 4 of the 53 delinquent returns filed by the high-income nonfilers included in the SFR case files obtained from the IRS closed examination case files,¹⁰ we noted significant compliance issues on all 4 delinquent returns. For the most part, the issues were complex enough to warrant face-to-face examinations.

(b)(3):26 U.S.C. 6103,(b)(7)(C)

Because personal living expenses, such as food and clothing, are not reported on tax returns, the gap between expenditures and income is likely much greater than that reflected on the delinquent tax return.

(b)(3):26 U.S.C. 6103,(b)(7)(C)

⁹ Examiners who screen returns to determine the type and scope of the examination are referred to as classifiers by the IRS.

¹⁰ We reviewed only 4 of the 53 delinquent returns because these were received when we requested the case files for the original SFR assessments. We did not attempt to obtain all 53 delinquent returns.



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(b)(3)-26 U.S.C. 6103,(b)(7)(C)

While we reviewed only 4 of the 53 delinquent returns used to abate \$109 million of the \$696 million abated SFR assessments in our sample cases, the remaining cases likely contain similar issues because the information used to prepare the other 49 SFRs involved millions of dollars in securities transactions, significant amounts of self-employment income, and interests in various partnerships. In addition, we found no evidence that any of the delinquent returns submitted after the SFR assessments had been made were referred to an IRS field office for additional screening and, if needed, face-to-face examinations.

Given the significant amount of abatements associated with this relatively small number of high-income nonfilers, we believe that all the delinquent returns they submit to have SFR assessments abated need to be referred to experienced examiners in an IRS field office. At a minimum, this would better ensure that the compliance risk they pose receives a greater level of scrutiny and might discourage those who believe that they can avoid paying taxes and not get caught by filing delinquent returns to have SFR assessments abated.

Recommendations

The Director, Campus Compliance Services, Small Business/Self-Employed Division, should:

Recommendation 1: Determine the costs and benefits of using locator services to find better addresses when initial contact letters involving high-income taxpayers are returned as undeliverable.

Management's Response: IRS management agreed with this recommendation. The Director, Campus Compliance Services, Small Business/Self-Employed Division, will ensure that information is gathered—including benefits, direct costs, and indirect costs—from Compliance functions that are currently using locator services and prepare a cost-benefit analysis. Appropriate actions will be taken based upon a review of the cost-benefit analysis.

Recommendation 2: Work with the Director, Examination, in revising the IRS field office selection criteria for the high-income nonfiler cases to better ensure that appropriate delinquent returns submitted by high-income nonfilers in response to SFR assessments are considered for face-to-face examinations.

Management's Response: IRS management agreed with this recommendation. The Director, Campus Compliance Services, Small Business/Self-Employed Division, and the



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Director, Examination, Small Business/Self-Employed Division, will continue to review the return selection process and revise the criteria as necessary. The Director, Campus Compliance Services, Small Business/Self-Employed Division, will also prepare a memorandum to examiners reinforcing the criteria and procedures for referring cases to classification. The Director, Examination, Small Business/Self-Employed Division, will issue a reminder regarding when it is appropriate to survey high-income nonfiler delinquent returns selected for examination.

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Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine whether the IRS can improve its processes to minimize the large number of cases closed with assessments for which taxpayers were not responsive to IRS contacts. To accomplish this objective, we:

- I. Determined whether controls were in place to ensure that taxpayers are locatable both prior to initiation of an examination and prior to assessment of tax when there is no response to contact letters.
 - A. Interviewed IRS management and analysts to determine whether an effective process exists to ensure a consistent approach for contacting or locating taxpayers.
 - B. Researched IRS policies and procedures for locating and contacting taxpayers.
 - C. Reviewed the results of operational reviews of closed cases for returns closed with no response from the taxpayers or as undeliverable mail.
- II. Performed a trend analysis of individual tax return examination cases closed with no response from the taxpayers using IRS closed case data¹ for FYs 2003 through 2007. We established the reliability of the closed case data by comparing the number of returns examined and the examination amounts to enforcement and service statistics reported by the IRS.
- III. Selected a random sample of 97 individual tax return examination cases² closed as no response from the taxpayers with assessments of [REDACTED] or more from a population of 5,626 cases closed between April 1, 2005, and March 31, 2006. We established the reliability of the sampled case data received by verifying the data against amounts on the Integrated Data Retrieval System³ and to the actual examination reports in the case files. We reviewed the sampled cases and determined whether they were processed in accordance with established procedures.
 - A. Identified IRS attempts to locate the taxpayers before examinations were initiated and subsequent to receiving no response to the examinations' results.

(b)(3);26 U.S.C. 6103,(b)(7)(E)

¹ The IRS data were from the Automated Information Management System, which is a computer system used to control tax returns during examinations, input assessments and adjustments to taxpayer accounts, and provide management reports.

² We used a random sample because no statistical projections were being made.

³ This is an IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer's account records.



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- B. Attempted to locate a more recent address for each taxpayer using the resources listed in the case file and other means.
 - C. Researched the Integrated Data Retrieval System to identify taxpayer address information and to determine the prior collection history and current collection status of the account.
 - D. Determined whether the case file indicated an incorrect address or undeliverable mail and whether there were any attempts to locate the taxpayer through third parties.
- IV. Evaluated examination assessments for which the taxpayer 1) did not respond to a request for a correspondence audit or 2) did not show up for an appointment and did not respond to the statutory notice of deficiency, then subsequently requested audit reconsideration after the assessment.
- A. Reviewed the criteria for audit reconsideration and determined the rate of audit reconsideration for the returns sampled in Step III.
 - B. Selected all reconsideration cases from the sampled returns, reviewed the case documentation, and determined 1) what in the initial audit process made each case a no-response case, 2) what occurred that made this previously non-responsive taxpayer contact the IRS, and 3) whether the IRS could have done something different to locate the taxpayer and receive a response when the initial examination took place.



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Appendix II

Major Contributors to This Report

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Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Deputy Chief Financial Officer, Department of the Treasury
Deputy Commissioner for Services and Enforcement SE
Deputy Commissioner, Small Business/Self-Employed Division SE:S
Director, Campus Compliance Services, Small Business/Self-Employed Division SE:S:CCS
Director, Communications, Liaison, and Disclosure, Small Business/Self-Employed Division
SE:S:CLD
Director, Examination, Small Business/Self-Employed Division SE:S:E
Audit Liaison: Commissioner, Small Business/Self-Employed Division SE:S



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Appendix IV

Detailed Breakdown of Sampled Examination Cases

(b)(3) 26 U.S.C. 6103,(b)(7)(E)

The table below provides additional details about the 97 SFR cases discussed throughout the report. The sample was selected from the 5,626 examinations with assessments of [redacted] or more that were listed in the Audit Information Management System¹ as closed with no response from the taxpayers between April 1, 2005, and March 31, 2006.

(b)(3) 26 U.S.C. 6103,(b)(7)(E)

(b)(3) 26 U.S.C. 6103,(b)(7)(E)

Assessment Amount	Total Number of Cases	Percentage of Total Cases	Total Assessment Amount	Sample Size	Sample Assessment Amount
Up to [redacted]	365,147	98.5%	\$2.683 billion	0	Not applicable
Greater than [redacted] but less than or equal to \$1 million	5,362	1.4%	\$1.227 billion	49	\$27.2 million
Greater than \$1 million but less than or equal to \$20 million	250	1%	\$0.861 billion	34	\$99.8 million
More than \$20 million	14	0%	\$0.746 billion	14	\$745.9 million
Totals	370,773	100.0%	\$5.517 billion	97	\$872.9 million

Source: Our analysis of sampled closed examination cases.

¹ The Audit Information Management System is a computer system used to control tax returns during examinations, input assessments and adjustments to taxpayer accounts, and provide management reports.



Opportunities Exist to Improve the Correspondence Examination Process for High-Income Nonfilers

Appendix V

Examinations and Assessments for Individual Tax Returns (by Fiscal Year)

	2003	2004	2005	2006	2007
Returns Examined	849,296	997,028	1,199,035	1,283,950	1,384,559
Examinations Closed Without a Taxpayer Response	226,805	302,106	383,018	426,512	487,822
Percentage of Total Examinations	27%	30%	32%	33%	35%
Total Assessment Amount	\$4,120,354,090	\$5,660,770,866	\$12,951,625,344	\$12,268,355,545	\$15,017,420,642
Assessment Amount for Cases Closed Without a Taxpayer Response	\$1,138,921,677	\$2,377,276,446	\$4,943,761,138	\$5,910,370,194	\$6,914,541,456
Percentage of Total Assessment Amount	28%	42%	38%	48%	46%
Correspondence Examinations Without a Taxpayer Response	216,504	292,629	370,462	404,857	468,171
Percentage of Examinations Closed Without a Taxpayer Response	95%	97%	97%	95%	96%
Correspondence Assessment Amount for Cases Closed Without a Taxpayer Response	\$1,024,031,393	\$2,282,557,174	\$4,809,951,433	\$5,662,883,696	\$6,702,055,999
Percentage of Assessment Amount for Cases Closed Without a Taxpayer Response	90%	96%	97%	96%	97%

Source: Our analysis of Audit Information Management System¹ closed case data for FYs 2003-2007.

¹ The Audit Information Management System is a computer system used to control tax returns during examinations, input assessments and adjustments to taxpayer accounts, and provide management reports.



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Appendix VI

Memorandum #1: Errors in Examination Technique Code Usage Produce Inaccurate Statistics



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

September 27, 2007

MEMORANDUM FOR DIRECTOR, CAMPUS COMPLIANCE SERVICES,
SMALL BUSINESS/SELF-EMPLOYED DIVISION

FROM: Daniel R. Devlin
Assistant Inspector General for Audit (Small Business and Corporate Programs)

SUBJECT: Errors in Examination Technique Code Usage Produce Inaccurate Statistics

The purpose of this memorandum is to inform you of a condition identified during a review of examinations closed with no taxpayer response (Audit # 200630031). We consider this issue to be of lesser significance and risk and, therefore, will not specifically address it in our report. While we are not making a recommendation, we suggest management take the actions deemed necessary to correct the condition.

We determined that examiners did not always use the correct technique code¹ when closing an examination case if the taxpayer did not respond to the tax assessment letter or if the assessment letter was returned to the Internal Revenue Service as undeliverable mail. For example, our review of 100 examination cases closed between April 1, 2005, and March 31, 2006, found that examiners used incorrect technique codes in nearly 34 percent of the cases closed as either no response from taxpayer or undeliverable mail. Errors in technique code usage produce inaccurate statistics, which hampers management's ability to make sound decisions when analyzing the data to consider measures for improving the effectiveness and efficiency of operations. Although prior internal reviews identified the same condition, management has not taken effective corrective actions to ensure that examiners use the correct technique code.

¹ Examination technique codes identify the type of examination conducted and are required for all examined returns. If the taxpayer does not respond to the tax assessment letter, then technique code 8 should be used to close the case. If the assessment letter is returned to the IRS as undeliverable mail, then technique code 7 should be used to close the case.

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***Opportunities Exist to Improve the Correspondence Examination
Process for High-Income Nonfilers***

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Please contact me at (202) 622-5894 if you have any questions or Philip Shropshire, Director, Special Tax Matters, at (215) 516-2341.

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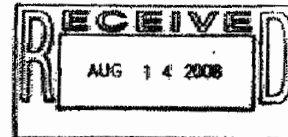
Appendix VII

Management's Response to the Draft Report



COMMISSIONER
SMALL BUSINESS/Self-EMPLOYED DIVISION

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



August 14, 2008

MEMORANDUM FOR MICHAEL R. PHILLIPS
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Christopher Wagner
Acting Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report - Opportunities Exist to Improve the Correspondence Examination Process for High-Income Nonfilers (Audit No. 200630031)

We have reviewed your draft report, "Opportunities Exist to Improve the Correspondence Examination Process for High-Income Nonfilers" and concur with the recommendations.

Correspondence examinations are critical to IRS' ability to address noncompliance that contributes to the tax gap, including nonfiling. Sometimes, nonfiler cases result in taxpayers filing delinquent returns after the examination, requiring special handling by the Service.

We agree with your recommendation that we should determine the costs and benefits of using locator services to find current addresses when initial contact letters involving high-income taxpayers are returned as undeliverable. We also agree to review our procedures and return selection criteria for delinquent returns for high-income nonfilers to identify improvement opportunities.

Attached is a detailed response to your recommendations.

If you have any questions, please contact me at (202) 622-0600 or Cheryl Sherwood, Director Campus Compliance Services, Small Business/Self-Employed Division, at (202) 283-7650.

Attachment

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**Opportunities Exist to Improve the Correspondence Examination
Process for High-Income Nonfilers**

Attachment

RECOMMENDATION 1:

The Director, Campus Compliance Services should determine the costs and benefits of using locator services to find better addresses when initial contact letters involving high-income taxpayers are returned as undeliverable.

CORRECTIVE ACTIONS:

We concur with this recommendation. The Director, Campus Compliance Services will:

1. Gather information, including benefits, direct and indirect costs, from Compliance functions that are currently using locator services.
2. Review the information and prepare a cost-benefit analysis.
3. Take appropriate action based upon a review of the cost-benefit analysis.

IMPLEMENTATION DATE:

July 15, 2009

RESPONSIBLE OFFICIAL:

Director, Campus Reporting Compliance

CORRECTIVE ACTION(S) MONITORING PLAN:

The Director, Campus Reporting Compliance will monitor the status and advise the Director, Campus Compliance Services of any delays in implementation.

RECOMMENDATION 2:

The Director, Campus Compliance Services should work with the Director, Examination, in revising the IRS field office selection criteria for the high-income nonfiler cases to better ensure that appropriate delinquent returns submitted by high-income nonfilers in response to SFR assessments, are considered for face-to-face examinations.

CORRECTIVE ACTIONS:

We concur with this recommendation and will take the following actions:

1. The Directors, Examination, and Campus Compliance Services will continue to review the Return Selection Matrix on an annual basis and, if necessary, will revise the return selection criteria for delinquent returns filed by high-income nonfilers.
2. The Director, Campus Compliance Services will prepare a memorandum to tax examiners whose workload includes delinquent high-income nonfiler returns that reinforces the criteria and procedures for referring cases to classification.
3. The Director, Examination will issue a reminder regarding when it is appropriate to survey high-income nonfiler delinquent returns selected for examination.

IMPLEMENTATION DATE:

March 15, 2009



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Opportunities Exist to Improve the Correspondence Examination Process for High-Income Nonfilers

RESPONSIBLE OFFICIAL:

Directors, Examination Planning & Delivery, and Campus Reporting Compliance

CORRECTIVE ACTION(S) / MONITORING PLAN:

The Directors, Examination Planning & Delivery, and Campus Reporting Compliance will monitor the status and advise the Directors, Examination, and Campus Compliance Services of any delays in implementation.

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