

**Key Areas of Noncompliance Among Small
Business and Self-Employed Taxpayers Could
Be Addressed Through More Effective Use of
Correspondence Examinations**

November 2003

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INSPECTOR GENERAL
for TAX
ADMINISTRATION

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MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED
DIVISION

Gordon C. Milbourn III

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

SUBJECT: Final Audit Report - Key Areas of Noncompliance Among Small
Business and Self-Employed Taxpayers Could Be Addressed
Through More Effective Use of Correspondence Examinations
(Audit # 200230054)

This report presents the results of our review of the steps the Internal Revenue Service (IRS) has taken to ensure that the process used to select inventory for its Small Business/Self-Employed (SB/SE) Division Campus¹ Correspondence Examination Program addressed key areas of SB/SE Division² noncompliance.

Correspondence examinations are conducted through the mail, with the IRS typically asking taxpayers for more support regarding one or two simple issues on United States Individual Income Tax Returns (Form 1040). Correspondence examinations accounted for 73 percent (540,902) of the 743,417 individual income tax returns examined by the IRS in Fiscal Year (FY) 2001.

As the IRS reorganized to the business unit concept, the Correspondence Examination Program likewise underwent organizational changes. The SB/SE Division Compliance Services function handles the SB/SE Division compliance activities not requiring face-to-face interaction with taxpayers, including correspondence examinations

¹ The campuses are the data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the computing centers for analysis and posting to taxpayer accounts.

² SB/SE Division customers include 45 million taxpayers filing personal, corporate, employment, excise, estate, and gift tax returns paying \$915 billion in taxes annually. Approximately 33 million of these customers are fully or partially self-employed individuals, and 7 million are small business entities having assets of \$10 million or less.

conducted at the IRS' Brookhaven, New York; Cincinnati, Ohio; Memphis, Tennessee; Ogden, Utah; and Philadelphia, Pennsylvania, Campuses. The SB/SE Division Compliance Policy Office of Centralized Workload Selection and Delivery develops the compliance work plan and selects the inventory for the Program.

In FY 2002, SB/SE Division executives announced that resources were being realigned to focus on the biggest areas of risk to the tax system, referred to as key areas of noncompliance. The SB/SE Division workload was to be associated with strategic noncompliance priorities: abusive tax schemes and promoter investigations; misuse of devices such as offshore accounts to hide or improperly reduce income; abusive corporate tax avoidance transactions; high-risk, high-income individuals; Unreported Income Discriminant Index Formula;³ and the National Research Program.⁴

In summary, we found that correspondence examinations did not always address strategic noncompliance priorities and that the Correspondence Examination Program could be used more effectively to reduce the tax gap and increase coverage and voluntary compliance. In addition, the IRS does not always use the most cost-effective method to examine tax returns, and the current Examination Workload Selection Process results in inequitable treatment of taxpayers.

In FY 2003, Earned Income Tax Credit (EITC) cases made up 33 percent of the SB/SE Division Campus Correspondence Examination Program inventory.⁵ While the IRS cannot ignore the risks presented by EITC claims, the workload selected does not seem to be balanced against the compliance risks associated with other SB/SE Division taxpayers. Program inventory included many examinations of "personal" issues on individual income tax returns (e.g., pension account distributions, alimony, contributions, and the Child Care Credit). In effect, the SB/SE Division Correspondence Examination Program was largely covering types of tax issues also covered by the Wage and Investment Division.

The SB/SE Division Correspondence Examination Program could be used more effectively to reduce the tax gap and increase coverage and voluntary compliance in areas of egregious tax law abuse. In 1998, SB/SE Division taxpayers were responsible for \$141 billion (68 percent) of the \$207 billion tax gap. Sole Proprietors, who file a Form 1040 Profit or Loss From Business (Schedule C), accounted for 94 percent of the SB/SE Division tax gap. However, we found that Schedule C examination issues were largely ignored when inventory was selected for the Correspondence Examination Program.

The IRS selects inventory and allocates resources based on past practices and perceptions of what examination issues can best be handled by the various examination techniques, rather than on activity-based costing models. In fact, IRS performance

³ The Unreported Income Discriminant Index Formula is a new tool developed by the IRS that rates the probability of income being omitted from a tax return.

⁴ The National Research Program replaced the Taxpayer Compliance Measurement Program and is designed to measure compliance and help identify compliance issues.

⁵ EITC casework is mandated work with appropriated funding to combat EITC abuse.

measures do not include costs. Because the correspondence examination technique lends itself to automation, the Correspondence Examination Program is an efficient, cost-effective program that maximizes net revenue. Correspondence examinations are a cost-effective way to increase the reporting of income by fostering the voluntary compliance of those contacted and, indirectly, the compliance of those not contacted.

The IRS has stated that the current Examination Workload Selection Process does not adequately identify cases with the greatest yield potential. As a result, excessive resources are dedicated to less egregious noncompliant taxpayers rather than to the biggest areas of risk to the tax system. This damages the IRS' commitment to promoting the highest degree of voluntary compliance through a fair and equitable system for all taxpayers. Achievement of this goal is further endangered when the function performing the majority of examinations does not always examine returns and schedules associated with the key areas of SB/SE Division noncompliance. While SB/SE Division management plans to introduce some abusive tax scheme cases and increase the High Income Non-Filer and Frivolous Filer cases in the correspondence examination inventory for FY 2004, there does not appear to be an aggressive plan to rebalance the inventory selected for the various examination methods to ensure that correspondence examinations can address more key areas of noncompliance.

Accordingly, we recommended that the IRS restore the strength of the Compliance function and ensure fair and balanced treatment for all taxpayers by expanding the tax issues that can be selected for correspondence examination to ensure that more of the inventory addresses strategic noncompliance priorities. We also recommended that the IRS initiate any necessary training programs, and select the most cost-effective examination techniques based on performance measures reflecting cost and yield data.

Management's Response: SB/SE Division management agreed that the Campus Correspondence Examination Program should work more cases dealing with strategic priorities and plans to expand the tax issues and types of SB/SE Division returns selected for the Correspondence Examination Program inventory after a period of adequate testing. In addition, management agreed to initiate necessary training programs to ensure that Tax Examiners have the skills to examine additional types of SB/SE Division tax issues. However, SB/SE Division management stated that the IRS Restructuring and Reform Act of 1998 (RRA 98)⁶ prevented them from using cost and yield information to measure program performance. SB/SE Division management also disagreed with our assessment of their use of the most cost-effective examination technique and their fair and equitable treatment of taxpayers. Management's complete response to the draft report is included as Appendix IV.

Office of Audit Comment: We disagree with SB/SE Division management's opinion that the RRA 98 prevents them from using cost and yield information to measure program performance. Regulations permit the use of tax enforcement records for purposes such as forecasting, financial planning, resources management, and the formulation of case

⁶ 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., 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.).

selection criteria. We also do not agree with SB/SE Division management's assessment regarding their use of the most cost-effective examination techniques. We are concerned that the current limitations placed on the types of cases selected for the Correspondence Examination Program may prevent the application of such an efficient examination technique to higher-priority SB/SE Division tax issues. Finally, we believe that by not using the Correspondence Examination Program to address tax issues that fall solely under the domain of the SB/SE Division, the IRS is not maximizing its commitment to a fair and equitable system for all taxpayers.

While we still believe that all of our recommendations are worthwhile, we do not intend to elevate our disagreement concerning these matters to the Department of the Treasury for resolution.

Copies of this report are also being sent to the IRS managers who are affected by the report recommendations. Please contact me (202) 622-6510 if you have questions or Philip Shropshire, Director (Corporate and Customer Service), at (215) 516-2341.

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Key Areas of Noncompliance Among Small Business and Self-Employed Taxpayers Could Be Addressed Through More Effective Use of Correspondence Examinations

Background

Since 1996, Tax Examiners located at the Internal Revenue Service (IRS) campuses¹ have conducted the vast majority of examinations of United States (U.S.) Individual Income Tax Returns (Form 1040) using the correspondence examination technique. As the name implies, correspondence examinations are conducted through the mail, with the IRS typically asking taxpayers for more support regarding one or two simple issues on individual income tax returns (e.g., Earned Income Tax Credit (EITC),² Self-Employment Tax, and alimony payments).

During Fiscal Years (FY) 1992 to 2002, the annual number of correspondence examinations conducted by the IRS varied considerably, from just over 200,000 to about 1.2 million.³ Correspondence examinations accounted for 540,902 (73 percent) of the 743,417 individual income tax returns examined by the IRS in FY 2001.

As the IRS reorganized to the business unit concept, the Correspondence Examination Program likewise underwent organizational changes. The Small Business/Self-Employed (SB/SE) Division Compliance Services function is now responsible for handling SB/SE Division compliance activities not requiring face-to-face interaction with taxpayers,⁴ which includes correspondence examinations conducted by Tax Examiners at the IRS' Brookhaven, New York; Cincinnati, Ohio;

¹ The campuses are the data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the computing centers for analysis and posting to taxpayer accounts.

² In 1997, many EITC returns previously examined in the Correspondence Examination Program were moved to the Math-Error Program.

³ The fewest number of correspondence examinations (232,000) were closed in 1993. Between 1994 and 1995, the number of correspondence examinations tripled, from approximately 353,000 to about 1.1 million. The increase between 1994 and 1995 was due to increased emphasis on examining returns claiming the EITC.

⁴ SB/SE Division customers include 45 million taxpayers filing personal, corporate, employment, excise, estate, and gift tax returns paying \$915 billion in taxes annually. Approximately 33 million of these customers are fully or partially self-employed individuals, and 7 million are small business entities having assets of \$10 million or less.

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Memphis, Tennessee; Ogden, Utah; and Philadelphia, Pennsylvania, Campuses. The SB/SE Division Compliance Policy Office of Centralized Workload Selection and Delivery is charged with developing the compliance work plan and selecting inventory for the Program.

This audit was conducted at the IRS' Brookhaven Compliance Site and included analyses of the Correspondence Examination Program inventory⁵ in the five SB/SE Division campuses from October 2002 through April 2003. We interviewed IRS management in the SB/SE Division Headquarters, located in New Carrollton, Maryland, and at all SB/SE Division campuses, and reviewed IRS studies, reports, and records to obtain information about the Correspondence Examination Program.

The audit was conducted in accordance with *Government Auditing Standards*. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

Correspondence Examinations Did Not Always Address Strategic Noncompliance Priorities

Based on the results of Compliance Risk Assessments⁶ begun in FY 2000, the IRS began to identify and refocus its resources on the biggest areas of risk to the U.S. tax system in a comprehensive strategy. Toward the end of FY 2002, the IRS began realigning its resources to focus on key areas of noncompliance with U.S. tax law.

On July 30, 2002, former IRS Commissioner Charles Rossotti and SB/SE Division executives presented an overview of the new compliance strategies to the IRS Oversight Board and explained that FY 2003 would be a year of transition. As existing examination inventories were

⁵ The Table SC 35 (ARP 1640) is an IRS monthly cumulative report that tracks the overall productivity of the Correspondence Examination Program. The report provides data concerning the inventory worked in the Program, including dollars assessed, yield per return, staff hours per return, and no change rates.

⁶ Compliance Risk Assessments are part of the strategic assessment phase of the strategic planning budgeting process conducted by the IRS.

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closed, the new workload selected for SB/SE Division employees was to be associated with the new strategies. This new direction focused on seven priority areas:

- Abusive tax schemes and promoter investigations.
- Misuse of devices such as offshore accounts to hide or improperly reduce income.
- Abusive corporate tax avoidance transactions.
- High-risk, high-income individuals.
- Offshore credit card abuses.
- Unreported Income Discriminant Index Formula (UI DIF).⁷
- The National Research Program (NRP).⁸

During this audit, we analyzed the SB/SE Division Examination Plan and the Correspondence Examination Program inventory at the SB/SE Division and Wage and Investment (W&I) Division campuses⁹ for FY 2003. We found that approximately 59 percent of the combined SB/SE Division and W&I Division Correspondence Examination Program workload consisted of EITC cases.¹⁰ EITC cases made up approximately 33 percent (94,981 cases) of the SB/SE Division Correspondence Examination Program inventory to be completed in FY 2003 (288,489 cases).

While the FY 2003 Examination Plan called for a decrease of 59 percent from the number of EITC cases the SB/SE Division campuses worked in FY 2002, EITC cases were

⁷ The UI DIF is a new tool developed by the IRS for identifying returns with a high probability of unreported income. This new UI DIF score rates the probability of income being omitted from a tax return.

⁸ The NRP replaced the Taxpayer Compliance Measurement Program and is designed to measure compliance and help identify compliance issues. Data gathered from the NRP will enable the IRS to update existing screening techniques used to select tax returns for examination.

⁹ The W&I Division campuses are located in Andover, Massachusetts; Atlanta, Georgia; Austin, Texas; Fresno, California; and Kansas City, Missouri.

¹⁰ EITC casework is mandated work with appropriated funding to combat EITC abuse.

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still a significant part of their workload. In fact, the Philadelphia Campus almost doubled the number of correspondence examination resources allocated to work EITC cases in FY 2003, as compared to the prior year.

Tax Examiners at one SB/SE Division campus were even working W&I Division correspondence examination inventory.¹¹ IRS management indicated this occurred because of research projects or because W&I Division campuses could not handle their inventories.

Although there were some projects that potentially qualify as addressing key areas of noncompliance, such as 25,000 High Income Non-Filer (HINF) cases in the Memphis Campus correspondence examination inventory or 17,000 Frivolous Correspondence cases in the Ogden Campus correspondence examination inventory, we found that:

- Correspondence examinations conducted by Tax Examiners at SB/SE Division campuses did not always address the strategic noncompliance priorities outlined by SB/SE Division executives.
- The SB/SE Division Correspondence Examination Program inventory included many examinations of “personal” issues on taxpayers’ individual income tax returns, such as the Child Care Credit, 10 Percent Penalty,¹² contributions, alimony payments, dependents, and duplicate Social Security Numbers.

¹¹ The Cincinnati Campus is working some W&I Division Child Care Credit, Contributions, and 10 Percent Penalty cases.

¹² This type of case involves a penalty for an early distribution of funds from a pension account.

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- Many of the tax issues examined by correspondence at the SB/SE Division campuses were the same types of issues as those examined by correspondence at the W&I Division campuses.¹³

In recent years, the IRS has come under growing criticism for its focus on low-income taxpayers, especially due to the number of EITC examinations. While the IRS certainly cannot ignore the risks presented by SB/SE Division taxpayers claiming the EITC, the workload selected for correspondence examinations, which is the largest component of the Examination Coverage Rate,¹⁴ does not seem to be balanced against the compliance risks associated with other SB/SE Division taxpayers.

Currently, SB/SE Division management is working with the IRS Concept of Operations Project (CONOPS) researchers to help develop a noncompliance case selection model. In addition, they plan to introduce some abusive tax scheme cases and increase the HINF and Frivolous Filer cases in the correspondence examination inventory for FY 2004.

However, there does not seem to be an aggressive plan to rebalance the inventory selected for the various examination methods and ensure that correspondence examinations can address more key areas of noncompliance. The inventory selected for the SB/SE Division Correspondence Examination Program must change if the IRS plans to target limited resources at the most serious transgressions and threats to the tax system.

¹³ The SB/SE Division taxpayer segment includes Form 1040 filers with a Profit or Loss From Business (Schedule C), Supplemental Income or Loss (Schedule E), Profit or Loss From Farming (Schedule F), or Employee Business Expenses (Form 2106) attached to their returns. The W&I Division serves taxpayers who file a Form 1040 with no accompanying Schedules C, E, or F; no Forms 2106; and no international activity.

¹⁴ The IRS has traditionally calculated the Examination Coverage Rate by dividing the number of returns examined in the current fiscal year by the number of returns filed in the preceding calendar year.

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Recommendation

1. The Director, Compliance, SB/SE Division, should ensure that more of the inventory selected to be worked in the SB/SE Division Correspondence Examination Program addresses strategic noncompliance priorities.

Management's Response: SB/SE Division management agreed that the Correspondence Examination Program should work more cases dealing with strategic priorities. For FY 2004, they plan to increase the number of HINF and Frivolous Filer cases worked in the Program, and add more cases dealing with strategic priorities when identified. While management stated that they considered most of the strategic priority work too complex to be handled through correspondence examinations, they also indicated that their intention is to shift more complex SB/SE Division work to the Correspondence Examination Program over time.

Office of Audit Comment: In FY 2004, approximately one-third of the inventory worked in the SB/SE Division Correspondence Examination Program will involve EITC cases. This casework is mandated and accomplished with appropriated funding. This circumstance makes the selection of discretionary inventory that addresses the key areas of noncompliance even more crucial. While increasing the number of HINF and Frivolous Filer cases in the inventory for FY 2004 is certainly a step in the right direction, it is up to SB/SE Division management to ensure that more of the Correspondence Examination Program inventory addresses key areas of noncompliance.

The Correspondence Examination Program Could Be Used More Effectively to Reduce the Tax Gap and Increase Coverage and Voluntary Compliance

The Federal income tax system operates largely on a self-assessment basis. That is, the Federal Government expects taxpayers to determine their own tax obligations and to pay voluntarily whatever is due. By placing the onus on the taxpayers, the Federal Government avoids the costly alternative of determining each individual's tax liability and doing whatever it must to collect it. However, one cost of

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relying so heavily on the voluntary compliance of taxpayers is that not all tax is voluntarily paid.¹⁵

The difference between what taxpayers should pay and what they actually do pay voluntarily and timely is referred to as the tax gap. The tax gap was estimated at \$207 billion in 1998. The *IRS' FY 2003-2004 Compliance Risk Assessment* revealed that those areas of noncompliance associated with the tax gap – nonfiling, nonpayment, and underreporting – continue to widen.

Direct effect of the Examination Coverage Rate

IRS enforcement programs identify and collect some of the tax gap directly from the taxpayers they contact. This is a direct effect of the Examination Coverage Rate, which is the primary enforcement tool thought to influence voluntary compliance.¹⁶

The Examination Coverage Rates for IRS correspondence and field examinations of individual income tax returns and nonindividual business returns have declined dramatically since FY 1996.

- In FY 2001, the Examination Coverage Rate for individual income tax returns¹⁷ examined through correspondence and field examinations was .58 percent, a 65 percent decline from the 1996 rate of 1.67 percent.

¹⁵ *The Determinants of Individual Income Tax Compliance: Estimating the Impacts of Tax Policy, Enforcement, and IRS Responsiveness*, IRS Publication 1916 (Rev. 11-96).

¹⁶ The IRS uses several computer-matching and automated error-checking routines that result in adjustments to tax liabilities but are not included in the traditional Examination Coverage Rates.

¹⁷ In FY 2001, 127,097,400 individual income tax returns were filed and 743,417 were examined. In FY 1996, 116,059,700 individual income tax returns were filed and 1,941,546 were examined.

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- In FY 2002, the Examination Coverage Rate for nonindividual business returns¹⁸ examined through field examinations was approximately .2 percent, a 60 percent decline from the 1996 rate of .5 percent.¹⁹

This decrease in compliance activity was due to several factors, including budgetary constraints, the desire to provide increased customer service, and the need to implement and provide additional taxpayer protections and rights mandated by the IRS Restructuring and Reform Act of 1998 (RRA 98).²⁰

Voluntary compliance seems to have fallen concurrent with the decline in the Examination Coverage Rates. Since it is estimated that only a fraction of the tax gap will eventually be collected through enforcement and other late payments, it is crucial for the IRS to effectively use its limited resources to improve voluntary compliance.

Indirect effect of the Examination Coverage Rate

According to a study published in 1996,²¹ IRS examinations also produce an indirect revenue effect, referred to as the “ripple effect,” by inducing some level of voluntary compliance in the population at large. The study’s premise is that taxpayers perceive increased examinations by the IRS as an increase in their chances of being examined, and they improve their voluntary compliance as a result.

¹⁸ Nonindividual business returns include the following return types: Corporations < \$10 million, Corporations \$10 million and over, U.S. Corporation Income Tax Return for an S Corporation (Form 1120S) < \$10 million, 1120S \$10 million and over, Partnerships, Fiduciaries, Employment, Excise, Estate, Gift, Exempt Organizations, and Employee Plans.

¹⁹ In FY 2002, 41,502,453 nonindividual business returns were filed and 82,221 were examined. In FY 1996, 38,524,037 nonindividual business returns were filed and 194,000 were examined.

²⁰ 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., 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.).

²¹ *The Determinants of Individual Income Tax Compliance: Estimating the Impacts of Tax Policy, Enforcement, and IRS Responsiveness*, IRS Publication 1916 (Rev. 11-96).

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An IRS study released in November 2002²² stated that the indirect effect of increasing the Examination Coverage Rate would be to increase the deterrence factor (i.e., changing the public's perceptions of the certainty, severity, and celerity (swiftness) of getting caught in noncompliance). It could also involve education or shaping attitudes (e.g., changing the public's perceptions of the extent to which the law is applied and enforced fairly).

This study claimed that IRS examinations have a strong, positive impact on reporting compliance and estimated that the average indirect effect of the examinations started in 1991 was about 11.7 times as large as the average adjustment directly proposed by examinations closed that year. Moreover, if the Examination Coverage Rate had been 1 percentage point higher in 1991, the general population would have voluntarily reported an additional \$56 billion of additional tax.²³

Declining Examination Coverage Rates cause concern

During annual oversight hearings on the IRS, the Congress often raises questions about the declining Examination Coverage Rates and the possible effects on voluntary compliance. Taxpayers' willingness to voluntarily comply with tax laws depends in part on their confidence that friends, neighbors, and business competitors are paying their fair share of taxes. The IRS programs to ensure compliance and to collect delinquent taxes are viewed by many as critical for maintaining the public's confidence in our tax system. Many experts feel that this declining trend in

²² *The Impact of the IRS on Voluntary Tax Compliance: Preliminary Empirical Results*, Alan H. Plumley (November 2002, IRS Office of Research).

²³ *Management Advisory Report: The Internal Revenue Service's Response to the Falling Level of Income Tax Examinations and Its Potential Impact on Voluntary Compliance* (Reference Number 2002-30-092, dated June 2002). This final report discussed the "ripple effect" of examination coverage with respect to field examinations and referred to the same IRS studies.

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Examination Coverage Rates has the potential to undermine taxpayers' motivation to fulfill their tax obligations.²⁴

SB/SE Division correspondence examinations could reduce the tax gap through increased coverage and voluntary compliance

SB/SE Division taxpayers are responsible for the majority of the tax gap. Approximately \$141 billion (68 percent) of the \$207 billion tax gap in 1998 was attributed to SB/SE Division taxpayers. Sole Proprietors, who file a Form 1040 with a Profit or Loss From Business (Schedule C), fall under the domain of the SB/SE Division and accounted for \$132.5 billion (94 percent) of this \$141 billion. Corporate taxpayers were responsible for \$8.3 billion (6 percent).²⁵

Because SB/SE Division taxpayers, and specifically Sole Proprietors, are responsible for such a large portion of the tax gap, it is imperative that the SB/SE Division compliance programs use their limited resources effectively to increase their direct examination coverage of this taxpayer segment. This would also serve to increase the indirect or "ripple effect," thereby increasing voluntary compliance and ultimately reducing the tax gap.

Inventory selection criteria limit the Program's potential

The Internal Revenue Manual requires that tax returns identified for examination be classified to ensure that all questionable issues on returns are examined and to determine whether the issues can be addressed through correspondence examinations²⁶ or need to go to IRS field

²⁴ *Compliance and Collection-Challenges for IRS in Reversing Trends and Implementing New Initiatives* (GAO-03-732T, dated May 2003).

²⁵ Statistics obtained from the *IRS' FY 2003-2004 Compliance Risk Assessment*.

²⁶ The IRS uses both computer technology and manual review to select returns for examination. This selection process results in a determination of whether a return has examination potential. If the return does, the process helps identify specific tax issues to be examined and the examination technique to be used. This is called the Screening and Classification process.

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staff.²⁷ The IRS generally has one chance to examine a return. If returns including complex schedules are not classified for potential examination issues, tax noncompliance is more likely to go undetected.

Currently, the IRS has established standards and requirements for selecting, conducting, and reviewing the quality of correspondence examinations. The IRS uses computer programs to screen tax returns filed each year by individual taxpayers for examination potential. The IRS campuses also have their own computer programs to identify returns with issues to be examined through correspondence.

According to IRS criteria, campus correspondence examinations are to exclude complicated tax issues, such as those on business and investment schedules.²⁸ Tax returns assigned to the Correspondence Examination Program are to involve only one or two simple tax issues that can be examined by Tax Examiners who are not trained to examine complex issues on business and investment schedules.

However, we found that because of these restrictions, the most egregious cases of tax law abuse (e.g., the Sole Proprietor Taxpayer Segment²⁹) were largely ignored when inventory was selected for SB/SE Division campus correspondence examinations. Even when individual income tax returns with Schedules C attached were selected for examination in the Correspondence Examination Program, the issues examined rarely had anything to do with the Schedules C per se, but rather involved such things as the EITC or dependents claimed on the taxpayers' individual income tax returns.

²⁷ The Examination function field staff includes Revenue Agents and Tax Auditors/Tax Compliance Officers. Their examinations generally involve face-to-face meetings with taxpayers and/or their representatives.

²⁸ *IRS Audits-Weaknesses in Selecting and Conducting Correspondence Audits* (GAO/GGD-99-48, dated March 1999).

²⁹ Identified in the *IRS' FY 2003-2004 Compliance Risk Assessment* as the largest contributor to the tax gap.

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A U.S. General Accounting Office (GAO) report³⁰ issued in 1999 concluded that an estimated 22 percent of the correspondence examinations closed in 1996 had Schedules C attached to the taxpayers' individual income tax returns that were not examined. Approximately 21 percent of the closed correspondence examinations had Schedules D, E, and/or F³¹ attached that likewise were not examined. The report criticized the IRS for not referring returns with these attached schedules for field examination. The GAO stated that because the IRS missed this window of opportunity, potential tax noncompliance on the attached schedules went undetected.

We agree with the GAO that potential tax noncompliance went undetected when attached schedules were not examined. However, we believe that the IRS should use the SB/SE Division Correspondence Examination Program as part of a more focused approach to address the areas of key noncompliance.

As stated earlier in this report, in FY 2001, 73 percent of all individual income tax returns were examined by correspondence. If the IRS does not use the SB/SE Division Correspondence Examination Program more effectively to address the key areas of noncompliance, close the tax gap, and increase coverage and voluntary compliance, it will be difficult to reverse trends that have already undermined the fairness of the tax system and the attitude of compliant taxpayers toward their obligation to pay taxes. Furthermore, growth in the economy will cause the tax gap to increase every year if actions are not taken to reverse the trend.

³⁰ *IRS Audits-Weaknesses in Selecting and Conducting Correspondence Audits* (GAO/GGD-99-48, dated March 1999).

³¹ A Schedule D is the form used to report capital gains and losses, Schedule E is the form used to report supplemental income and loss, and Schedule F is the form used to report profit or loss from farming.

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Recommendations

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

2. Expand the tax issues and types of SB/SE Division returns that can be included in inventory selected for the Correspondence Examination Program after a period of limited testing.

Management's Response: SB/SE Division management plans to expand the tax issues and types of SB/SE Division returns selected for the Correspondence Examination Program inventory after a period of adequate testing. However, they stated this report did not make it clear that the SB/SE Division Correspondence Examination Program can influence only a part of the growth in the economic tax gap and that the SB/SE Division Correspondence Examination Program was not responsible for examining "73 percent of all individual income tax returns audited by correspondence."

Office of Audit Comment: We agree that the SB/SE Division Correspondence Examination Program can influence only a part of the growth in the economic tax gap. As stated on page 3 of this report, the SB/SE Division Correspondence Examination Program was scheduled to complete 288,489 cases in FY 2003. This represented approximately one-half of all the campus correspondence examinations scheduled to be completed by the IRS in FY 2003. The other one-half was scheduled to be completed by the W&I Division Campus Correspondence Examination Program, which was not the subject of this report.

3. Initiate training programs to ensure that Correspondence Examination Program Tax Examiners have the necessary skills to examine additional types of tax issues and schedules filed by SB/SE Division taxpayers.

Management's Response: SB/SE Division management plans to hold continual training programs to ensure that Correspondence Examination Program Tax Examiners have the necessary skills to examine additional types of tax issues and schedules filed by SB/SE Division taxpayers. They have also centralized certain types of returns/issues in

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The Most Cost-Effective Method Is Not Always Used to Examine Tax Returns

certain campuses to maximize training resources and coverage levels. They intend to obtain subject matter experts for Continuing Professional Education presentations and develop new courses for Tax Examiners as well as additional training for those campuses responsible for the CONOPS research returns.

The IRS is responsible for collecting the proper amount of taxes at the least cost to the Federal Government and taxpayers. To fulfill this responsibility, the IRS examines all types of tax returns to determine whether taxpayers have reported their correct tax liabilities. The IRS spends over \$1 billion annually on its examination programs, including staff costs. Based on its examinations, the IRS annually recommends that taxpayers pay additional taxes totaling tens of billions of dollars.

The range of size and complexity across tax returns affects the amount of time and resources the IRS uses to examine returns and resolve disputes over the assessment of recommended taxes. Examinations of large corporations may take years, while for small, less-complex returns, the time is shorter, usually under a year.

To deal with this varying complexity, the IRS has three types of examiners that conduct examinations using different methods.

1. Revenue Agents from IRS field offices visit individuals, corporations, and other types of taxpayers to address the most-complex tax returns. They also work in teams to perform Coordinated Industry Case examinations of large corporations, and they fall in the highest pay grades.
2. Tax Auditors/Tax Compliance Officers usually perform examinations by meeting with taxpayers at field offices and fall in the middle range with respect to their pay grades and the complexity of their examinations.
3. Tax Examiners perform correspondence examinations of simple tax issues at IRS campuses and are in the lowest pay grade of the three types of examiners.

Key Areas of Noncompliance Among Small Business and Self-Employed Taxpayers Could Be Addressed Through More Effective Use of Correspondence Examinations

The IRS uses a screening and classification process previously outlined in this report to select returns for examinations, help identify specific tax issues to be examined, and choose which of the examination techniques described above will be used to conduct the examination. The IRS allocates its inventory and examination resources based on preconceived perceptions of what the different types of examiners “are capable of examining” or what types of cases have traditionally been selected for their inventory, rather than on activity-based costing models.

The Correspondence Examination Program is an efficient, cost-effective, revenue-producing program

In 1994, the IRS Inspection Service issued a report on the IRS Service Center³² Correspondence Examination Program,³³ which stated that the Correspondence Examination Program was an efficient, cost-effective, revenue-producing program. Based on that review, it was concluded that Tax Examiners using the correspondence examination technique had much higher dollar per hour rates of return than Revenue Agents and Tax Auditors in the field. Tax Examiners assessed an average of \$2,130 per hour, as compared to \$713 per hour for individual return examinations conducted by Revenue Agents and \$485 for Tax Auditors.

The report criticized the IRS for not capitalizing on the potential of the Correspondence Examination Program to increase revenues and the Examination Coverage Rate. Despite the Correspondence Examination Program’s favorable cost, collectibility, and dollar per hour assessment statistics, the resources allocated to and the number of returns selected for correspondence examinations were declining.

At that time,³⁴ the IRS assigned low priority to the Correspondence Examination Program, and the Program’s favorable statistics were not variables included in the

³² Service centers are now referred to as IRS campuses.

³³ *The IRS Correspondence Examination Program* (Reference Number 94057, dated June 3, 1994).

³⁴ Period covered was 1988-1992.

Key Areas of Noncompliance Among Small Business and Self-Employed Taxpayers Could Be Addressed Through More Effective Use of Correspondence Examinations

Examination Resource Allocation Methodology. The Examination Cost Model used did not provide sufficient cost/yield data to ensure the efficient allocation of resources.

One of the recommendations made in the 1994 report was that the Correspondence Examination Program should be used to examine Schedule C expense line items as well as other nontraditional type examination issues, such as Passive Losses and Fiduciary Income (Form 1041). The report also advocated that Tax Examiners work more nonfiler cases themselves, rather than perform nonfiler case building for the field staff.

Additional research favors cost-effective examining

The IRS study, *The Impact of the IRS on Voluntary Compliance: Preliminary Empirical Results*, previously referred to in this report, stated that:

The most cost-effective activity is the one that is most automated and therefore cheapest because that would have the highest marginal indirect revenue to cost ratio. Automated activities have the greatest indirect yield to cost; examinations are among the activities with the largest indirect effect relative to their cost. Some IRS activities that do not produce direct enforcement revenue seem to produce an indirect effect on voluntary compliance.

Basically, correspondence examinations are potent tools to increase the reporting of income by fostering the voluntary compliance of those contacted and indirectly fostering the voluntary compliance of those not contacted.

Because the nature of the Correspondence Examination Program lends itself to automation improvements, these types of examinations help achieve the objective of maximizing net revenue – total revenue net of costs. Moreover, since most returns are examined by this method, it follows that statistically the indirect effect of correspondence examinations is significantly larger than the direct revenue effect of the examinations. Just by the sheer number of correspondence examinations conducted, there would tend to be a bigger indirect effect on voluntary compliance than by using other examination techniques.

Key Areas of Noncompliance Among Small Business and Self-Employed Taxpayers Could Be Addressed Through More Effective Use of Correspondence Examinations

Reengineering efforts have increased the productivity of the Correspondence Examination Program

Through the ongoing Examination reengineering efforts, the IRS has made multiple automation improvements within the correspondence examination process that further increased the Program's productivity and decreased operating costs.³⁵ For example, in FY 2002, the number of returns projected to be examined by correspondence examination was 575,216, and that number was expected to increase by 32 percent for FY 2003. While a small portion (4 percent) of this increase is attributable to additional staffing devoted to correspondence examinations, systemic improvements in case creation and inventory delivery account for most of the anticipated increases in productivity.

Other automation enhancements to the correspondence examination process will allow Tax Examiners to focus primarily on casework rather than spending time on clerical work. While the number of cases opened will increase, most will be processed automatically. Tax Examiners will be able to focus their efforts toward taxpayer responses, which truly require their expertise and attention.

IRS performance measures present an unbalanced picture

The IRS has traditionally measured the overall results of examinations by the amount of additional taxes recommended and the time charged directly to examinations by Examination function staff. These measures do not employ other existing data that could more fully represent the revenues and costs associated with examinations.

³⁵ A major initiative was the incorporation of batch processing into all correspondence examination cases. Batch processing is a multifunctional software application that interfaces with the Report Generation System used by the Tax Examiners. It allows for the automatic processing of cases from beginning to closure, eliminating Tax Examiner involvement with no-reply cases, including the automatic creation and issuance of the Statutory Notices of Deficiency and the closing of cases on the Audit Information Management System (the Examination function's automated inventory system) when Statutory Notice of Deficiency Periods expire.

Key Areas of Noncompliance Among Small Business and Self-Employed Taxpayers Could Be Addressed Through More Effective Use of Correspondence Examinations

In 1998, the GAO issued a report³⁶ criticizing existing IRS performance measures because:

- The measures did not report the dollar costs of the direct time charged to an examination or the indirect costs for the examination, settlement, and collection activities.
- The measures did not report how much of the recommended taxes were actually assessed and collected.

Measuring examination performance just by additional taxes recommended and direct examination staff time presents an unbalanced picture of the examination results. The GAO recommended the IRS report examination revenues with associated costs so that a fuller, more balanced picture is available to enable IRS management to make better decisions when allocating examination resources.

Furthermore, the GAO report stated the IRS needed performance measures that also took into consideration the indirect revenue effect of examinations (i.e., when examinations induced both examined and nonexamined taxpayers to be more voluntarily compliant and tax collections increased indirectly).³⁷

Recommendations

The Director, Compliance, SB/SE Division, should ensure that:

4. Examinations of tax returns are performed using the most cost-effective examination technique.

Management's Response: SB/SE Division management stated that while they agreed that returns needed to be

³⁶ *Tax Administration-IRS Measures Could Provide a More Balanced Picture of Audit Results and Costs* (GAO/GGD-98-128, dated June 1998).

³⁷ In response to the GAO's recommendations, the IRS indicated that it would annually report to the Congress the amounts of recommended taxes that are collected and continue to work on developing an activity-based costing model.

Key Areas of Noncompliance Among Small Business and Self-Employed Taxpayers Could Be Addressed Through More Effective Use of Correspondence Examinations

examined using the most cost-effective examination technique, they believe that they are accomplishing this through the automation of certain discretionary program inventory worked in the Correspondence Examination Program (i.e., Alternative Minimum Tax, Self-Employment Tax, and 10 Percent Penalty cases). They also stated that, through the CONOPS research projects, the SB/SE Division is actively exploring emerging noncompliance issues and existing issues suitable for correspondence examinations.

Office of Audit Comment: We are concerned that the current limitations placed on the types of cases selected for the Correspondence Examination Program may prevent the application of such an efficient examination technique to higher-priority SB/SE Division tax issues. The three tax issues that IRS management points to in their response – the Alternative Minimum Tax, Self-Employment Tax, and 10 Percent Penalty – are not new tax issues for the Correspondence Examination Program. Many of the CONOPS research projects conducted in FY 2003 (e.g., charitable contributions and the Child Care Credit) did not address key areas of SB/SE Division noncompliance. Likewise, projects planned for FY 2004 (e.g., home office expenses and gambling losses) will not identify new types of inventory for the Correspondence Examination Program.

5. Examination Program Performance Measures reflect cost and yield information for Revenue Agents, Tax Auditors/ Tax Compliance Officers, and Tax Examiners.

Management's Response: SB/SE Division management stated that they disagreed with this recommendation because it would be a violation of the RRA 98 to use cost and yield information to measure performance.

Office of Audit Comment: We are not suggesting that the cost and yield information be used to evaluate employee performance, but rather that the records of tax enforcement results be used for purposes such as financial planning, resources management, and the formulation of case selection criteria. The regulations contained in Part 801 of 26 CFR. Ch. 1 (1999) implement the provisions of RRA 98 §§ 1201 and 1204. These regulations specifically state that records of tax enforcement results may be used for purposes

Key Areas of Noncompliance Among Small Business and Self-Employed Taxpayers Could Be Addressed Through More Effective Use of Correspondence Examinations

The Current Examination Workload Selection Process Results in Inequitable Treatment of Taxpayers

such as forecasting, financial planning, resources management, and the formulation of case selection criteria. In fact, one of the examples contained in Part 801.6 (f) states that “a headquarters unit may use records of tax enforcement results to develop methodologies and algorithms for use in selecting tax returns to audit.”

On March 1, 2002, the IRS issued its *FY 2003-FY 2004 Small Business/Self-Employed Strategic Assessment Report*. This report stated that the Examination and Collection Workload Identification³⁸ Systems are antiquated and inefficient, and, as a result, the SB/SE Division does not have adequate workload identification systems and processes in place on which to base workload selection.

The IRS stated that Examination workload selection does not adequately identify cases with the greatest yield potential. As a result, excessive resources are dedicated to less egregious, noncompliant taxpayers rather than the biggest areas of risk to the U.S. tax system. The current workload selection system damages the IRS’ commitment to a fair and equitable system for all taxpayers.

The concept of coverage is to examine sufficient returns of all classes to assure all taxpayers of equitable consideration and to make the most efficient use of Examination staffing and other resources, with the objective of promoting the highest degree of voluntary compliance. Achievement of this objective is endangered when the function within the IRS that performs the majority of examinations does not always examine returns and schedules associated with the key areas of SB/SE Division noncompliance.

While SB/SE management plans to introduce some abusive tax scheme cases and increase the HINF and Frivolous Filer cases in the correspondence examination inventory for FY 2004, there does not appear to be an aggressive plan to rebalance the inventory selected for the various examination methods to ensure that correspondence examinations can address more key areas of noncompliance.

³⁸ Also referred to as inventory selection.

Key Areas of Noncompliance Among Small Business and Self-Employed Taxpayers Could Be Addressed Through More Effective Use of Correspondence Examinations

The growth of the SB/SE Division taxpayer segment (2.5 percent) is projected to exceed that for the W&I Division (1 percent) from FYs 2001 to 2007. Most of this growth is attributable to the growth in Schedule C filers (2.3 percent) for that period. Numerous demographic factors may be driving this growth, especially the proliferation of home-based and nonemployer businesses and the growth in immigrant entrepreneurs. Since multiple risk assessments identified Schedule C filers as major contributors to the tax gap, and new IRS projections point to accelerated growth among these Sole Proprietors, this creates an expectation of deepening compliance problems and the need to rebalance compliance efforts.

During this period of refocusing compliance efforts and Examination reengineering, the IRS needs to restore the strength of the Compliance function. Continuing to allocate resources to traditional methods of examination so that more of the same kind of inventory can be examined, in the same way as in the past, will not ensure that all taxpayers are treated equally and assume their fair share of the tax burden.

Recommendation

6. The Director, Compliance, SB/SE Division, should ensure that the workload selection process ensures fair and balanced treatment for all classes of taxpayers.

Management's Response: SB/SE Division management has taken a number of steps to identify different types of examination issues; these include establishing a team to identify unique SB/SE Division inventory other than the traditional inventory worked in prior years, coordinating with the National Headquarters Office of Research on a Risk-Based Selection CONOPS, coordinating with the Criminal Investigation function to identify potential inventory, and including more strategic priority work where possible. Management agreed to test the feasibility of introducing Schedule C expense examinations to the Correspondence Examination Program inventory, and they continue to work to circumvent the issue of non-transcribed lines on Schedules C and Forms 2106.

Key Areas of Noncompliance Among Small Business and Self-Employed Taxpayers Could Be Addressed Through More Effective Use of Correspondence Examinations

However, IRS management stated that the fact that the SB/SE and W&I Divisions cover the same tax issues does not make their treatment of taxpayers unfair or inequitable.

Office of Audit Comment: We agree with the steps SB/SE Division management has taken and plans to take to identify and introduce different types of examination issues into the Correspondence Examination Program inventory. However, as stated in this report, the IRS declared in the *FY 2003-FY 2004 Small Business/Self-Employed Strategic Assessment Report* that:

The Examination & Collection Workload Identification Systems are antiquated and inefficient and, as a result, the SB/SE Division does not have adequate workload identification systems and processes in place on which to base workload selection. The Examination workload selection does not adequately identify cases with the greatest yield potential. As a result, excessive resources are dedicated to less egregious, non-compliant taxpayers rather than the biggest areas of risk to the U.S. tax system. ...The current workload selection system damages the IRS' commitment to a fair and equitable system for all taxpayers.

We agree with this assessment. The fact that both the SB/SE and W&I Divisions cover the same tax issues is not what makes the system inequitable. It is the fact that certain tax issues fall solely under the domain of the SB/SE Division, and those issues are largely ignored when inventory is selected for the SB/SE Correspondence Examination Program.

Detailed Objective, Scope, and Methodology

The overall objective of this audit was to determine what steps the Internal Revenue Service (IRS) has taken to ensure that the process used to select inventory for its Small Business/Self-Employed (SB/SE) Division Campus¹ Correspondence Examination Program addressed key areas of SB/SE Division noncompliance. We also evaluated the workload selection process to determine how and what SB/SE Division cases were currently being selected for correspondence examinations at SB/SE Division campuses. To achieve our objective, we performed the following steps:

- I. Determined what role the IRS campus correspondence examinations have in helping to achieve the SB/SE Division's new compliance strategy.
 - A. Gathered and reviewed pertinent information related to the new SB/SE Division compliance strategy to determine what key areas of noncompliance the IRS hoped to address.
 1. Interviewed SB/SE Division headquarters staff to obtain information and documentation regarding the newly announced compliance strategy and the related initiatives intended to address key areas of noncompliance.
 2. Obtained information, reports, and documents regarding management's plans for the correspondence examinations conducted at the SB/SE Division campuses and their role in the overall compliance strategy.
 - B. Interviewed SB/SE Division management analysts to determine if they had any problems or concerns regarding the level and/or type of inventory selected for SB/SE Division correspondence examinations, the results of any pilot projects involving campus correspondence examinations, and any future plans for the Program.
- II. Determined the effects of the organizational redesign and reengineering efforts on the overall workload selection process for the SB/SE Division correspondence examination inventory and determined if IRS management had ensured that the inventory selected addressed the key areas of noncompliance identified in the new compliance strategy.
 - A. Interviewed SB/SE Division Compliance Services and Compliance Policy management analysts to determine how the overall workload selection process

¹ The campuses are the data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the computing centers for analysis and posting to taxpayer accounts.

Key Areas of Noncompliance Among Small Business and Self-Employed Taxpayers Could Be Addressed Through More Effective Use of Correspondence Examinations

- changed with regard to selection of inventory for the SB/SE Division Correspondence Examination Program as a result of the redesign and reengineering efforts.
- B. Reviewed the Internal Revenue Manual criteria and other documents regarding the selection of SB/SE Division inventory for correspondence examinations at IRS campuses.
 - C. Obtained the Fiscal Year 2003 SB/SE Division Examination Plan and evaluated the number of cases and types of issues scheduled to be selected for correspondence examination and the level of resources allocated to accomplish this work. We compared this information to the inventory worked at the Wage and Investment Division campuses and the resources allocated for the same period of time.
 - D. Using the information obtained from IRS inventory reports, determined the levels and types of correspondence examination inventory.

Major Contributors to This Report

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**Key Areas of Noncompliance Among Small Business and Self-Employed Taxpayers
Could Be Addressed Through More Effective Use of Correspondence Examinations**

Appendix III

Report Distribution List

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Key Areas of Noncompliance Among Small Business and Self-Employed Taxpayers Could Be Addressed Through More Effective Use of Correspondence Examinations

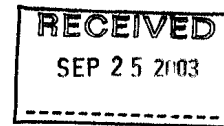
Appendix IV

Management's Response to the Draft Report



COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

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



SEP 23 2003

MEMORANDUM FOR TREASURY INSPECTOR GENERAL FOR TAX
ADMINISTRATION

FROM: Dale F. Hart *Dale Hart by M. S. [Signature]*
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – Key Areas of Noncompliance Among
Small Business and Self-Employed Taxpayers Could Be
Addressed Through More Effective Use of Correspondence
Examinations (Audit # 200230054)

I reviewed your draft report and agree, in part, with your findings and recommendations. I appreciate your acknowledgement of the actions we have taken to improve the case identification and selection for Correspondence Examination.

The Correspondence Exam Program conducts examinations on less complex individual income tax returns (Form 1040), by requesting information through the mail or by fax. The Correspondence Exam Program is designed to provide increased coverage¹ and improve voluntary compliance in an efficient, cost effective way. Issues examined in the correspondence program are commensurate with the technical knowledge of our grade 7 tax examiners working these cases.

Prior to Fiscal Year (FY) 2003, five SB/SE Campuses worked a significant Earned Income Tax Credit (EITC) inventory. In FY 2003, the resources for EITC were reduced and the EITC Program was consolidated in two SB/SE Campuses. Therefore, FY 2003 was a transition year from EITC work to more complicated SB/SE work. Because of the training implications and the potential impact on the coverage rate, we decided to transition from EITC to more complex work over a period of time, resulting in delivery of some traditional work² to the Campuses in FY 2003. The Centralized Workload Selection and Delivery (CWSD) office is responsible for case identification and selection of correspondence exam inventory.

¹ The exam coverage rate is calculated by dividing the number of returns examined in the current fiscal year by the number of returns filed in the preceding calendar year.

² Traditional work is defined as simple personal issues such as alimony, charitable contributions, dependency exemptions, etc.

Key Areas of Noncompliance Among Small Business and Self-Employed Taxpayers Could Be Addressed Through More Effective Use of Correspondence Examinations

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We are improving the identification and selection of SB/SE correspondence inventory in various ways. We established a Case Identification Team, including participants from CWSD, Headquarters Policy, and Operations to identify unique SB/SE inventory other than the traditional inventory worked in prior years. We are coordinating with the National Headquarters (NHQ) Office of Research on a Risk Based Selection Strategy Concept of Operations (CONOPS) by looking at issue identification, risk assessment, resource allocation, and workload selection, delivery, and feedback mechanisms. We are coordinating with the Criminal Investigation Division to identify Return Preparer Project (RPP) cases and Questionable Refund Program (QRP) referrals. We included strategic priority work, where possible, when developing the FY 2004 Work Plan. For instance, we centralized two strategic priorities in two separate Campuses (high-income, non-filer cases in the Memphis Campus and the frivolous filer inventory in the Ogden Campus), representing 37 percent of the total discretionary inventory.

Our comments on your recommendations follow:

RECOMMENDATION 1

The Director, Compliance, SB/SE Division, should ensure that more of the inventory selected to be worked in the SB/SE Division's Correspondence Examination Program addresses strategic noncompliance priorities.

CORRECTIVE ACTION

We agree, in part, with this recommendation. The key strategic noncompliance strategies for SB/SE are:

- Abusive tax avoidance transactions (ATAT) and promoter investigations
- Offshore accounts to hide or reduce income
- High-risk high-income individuals; high-income non-filer individuals (HINF)
- Unreported Income Discriminant Index Formula (UIDIF).

To the extent possible, the Correspondence Examination Program should be working strategic priorities. However, the majority of the work in the strategic priorities is either too complex to be handled through a correspondence examination or requires face-to-face contact. Therefore, we will continue our approach to work on strategic priorities that we can work in Correspondence Examination. We also believe that we need to provide compliance coverage in other taxpayer segments beyond those included in the strategic priorities. Because Correspondence Examination is a cost effective use of resources in providing coverage for many issues, we will continue to select work from areas beyond our strategic priorities.

We considered our key strategies and determined that it is unrealistic to conduct correspondence examinations on complex returns and sophisticated tax avoidance schemes. Verifying issues contained in bookkeeping records and journals, or the need

Key Areas of Noncompliance Among Small Business and Self-Employed Taxpayers Could Be Addressed Through More Effective Use of Correspondence Examinations

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for an interview, is not conducive to the correspondence process. Brief telephone contact is possible, but this is not a substitute for a taxpayer interview. During FY 2003, the Correspondence Examination Program worked cases in the High Income Non-Filer (HINF) program. These are SB/SE taxpayers with significant Form 1099-NEC, Non-Employee Compensation, income for which no tax return was filed. To date, this program accounts for 16 percent of the discretionary work. By the end of FY 2003, it will account for approximately 23 percent of the discretionary plan

The frivolous filer program addresses individuals that present tax avoidance arguments. This program is 21 percent of the discretionary workload for FY 2003. We included strategic priority work, where possible, when developing the FY 2004 Work Plan, representing 37 percent of the total discretionary inventory. We will continue to identify strategic priority work that is conducive to correspondence examination.

Because of the shifting of resources in field examination offices to more complex strategic priority inventory, we recognized the Correspondence Examination Program and the Tax Compliance Officer programs as SB/SE's opportunity to maintain and influence the coverage rate. Therefore, we decided to maintain the level of staffing for the Correspondence Examination Program at the FY 2002 level and to shift to more complex SB/SE work over time.

IMPLEMENTATION DATE

Completed

RESPONSIBLE OFFICIAL(S)

Director, Centralized Workload Selection and Delivery, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN

N/A

RECOMMENDATION 2

The Director, Compliance, SB/SE Division, should expand the tax issues and types of SB/SE Division returns that can be included in inventory selected for the Correspondence Examination Program after a period of limited testing.

CORRECTIVE ACTION

We agree. However, we believe the expansion of issues be done over time and after adequate testing. Your report refers to "73 percent of all individual income tax returns audited by correspondence, and that the IRS does not use the SB/SE Divisions' Correspondence Examination Program more effectively address the key areas of non-compliance, close the tax gap, and increase coverage and voluntary compliance..." This references all correspondence examinations completed by both

Key Areas of Noncompliance Among Small Business and Self-Employed Taxpayers Could Be Addressed Through More Effective Use of Correspondence Examinations

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Wage & Investment (W&I) and SB/SE. The SB/SE Division can influence only a part of the growth in the economic tax gap and not to the extent you cite in your report. In addition, correspondence examinations cannot affect the tax gap through unreported income audits due to the audit work necessary for those examinations. However, correspondence examinations can affect audits of abusive credits and personal and business issues.

To expand the issues and types of returns in correspondence examinations, SB/SE will need to test new issues to ensure we use the most cost effective means of examinations and that coverage is not affected by the potential increased time per case due to more complex issues. Through the use of CONOPS, we are expanding the issues covered by correspondence examination and will continue to seek business issues conducive to correspondence examination. For example, the Cincinnati Campus is coordinating with the Taxpayer Education and Communication (TEC), SB/SE Division on hobby loss issues. In addition, we have plans to work certain types of cases resulting from Abusive Tax Avoidance Transactions (ATAT) that may be worked via correspondence (e.g., cases claiming certain credits or home office expenses).

IMPLEMENTATION DATE

October 15, 2004

RESPONSIBLE OFFICIAL

Director, Filing Compliance Policy, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN

The Program Manager, Examination Service Centers, will advise the Director, Filing Compliance Policy of corrective action delays.

RECOMMENDATION 3

The Director, Compliance, SB/SE Division, should initiate training programs to ensure that Correspondence Examination Program Tax Examiners have the necessary skills to examine additional types of tax issues and schedules filed by SB/SE Division taxpayers.

CORRECTIVE ACTION

We have continual training programs, and we have centralized certain types of returns/issues in certain campuses to maximize our training resources and our coverage levels. Our tax examiners use the On-line Tax Advisor (OTA) and job aids posted to the Servicewide Electronic Research Program (SERP) to assist them while examining cases. Also, the office of Compliance Policy coordinates with Compliance Services and SB/SE Learning and Education to obtain subject matter experts (SMEs) for Continuing Professional Education (CPE) presentations and develop new courses for tax examiners.

Key Areas of Noncompliance Among Small Business and Self-Employed Taxpayers Could Be Addressed Through More Effective Use of Correspondence Examinations

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We will provide training for those campuses responsible for CONOPS research returns. As we centralize certain projects in the Campuses, we will provide the associated training. We will continue to develop and coordinate training programs to ensure tax examiners have the necessary skills to examine additional types of tax issues and schedules filed by SB/SE Division taxpayers.

IMPLEMENTATION DATE

January 15, 2004

RESPONSIBLE OFFICIAL

Director, Filing Compliance Policy, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN

The Program Manager, Examination Service Centers, will advise the Director, Filing Compliance Policy of corrective action delays.

RECOMMENDATION 4

The Director, Compliance, SB/SE Division, should ensure that examinations of tax returns are performed using the most cost-effective examination technique.

CORRECTIVE ACTION

We agree with the need to examine tax returns using the most cost-effective examination technique. We recognize the value of using correspondence examinations whenever practical. Our transition activity during FY 2003 demonstrates this along with our plans for FY 2004. Through CONOPS, SB/SE and W&I actively explore emerging non-compliance issues and existing issues suitable for a correspondence audit.

For campus Correspondence Examination, the most cost-effective examination technique requires the automation of the discretionary programs. Three programs will be automated in FY 2004: Alternative Minimum Tax (AMT), Self Employment Tax (SET) and 10 Percent Penalty. Efforts to provide automation support for other discretionary programs are under development for future implementation. We have performed Earned Income Tax Credit examinations with automation for the last two and a half years, which has greatly enhanced efficiency. Implementation of the batch processing technique significantly enhanced the efficiency of the correspondence examination program.

We disagree, however, with your report's statement "...the IRS allocates its inventory and examination resources based on preconceived perceptions of what the different types of examiners are capable of examining or what types of cases have traditionally been selected for their inventory, rather than on activity-based costing models." Your report cites a 1994 IRS Inspection Service Report on the IRS Service Center Correspondence Examination Program and its criticism that we did not capitalize on the

Key Areas of Noncompliance Among Small Business and Self-Employed Taxpayers Could Be Addressed Through More Effective Use of Correspondence Examinations

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potential of the correspondence examination program to increase revenue and the examination coverage rate. We did not agree with the recommendation made in that report about allocating methodology for the same reasons we do not agree with your report today.

Our resource allocation strategy allocates available resources to meet our strategic priorities and goals. We allocate resources to maintain or improve compliance, to support mandated programs, and to maximize enforcement. The actual "mix" of technical staffing is determined through strategic planning and priorities. Since our strategic priorities are to combat abusive schemes and the tax gap in the area of unreported income, workload requires the expertise of revenue agents, and to some extent, tax compliance officers, in lieu of tax examiners. For FY 2004, we diverted additional resources to correspondence discretionary return programs to maintain the FY 2002 level of coverage. Our projected discretionary return closures projected for FY 2004 increased by 14 percent over FY 2002 levels and will increase by approximately 40 percent by FY 2005.

IMPLEMENTATION DATE

Completed

RESPONSIBLE OFFICIAL

Director, Centralized Workload Selection and Delivery, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN

N/A

RECOMMENDATION 5

The Director, Compliance, SB/SE Division, should ensure that Examination Program Performance Measures reflect cost and yield information for Revenue Agents, Tax Compliance Officers, and Tax Examiners.

CORRECTIVE ACTION

We disagree. We cannot change our performance measures to reflect cost and yield information because it violates the IRS Restructuring and Reform Act of 1998 (RRA 98). However, we do agree that for financial planning, allocation of resources, and work planning, we use a cost based model.

We are committed to Performance Based Budgeting. We rely on a number of internal systems to provide hourly information and case closures. We calculate the Full Time Equivalents (FTE) from those systems and apply a labor dollar rate from our Automated Financial System (AFS). We plan to implement the Information Financial System (IFS),

Key Areas of Noncompliance Among Small Business and Self-Employed Taxpayers Could Be Addressed Through More Effective Use of Correspondence Examinations

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which will accommodate a cost accounting model and should fully account for projects, processes, and performance measures.

During this fiscal year, we used a cost-based model and other strategic considerations to determine the allocation of the new hires. Our model consistently shows additional staffing needs for correspondence exam. However, because of the major resource shifts in the field exam program in FY 2003 and 2004 to combat abusive promotions and schemes, and constraints by tight budget conditions, we decided to allocate the resources to our strategic priorities first. We have requested additional enforcement resources through the Achieving Balanced Levels of Enforcement (ABLE) initiative for FY 2004, including resources for correspondence exam.

IMPLEMENTATION DATE

Completed

RESPONSIBLE OFFICIAL

Director, Centralized Workload Selection and Delivery, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN

N/A

RECOMMENDATION 6

The Director, Compliance, SB/SE Division, should ensure that the workload selection process ensures fair and balanced treatment for all classes of taxpayers.

CORRECTIVE ACTION

We agree. We have taken a number of steps to identify different types of examination issues. These steps include:

- Establishing a team including participants from CWSD, Headquarters Policy, and Operations to identify unique SB/SE inventory other than the traditional inventory worked in prior years
- Coordinating with NHQ Office of Research on a Risk Based Selection CONOPS by looking at issue identification, risk assessment, resource allocation, and workload selection, delivery, and feedback mechanisms
- Coordinating with Criminal Investigation to identify RPP cases and QRP referrals
- Including strategic priority work, where possible, when developing the FY 04 Work Plan

We agree that Schedule C expense audits should be tested, but remain aware of potential barriers. We continue to find ways to circumvent these barriers. For instance,

Key Areas of Noncompliance Among Small Business and Self-Employed Taxpayers Could Be Addressed Through More Effective Use of Correspondence Examinations

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the lack of transcribed lines on Form 2106³ and Form 1040 Schedule C⁴ severely limits identification and classification through automated sources. In addition, a correspondence examination would essentially verify an expense was paid; however, determining whether it is an ordinary and necessary expense would not be addressed. The examination of a Schedule C expense item by correspondence exam may potentially result in missing unreported income. We will continue to test Schedule C.

We disagree, however, that because SB/SE and W&I cover the same issues, we are not fair and balanced in our treatment of all classes of taxpayers. We cannot ignore a segment of the population (i.e., SB/SE taxpayers, just because W&I examine those issues). If we do, then we will have inequitable treatment of one segment of taxpayers. As an organization, we must balance any inequitable treatment of taxpayers with similar issues. We will continue our efforts to ensure fair and equitable treatment for all classes of taxpayers.

IMPLEMENTATION DATE

Completed

RESPONSIBLE OFFICIAL

Director, Director, Centralized Workload Selection and Delivery, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN

N/A

If you have any questions, please call me at (202) 622-0600 or Joseph R. Brimacombe, Deputy Director, Compliance Policy, Small Business/Self-Employed Division, at (202) 283-2200.

³ Form 2106 line items are not transcribed at all, nor is the line 20 of Schedule A where Form 2106 information is reported.

⁴ Only 11 lines out of 25 expense line items on the Schedule C are transcribed.