

**The Wage and Investment Division Does Not
Have a Reliable System for Identifying Trends
Related to Automated Underreporter
Reconsideration Cases**

December 2003

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

December 30, 2003

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

Gordon C. Milbourn III

FROM: Gordon C. Milbourn III
Acting Deputy Inspector General for Audit

SUBJECT: Final Audit Report - The Wage and Investment Division
Does Not Have a Reliable System for Identifying Trends
Related to Automated Underreporter Reconsideration Cases
(Audit # 200340032)

This report presents the results of our review of Automated Underreporter (AUR) Reconsideration Cases. The overall objective of this review was to determine whether Internal Revenue Service (IRS) efforts have successfully reduced the number of subsequent AUR abatements related to Wage and Investment (W&I) Division taxpayers.

We conducted this review as a follow-up to our prior audit report¹ and as part of the Treasury Inspector General for Tax Administration's Fiscal Year (FY) 2003 discretionary audit coverage. In FY 2002, the IRS received over 130 million individual income tax returns and over 1.4 billion information returns. The IRS' AUR Program is part of the Information Reporting Program.

The IRS' AUR Program is an automated system that attempts to match taxpayer income and deduction information submitted by third parties² to amounts reported on individual income tax returns. The IRS attempts to reconcile any discrepancies by corresponding with taxpayers. If the taxpayers agree with the third-party information or do not provide any additional information to resolve the discrepancies, the taxpayers are assessed additional tax and their AUR cases³ are closed. Taxpayers sometimes

¹ *Audit Reconsideration Cases Create Unnecessary Burden on Taxpayers and the Internal Revenue Service* (Reference Number 2001-40-053, dated March 2001).

² Third parties such as banks, brokerage firms, employers, and others are required to file information returns to report income and certain deductions to the IRS.

³ An AUR case is a tax return that has been identified with one or more potential underreporter discrepancies.

respond to the IRS after their AUR cases are closed, asking the IRS to reevaluate, or “reconsider,” the AUR assessments. In our prior review, we determined that the IRS did not have an adequate system in place to measure the total volume of reconsideration cases to enable it to determine relative causes and develop corrective actions to reduce the total volume of future reconsideration cases. The IRS agreed and stated that it would develop and issue a monthly report to provide data from reconsideration cases worked by the various functions in the IRS.

Neither we nor the IRS can determine if the IRS has reduced the number of subsequent AUR abatements related to W&I Division taxpayers because the IRS still does not have a reliable reporting system that will effectively account for the total population of AUR reconsideration cases. The Reconsideration Management Information System (MIS) Report developed in response to our prior audit report does not sufficiently or accurately capture the information available from the reconsideration process. Without this information, the W&I Division Compliance function cannot perform valid analyses to develop and implement effective corrective actions to reduce the number of AUR reconsideration cases.

We recommended that the W&I Division Commissioner ensure that the Reconsideration MIS Report captures the correct W&I Division AUR Program information. In addition, the W&I Division Commissioner should also ensure that the Compliance function coordinates with the IRS’ Office of Revenue Analysis (ORA) to determine if the Reconsideration MIS Report can be modified to provide sufficient information to enable the W&I Division AUR Program to identify specific causes or trends and to develop effective corrective actions. If the Reconsideration MIS Report cannot be modified, then the W&I Division Compliance function needs to identify both a reliable method of tracking and counting AUR reconsideration case closures and what additional information is needed to perform valid trend analyses for identifying specific causes and developing effective corrective remedies.

Management’s Response: IRS management agreed with our recommendations and will implement corrective actions. IRS management will ensure that AUR employees use the correct reason codes on reconsideration cases as a means towards obtaining correct Reconsideration MIS Reports. The IRS will do this by including reviews of closed reconsideration cases during FY 2004 site reviews at W&I Division AUR campuses and by ensuring that reporting and closing procedures are stated clearly. The IRS will develop quality review requirements for reconsideration casework for the Quality function. The IRS will also ensure that training materials are updated and that the training sessions are scheduled and conducted.

In addition, the IRS will work with the ORA to capture information on those cases from other Business Operating Divisions (BOD)⁴ worked by the W&I Division AUR Program, eliminate the tentative allowance adjustment cases, and capture the W&I Division AUR reconsideration abatements processed by other IRS functions.

Lastly, management will work with the ORA to determine if the Reconsideration MIS Report can be modified to capture the recommended information. If the existing Reconsideration MIS Report cannot be modified to include the necessary information to identify trends and develop corrective actions, the IRS will explore other systemic methods to capture this information.

IRS management agreed with our outcome measure relative to Reliability of Information. However, they could not concur with the measure on Inefficient Use of Resources without conducting some analysis related to the measure. Management's complete response to the draft report is included as Appendix VIII.

Copies of this report are also being sent to the IRS managers who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions, or Michael R. Phillips, Assistant Inspector General for Audit (Wage and Investment Income Programs), at (202) 927-0597.

⁴ IRS operations are segregated and directed by four BODs known as the Large and Mid-Size Business, Small Business/Self-Employed, Tax Exempt and Government Entities, and W&I Divisions.

**The Wage and Investment Division Does Not Have a Reliable System for
Identifying Trends Related to Automated Underreporter Reconsideration Cases**

Table of Contents

Background	Page 1
More Information Is Needed to Determine Whether the Wage and Investment Division Has Successfully Reduced the Number of Reconsideration Cases	Page 4
<u>Recommendation 1:</u>	Page 10
<u>Recommendation 2:</u>	Page 11
Appendix I – Detailed Objective, Scope, and Methodology	Page 12
Appendix II – Major Contributors to This Report.....	Page 14
Appendix III – Report Distribution List	Page 15
Appendix IV – Outcome Measures	Page 16
Appendix V – Comparison of Automated Underreporter Assessments and Reconsideration Adjustments.....	Page 18
Appendix VI – Automated Underreporter Cases That Resulted in a Reconsideration Abatement by Category Code.....	Page 19
Appendix VII – Automated Underreporter Cases That Resulted in a Reconsideration Abatement by Process Code	Page 20
Appendix VIII – Management’s Response to the Draft Report	Page 21

The Wage and Investment Division Does Not Have a Reliable System for Identifying Trends Related to Automated Underreporter Reconsideration Cases

Background

The Internal Revenue Service's (IRS) Information Reporting Program is the cornerstone of voluntary compliance and affects compliance and revenue across every taxpayer and market segment. The Information Reporting Program helps ensure a high level of compliance by requiring third parties such as banks, brokerage firms, employers, and others to file information returns to report income and certain deductions to the IRS.¹ In Fiscal Year (FY) 2002, the IRS received over 130 million individual income tax returns and over 1.4 billion information returns.

The IRS' Automated Underreporter (AUR) Program is part of the Information Reporting Program. The AUR Program is an automated system that attempts to match taxpayer income and deduction information submitted by third parties to amounts reported on individual income tax returns. The IRS attempts to reconcile any discrepancies by corresponding with taxpayers. If the taxpayers agree with the third-party information or do not provide any additional information to resolve the discrepancies, the taxpayers are assessed additional tax and their AUR case² is closed. This process is not considered an examination of the tax return.

Taxpayers sometimes respond to the IRS after their AUR case is closed, asking the IRS to reevaluate, or "reconsider," the AUR assessment. This becomes an AUR reconsideration case. The IRS has discretionary authority under Internal Revenue Code Section 6404(a)³ to abate any unpaid portion of tax that is determined to be excessive. Under this authority, the IRS provides the taxpayer the opportunity to present information previously not considered. The IRS considers the additional information provided and makes one of the following determinations:

¹ Information returns are submitted by third parties to report certain business transactions to the IRS (e.g., the amount of payments made to and from individuals such as dividends, interest, sales of certain assets, and wages). The information is reported to the IRS on various forms such as the Form 1099 series (for various incomes such as Dividend, Interest, Miscellaneous, etc.) and the Wage and Tax Statement (Form W-2).

² An AUR case is a tax return that has been identified with one or more potential underreporter discrepancies.

³ Internal Revenue Code Section 6404(a) (1954).

The Wage and Investment Division Does Not Have a Reliable System for Identifying Trends Related to Automated Underreporter Reconsideration Cases

- The taxpayer is entitled to a full or partial abatement of the prior assessment.
- The taxpayer is not entitled to a full or partial abatement of the prior assessment and the reconsideration request is disallowed in full.
- The taxpayer needs to provide additional information.

In addition to reconsideration requests, the IRS resolves other post-AUR inquiries, which are referred to as quick closures. Normally, these closures are related to taxpayer inquiries where the IRS only provides an explanation for the basis of the original AUR assessment. The IRS does not consider these closures as true reconsiderations and does not track them.

The AUR Program is administered by the Compliance functions in the Small Business/Self-Employed (SB/SE) and Wage and Investment (W&I) Divisions, and operates in six IRS campuses.⁴ The W&I Division campuses are located in Atlanta, Georgia; Austin, Texas; and Fresno, California. The W&I Division's AUR sites work about 55 percent of the approximately 3 million AUR cases in inventory. During FYs 2000, 2001, and 2002, the W&I Division AUR Program closed from 1.2 million to 1.6 million cases and assessed from \$1 billion to \$1.4 billion each year.

An analysis of the IRS' main computer system identified 91,428 W&I Division AUR reconsideration cases processed during FYs 2000, 2001, and 2002. The chart on the next page shows the number of AUR reconsideration case abatements and the fiscal years in which they were processed.

⁴ 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.

The Wage and Investment Division Does Not Have a Reliable System for Identifying Trends Related to Automated Underreporter Reconsideration Cases

Automated Underreporter Reconsideration Abatements

Abatement Type	Fiscal Year			Totals
	2000	2001	2002	
Full	13,478	22,264	21,841	57,583
Partial	9,274	12,043	12,528	33,845
Totals	22,752	34,307	34,369	91,428

Source: Extracts from the Internal Revenue Service's main computer system.

Based on an AUR database provided by the W&I Division Compliance function for Tax Year (TY) 1999 tax returns, the W&I Division AUR Program selected 1,591,093 cases for review. As of December 2002, 912,331 of these AUR cases had resulted in a net adjustment to tax of \$1.36 billion. The IRS subsequently abated \$63.82 million after working reconsiderations on 26,207 of these AUR cases. These abatements represent 2.9 percent of the total number of AUR cases with adjustments and 4.7 percent of the total net tax dollars adjusted on AUR cases processed by the W&I Division AUR Program in TY 1999. Further details of the TY 1999 data are presented in Appendices V, VI, and VII.

In March 2001, we issued an audit report⁵ stating that the IRS did not have an adequate system in place to measure the total volume of reconsideration cases. We recommended the IRS improve its management information reports, track reconsideration cases to determine relative causes, and develop corrective actions to reduce the total volume of future reconsideration cases. A reduction in the volume of reconsideration cases would eliminate unnecessary taxpayer burden, as well as free up valuable resources that could be redirected to other compliance work.

The IRS agreed to our recommendations and stated that it would develop and issue a monthly report to provide data from reconsideration cases worked by the various functions in the IRS. Each of the functions would be responsible for

⁵ *Audit Reconsideration Cases Create Unnecessary Burden on Taxpayers and the Internal Revenue Service* (Reference Number 2001-40-053, dated March 2001).

The Wage and Investment Division Does Not Have a Reliable System for Identifying Trends Related to Automated Underreporter Reconsideration Cases

reviewing this report to identify trends, including the causes of reconsideration cases, and for developing corrective actions to reduce the total volume of future reconsideration cases.

We limited this follow-up review to those reconsideration cases resulting from the W&I Division AUR Program. We conducted our fieldwork from April to September 2003 in the W&I Division AUR Program in Atlanta, Georgia, and the IRS National Headquarters in Washington, D.C. We also conducted telephone interviews with functional personnel in the AUR campuses in Atlanta, Georgia; Austin, Texas; and Fresno, California. This 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.

More Information Is Needed to Determine Whether the Wage and Investment Division Has Successfully Reduced the Number of Reconsideration Cases

Neither we nor the IRS can determine if the IRS has reduced the number of subsequent AUR abatements related to W&I Division taxpayers because the Reconsideration Management Information System (MIS) Report that the IRS developed in response to our prior audit report does not sufficiently or accurately capture the information available from the reconsideration process. Without an adequate management information and reporting system, the IRS cannot track these cases, determine their causes, or implement measurable corrective actions that will reduce their number and ultimately decrease taxpayer burden.

The Reconsideration MIS Report has not provided the expected results for the following reasons:

- *The Reconsideration MIS Report was not completed on schedule.*

In response to our prior audit report, the IRS' Office of Revenue Analysis (ORA) planned to modify a prototype of the Reconsideration MIS Report that was under development and issue it by March 2001. The ORA worked in partnership with the W&I Division during this modification process. However, due to data anomalies and limited personnel resources, the FY 2001 Reconsideration MIS Report was delayed

The Wage and Investment Division Does Not Have a Reliable System for Identifying Trends Related to Automated Underreporter Reconsideration Cases

until May 2003. As a result, the W&I Division Compliance function has only recently begun to perform any trend analyses.

- *The Reconsideration MIS Report does not include the necessary information for trend analyses.*

The FY 2001 Reconsideration MIS Report provides very limited information on AUR reconsideration case activities. Although the Reconsideration MIS Report separates information into four distinct categories (i.e., full allowance, partial allowance, full disallowance, and no response by the taxpayer), it does not include any case-related or account information, such as the Social Security Numbers, or information specific to the AUR Program, such as the process⁶ or category⁷ codes. This information is essential for the W&I Division AUR Program to direct and perform effective cause and trend analyses.

As a result, the W&I Division Compliance function had to request the Reconsideration MIS Report's supporting data from the ORA. Even with this information, it will be necessary for the Compliance function to match these data to other IRS databases (e.g., the AUR database and the Individual Master File (IMF)⁸) so that effective trend analyses can be done. Without this case-specific information, the Reconsideration MIS Report by itself is useless in determining causes or taxpayer trends.

- *The Reconsideration MIS Report does not accurately capture the total volume of W&I Division AUR reconsideration cases.*

The accuracy of the Reconsideration MIS Report is dependent upon IRS employees using a reason code. AUR employees use reason codes to identify tax

⁶ The Process Code designates the status of the AUR case, which includes the various closing actions.

⁷ The Category Code designates the AUR mismatch situation or the reason the case was selected for resolution (e.g., wages or non-employee compensation).

⁸ The IRS database that maintains transactions or records of individual tax accounts.

The Wage and Investment Division Does Not Have a Reliable System for Identifying Trends Related to Automated Underreporter Reconsideration Cases

adjustments related to AUR reconsideration closures. Reason codes explain the type of reconsideration closure, such as a full allowance, partial allowance, full disallowance, or no taxpayer response to a request for additional information. IRS employees do not always input the reason codes into the computer system and, therefore, the codes are not included in the account information.

When reason codes are not included in the account information, the computer defaults to an analysis to identify those accounts with adjustments made after the original AUR assessments. These accounts are included in the Reconsideration MIS Report, although the adjustments or abatements may not be related to the AUR reconsideration assessment.

However, our analysis of account data extracted from the IMF showed that the W&I Division AUR Program closed a total of 34,307 cases in FY 2001 with either a full or partial abatement of the original AUR assessment. The Reconsideration MIS Report for the same period showed 14,592 reconsideration case closures for the W&I Division AUR Program, which indicates that not all full or partial abatements were captured.

- *The Reconsideration MIS Report does not accurately capture the total volume of W&I Division AUR nonadjustment reconsideration closures.*

Generally, W&I Division AUR Program employees close nonadjustment reconsideration cases (i.e., those cases where the IRS does not adjust the original AUR assessment) with a letter to the taxpayer but rarely input the related reason code to the IRS' computer system. There is no account analysis process to identify these closures for inclusion in the Reconsideration MIS Report.

For FY 2001, the W&I Division reported a total of 88,586 adjustment and nonadjustment post-AUR case closures. This number also includes quick closures, which are not considered true AUR reconsideration

The Wage and Investment Division Does Not Have a Reliable System for Identifying Trends Related to Automated Underreporter Reconsideration Cases

cases. Since the IRS does not consistently track nonadjustment reconsideration closures, there is currently no way to segregate these quick closures from the true nonadjustment reconsideration cases.

Deducting the 34,307 adjustment closures identified in our IMF analysis from the total of 88,586 adjustment and nonadjustment post-AUR case closures resulted in potentially 54,279 cases related to nonadjustment reconsideration closures during FY 2001. The Reconsideration MIS Report for the same period showed a total of 21 nonadjustment closures, which indicates a significant number of these cases may have been omitted.

- *The Reconsideration MIS Report incorrectly categorizes W&I Division AUR reconsideration closures.*

The IMF determines the Business Operating Division (BOD) Code⁹ based on the type of tax returns and related schedules filed by the taxpayers. W&I Division individual taxpayers file tax returns and related schedules used to report income from sources such as wages and investments. SB/SE Division individual taxpayers file tax returns and related schedules used to report income from sources such as self-employment, farming, and partnerships.

The FY 2001 Reconsideration MIS Report uses the current BOD designation to categorize the AUR reconsideration closures between W&I and SB/SE Division taxpayers. However, the BOD code is not the determining factor of whether an AUR case is selected for the W&I Division or SB/SE Division AUR Program inventory. For example, if a taxpayer with a SB/SE Division designation reports wage income on his or her tax return and the amount does not match IRS records, then the case would be selected and included in the W&I Division AUR Program inventory, regardless of the current BOD designation.

⁹ IRS operations are segregated and directed by four BODs known as the Large and Mid-Size Business, SB/SE, Tax Exempt and Government Entities, and W&I Divisions.

The Wage and Investment Division Does Not Have a Reliable System for Identifying Trends Related to Automated Underreporter Reconsideration Cases

- *The Reconsideration MIS Report includes tax adjustments that are not related to AUR reconsideration abatements.*

Based on its current criteria, the FY 2001 Reconsideration MIS Report includes certain taxpayer accounts that are not related to reconsideration abatements. The Reconsideration MIS Report criterion for capturing subsequent adjustments does not differentiate between tentative allowance adjustments and AUR reconsideration adjustments. A tentative allowance is an adjustment to the tax on a particular tax year that is based on issues related to a different tax year, such as a current tax year net operating loss applied to prior tax year earnings. As a result, the Reconsideration MIS Report included 510 tentative allowance adjustments, which are not AUR reconsideration adjustments.

- *The Reconsideration MIS Report excludes W&I Division AUR reconsideration abatements that were processed by another IRS function.*

The FY 2001 Reconsideration MIS Report excluded 219 W&I Division AUR reconsideration cases where the W&I Division AUR Program processed the original assessments and the subsequent abatements were processed by another IRS function. None of these cases are included in the Reconsideration MIS Report because the criterion does not recognize AUR assessments abated by another IRS function.

The *Standards for Internal Control in the Federal Government*¹⁰ state that for an entity to run and control its operations, it must have relevant, reliable, and timely communications and information.

The Reconsideration MIS Report was supposed to serve as the primary information source of all AUR reconsideration case closures. If the W&I Division AUR Program cannot rely on the accuracy of the Reconsideration MIS Report, it

¹⁰ *Standards for Internal Control in the Federal Government* (GAO/AIMD-00-21.3.1, dated November 1999).

The Wage and Investment Division Does Not Have a Reliable System for Identifying Trends Related to Automated Underreporter Reconsideration Cases

cannot perform valid and reliable analyses to identify specific causes or case trends or develop effective corrective actions.

Reconsideration cases create an unnecessary burden on the IRS when its employees work them because it must redirect its compliance resources away from current compliance work. Based on the 91,428 total W&I Division AUR reconsideration case closures with adjustments identified for FYs 2000, 2001, and 2002, and using IRS-computed production rates and associated costs for each respective fiscal year, the W&I Division AUR Program expended an estimated 38,652 staff hours at a cost of \$670,872.

Although neither the IRS nor we are able to specifically determine the total number of nonadjustment W&I Division AUR reconsideration closures through an analysis of the IMF, there were potentially 195,399 W&I Division AUR nonadjustment closures, which included quick closures, for FYs 2000, 2001, and 2002.

The IRS is burdened when taxpayers fail to respond to its initial requests for information to resolve discrepancies during the processing of the original AUR case and/or when taxpayers request an AUR reconsideration but do not respond to the IRS' requests for additional information. The National Taxpayer Advocate reports¹¹ that, "A variety of reasons have been put forth as to why taxpayers do not respond in EITC [Earned Income Tax Credit] examinations." These same reasons (such as language and literacy barriers, nonreceipt of notices, lack of time or resources to gather documentation, feelings of intimidation, etc.) could apply to IRS inquiries on AUR cases. The IRS does not know why taxpayers do not respond to the initial AUR inquiries.

The Reconsideration MIS Report should allow the IRS to analyze AUR reconsideration cases to identify AUR case trends. Further actions will be required to identify the specific reasons why some taxpayers do not respond during the initial processing of their AUR case and to develop and

¹¹ *National Taxpayer Advocate Fiscal Year 2002 Report to Congress.*

The Wage and Investment Division Does Not Have a Reliable System for Identifying Trends Related to Automated Underreporter Reconsideration Cases

monitor education/outreach programs to help these taxpayers. The expectation is that these efforts should eventually result in a decrease in the number of AUR reconsideration cases processed by the IRS each year.

Recommendations

The Commissioner, W&I Division, should:

1. Ensure that the Reconsideration MIS Report captures the correct W&I Division AUR Program information. This would include:
 - Ensuring W&I Division AUR employees follow existing case closing procedures by using the appropriate reason codes.
 - Working with the ORA to capture information on those cases from the other BODs worked by the W&I Division AUR Program, eliminate the tentative allowance adjustment cases, and capture the W&I Division AUR reconsideration abatements processed by other IRS functions.

Management's Response: The IRS will ensure that AUR employees use the correct reason codes on reconsideration cases as a means towards obtaining correct Reconsideration MIS Reports. The IRS will do this by including reviews of closed reconsideration cases during FY 2004 site reviews at W&I Division AUR campuses and by ensuring that reporting and closing procedures are stated clearly. The IRS will develop quality review requirements for reconsideration casework for the Quality function. The IRS will also ensure training materials are updated and that the training sessions are scheduled and conducted.

In addition, the IRS will work with the ORA to capture information on those cases from other BODs worked by the W&I Division AUR Program, eliminate the tentative allowance adjustment cases, and capture the W&I Division AUR reconsideration abatements processed by other IRS functions.

The Wage and Investment Division Does Not Have a Reliable System for Identifying Trends Related to Automated Underreporter Reconsideration Cases

2. Ensure that the W&I Division Compliance function coordinates with the ORA to determine if the Reconsideration MIS Report can be modified to provide sufficient information to enable the W&I Division AUR Program to identify specific causes or trends and to develop effective corrective actions. If the Reconsideration MIS Report cannot be modified, then the W&I Division Compliance function needs to identify a reliable method of tracking and counting AUR reconsideration case closures and identify what additional information is needed to perform valid trend analyses for identifying specific causes and developing effective corrective remedies.

Management's Response: The IRS will work with the ORA to determine if the Reconsideration MIS Report can be modified to capture the recommended information. If the existing report cannot be modified to include the necessary information to identify trends and develop corrective actions, the IRS will explore other systemic methods to capture this information.

The Wage and Investment Division Does Not Have a Reliable System for Identifying Trends Related to Automated Underreporter Reconsideration Cases

Appendix I

Detailed Objective, Scope, and Methodology

Our overall objective was to determine whether Internal Revenue Service (IRS) efforts have successfully reduced the number of subsequent Automated Underreporter (AUR) abatements related to Wage and Investment (W&I) Division taxpayers. To accomplish this objective, we performed the following tests:

- I. Determined the progress of efforts on the Reconsideration Management Information System (MIS) Report and whether it provided the information W&I Division Compliance function management needed to identify trends and causes of AUR reconsideration cases and develop and monitor corrective actions to reduce the total volume of future reconsideration cases.
 - A. Interviewed W&I Division Compliance function management to determine the status and expected purpose of the Reconsideration MIS Report, the information available for performing reconsideration trend analyses, and the input they provided in the development of the Reconsideration MIS Report.
 - B. Interviewed Office of Revenue Analysis (ORA) management to determine the:
 1. Status, composition, frequency, and expected purpose and scope of the Reconsideration MIS Report.
 2. Input W&I Division Compliance function management provided and how the ORA kept them informed of the Reconsideration MIS Report's development.
 - C. Analyzed the Fiscal Year (FY) 2001 Reconsideration MIS Report to determine whether it:
 1. Provided the information needed to identify trends and develop and monitor corrective actions needed to reduce the total volume of future AUR reconsideration cases.
 2. Included the total volume of AUR reconsideration cases and provided sufficient information to identify related account characteristics to determine the causes of the AUR reconsideration.
- II. Identified and analyzed the population of AUR assessments with subsequent full or partial abatements occurring in FYs 2000, 2001, and 2002 for trends and account characteristics.
 - A. Secured a download of selected information from the Tax Year (TY) 1999 and 2000 W&I Division AUR databases. We used this download information to identify the W&I Division AUR inventory of taxpayer accounts selected for resolution for those tax years.

The Wage and Investment Division Does Not Have a Reliable System for Identifying Trends Related to Automated Underreporter Reconsideration Cases

- B. Requested an Individual Master File (IMF)¹ extract through the Treasury Inspector General for Tax Administration's (TIGTA) Data Center Warehouse (DCW)² to secure a download of all IMF accounts that contained an Information Returns Processing indicator.
 - C. Matched taxpayer accounts for TYs 1999 and 2000 identified in Sub-Objective II.A. against the IMF transactions secured in Sub-Objective II.B. We identified the accounts that had an AUR assessment and an abatement posting subsequent to the AUR assessment and during FYs 2000, 2001, or 2002.
 - D. Selected taxpayer accounts for TYs 1997 and 1998 and earlier with a W&I Division Business Operating Division (BOD) Code³ designation. From that population, we identified the accounts that had an AUR assessment and an abatement posting subsequent to the AUR assessment and during FYs 2000, 2001, or 2002.
 - E. Selected 271 accounts from the raw data provided by the TIGTA DCW, and used the Integrated Data Retrieval System⁴ to validate that each account met our criteria (i.e., where an account with an AUR assessment had a subsequent adjustment). In addition, we used this validation process to identify any data anomalies (i.e., where the criteria were met but the accounts were not reconsideration case closures).
 - F. Performed a separate analysis of TY 1999 AUR data provided by W&I Division Compliance function management to determine the total population of W&I Division AUR cases identified for resolution, the number of W&I Division AUR cases resulting in an adjustment to tax, and the total number of those adjustment cases that resulted in a full or partial abatement of the original W&I Division AUR tax adjustment.
- III. Estimated the affect of processing AUR reconsideration cases using the populations determined in Sub-Objective II.
- A. Determined the number of taxpayer accounts excluded from the FY 2001 Reconsideration MIS Report where an original AUR adjustment was subsequently abated in part or full.
 - B. Determined the related cost of abating prior AUR assessments by using the cost data compiled by the IRS for the specific production program used for processing AUR reconsideration cases and applying that cost to the number of taxpayers receiving a full or partial abatement of the original AUR assessment in FYs 2000, 2001, or 2002.

¹ The IRS database that maintains transactions or records of individual tax accounts.

² The DCW consists of data used by the TIGTA in audits, investigations, integrity projects, and administrative requirements.

³ IRS operations are segregated and directed by four BODs known as the Large and Mid-Size Business, Small Business/Self-Employed, Tax Exempt and Government Entities, and W&I Divisions.

⁴ The IRS computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer's account records.

**The Wage and Investment Division Does Not Have a Reliable System for
Identifying Trends Related to Automated Underreporter Reconsideration Cases**

Appendix II

Major Contributors to This Report

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**The Wage and Investment Division Does Not Have a Reliable System for
Identifying Trends Related to Automated Underreporter Reconsideration Cases**

Appendix III

Report Distribution List

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The Wage and Investment Division Does Not Have a Reliable System for Identifying Trends Related to Automated Underreporter Reconsideration Cases

Appendix IV

Outcome Measures

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

Type and Value of Outcome Measure:

- Reliability of Information – Actual; 20,225 taxpayer accounts not included in the Fiscal Year (FY) 2001 Reconsideration Management Information System Report where an original Automated Underreporter assessment was subsequently abated in part or full (see page 4).

Methodology Used to Measure the Reported Benefit:

We analyzed an extract from the Internal Revenue Service's (IRS) Individual Master File (IMF)¹ and identified 34,307 taxpayer accounts where an Automated Underreporter (AUR) assessment was subsequently abated in FY 2001. We analyzed the FY 2001 Reconsideration MIS Report and determined a total of 14,592 taxpayer accounts were included as closed with a partial or full abatement of the original AUR assessment. We compared the Reconsideration MIS Report's related supporting information with an IMF extract of taxpayer accounts with an AUR assessment followed by a tentative allowance adjustment in FY 2001. We determined a total of 510 tentative allowances, which are not related to reconsideration abatements, were incorrectly included in the Reconsideration MIS Report. We deducted the 510 tentative allowance adjustments from the 14,592 total adjustments to determine the Reconsideration MIS Report accounted for 14,082 true reconsideration adjustments. The difference between these adjustments and the 34,307 identified in our IMF analysis represents an understatement of 20,225 adjustment cases that should have been included in the Reconsideration MIS Report.

Type and Value of Outcome Measure:

- Inefficient Use of Resources – Potential; approximately \$670,872 expended² during FYs 2000, 2001, and 2002 to process 91,428 full or partial abatements for accounts that could have been resolved during the original AUR resolution process (see page 4).³

¹ The IRS database that maintains transactions or records of individual tax accounts.

² Neither the IRS nor we can calculate the additional cost (if any) that these cases would have caused if the taxpayers had responded during the initial AUR inquiry. This figure does not take into consideration that cost. As a result, this figure may be overstated.

³ The numbers following this paragraph, which support these totals, may not equal these totals due to rounding.

The Wage and Investment Division Does Not Have a Reliable System for Identifying Trends Related to Automated Underreporter Reconsideration Cases

Methodology Used to Measure the Reported Benefit:

We analyzed an extract from the IMF for any AUR assessment subsequently abated in FYs 2000, 2001, or 2002. We determined that 22,752 reconsideration abatements posted in FY 2000, 34,307 posted in FY 2001, and 34,369 posted in FY 2002. We used the IRS' production figures cost index amounts to determine the hourly production rate, hours expended, the cost per hour, and the total resulting cost for each fiscal year.

The Wage & Investment Division AUR Program closed:

- 22,752 cases at a rate of 1.96546891 cases an hour and expended 11,576 staff hours at a cost of \$16.48 an hour for a total cost of \$190,772 in FY 2000.
- 34,307 cases at a rate of 1.94762994 cases an hour and expended 17,615 staff hours at a cost of \$17.48 an hour for a total cost of \$307,910 in FY 2001.
- 34,369 cases at a rate of 3.63280095 cases an hour and expended 9,461 staff hours at a cost of \$18.20 an hour for a total cost of \$172,190 in FY 2002.

**The Wage and Investment Division Does Not Have a Reliable System for
Identifying Trends Related to Automated Underreporter Reconsideration Cases**

Appendix V

**Comparison of Automated Underreporter Assessments
and Reconsideration Adjustments**

Tax Year 1999 with Automated Underreporter (AUR) Reconsideration Adjustments Posted from October 1, 1999, through December 31, 2002								
Original AUR Assessments					AUR Reconsideration Adjustments			
Category Code and Description		Closed Cases		Net Tax Change	Cases		Tax Change	
		Totals	Adjusted		Totals	%	Total	%
01	100 Percent Mortgage Interest	10,549	2,600	\$3,531,496	179	6.9%	\$323,099	9.1%
16	Withholding	104,982	53,542	\$10,861,308	4,569	8.5%	\$6,949,343	64.0%
19	Rents and Royalties	11,581	5,134	\$6,089,815	306	6.0%	\$561,730	9.2%
21	Medical Payments	4,720	803	\$1,311,924	42	5.2%	\$186,733	14.2%
26	Patronage Dividends	426	151	\$139,950	9	6.0%	\$12,800	9.1%
29	Cancellation of Debt	3,243	1,573	\$10,908,136	156	9.9%	\$1,472,415	13.5%
37	Crop Insurance	40	9	\$77,194	1	11.1%	\$461	0.6%
57	Non-Employment Compensation on Schedule F	1,002	134	\$211,871	12	9.0%	\$48,001	22.7%
60	Gross Long Term Care Benefit	22	6	\$13,337	2	33.3%	\$7,469	56.0%
*	No Reconsideration Adjustment	255	117	\$222,709				
**	Adjustment Rate Less Than 5 Percent	1,449,542	848,262	1,331,043,499	20,931		54,258,835	
Totals		1,586,362	912,331	\$1,364,411,239	26,207	2.9%	\$63,820,886	4.7%

Source: Internal Revenue Service Reports and Extracts from the Internal Revenue Service Computer System.

* Total for Category Codes that did not have a reconsideration adjustment.

** Total for Category Codes that had an adjustment rate of less than 5 percent.

**The Wage and Investment Division Does Not Have a Reliable System for
Identifying Trends Related to Automated Underreporter Reconsideration Cases**

Appendix VI

**Automated Underreporter Cases That Resulted in
a Reconsideration Adjustment by Category Code**

Tax Year 1999 Automated Underreporter (AUR) Reconsideration Adjustments Posted from October 1, 1999, through December 31, 2002			
Category Code		AUR Reconsideration Adjustments	
#	Description	Count	Percentage
04	Non-Employment Compensation (NEC)	5,926	22.6%
05	50 Percent Gross Receipts / NEC	844	3.2%
07	Wages	5,313	20.3%
08	Social Security / Railroad Retirement	923	3.5%
09	100 Percent Interest or Dividends	474	1.8%
13	Pension Taxable	1,597	6.1%
16	Withholding	4,569	17.4%
19	Rents and Royalties	306	1.2%
24	Gambling	954	3.6%
27	Prizes and Awards	393	1.5%
33	Unemployment Compensation	529	2.0%
34	Interest Combinations (not 07, 11, 13, 14)	411	1.6%
41	Not Categories 02 or 31	1,009	3.9%
42	Excess Individual Retirement Account Contribution \$150 Tax	729	2.8%
46	Excess Federal Insurance Contribution Act Withholding	260	1.0%
99	No Category Assignment	371	1.4%
*	Adjustment Rate Less Than 1 Percent	1,599	
Total		26,207	

Source: Internal Revenue Service Reports and Extracts from the Internal Revenue Service Computer System.

* Total for Category Codes with a reconsideration adjustment rate of less than 1 percent.

**The Wage and Investment Division Does Not Have a Reliable System for
Identifying Trends Related to Automated Underreporter Reconsideration Cases**

Appendix VII

**Automated Underreporter Cases That Resulted in a
Reconsideration Adjustment by Process Code**

Tax Year 1999 Automated Underreporter (AUR) Reconsideration Adjustments Posted from October 1, 1999, through December 31, 2002			
Process Code		AUR Reconsideration Adjustments	
#	Description	Count	Percentage
20	Adjustment for Withholding or Excess Social Security Tax Withheld	4,932	18.8%
67	Fully Agreed	4,629	17.7%
68	Partially Agreed	121	0.5%
87	Fully Agreed (Statutory Notice of Deficiency)	1,023	3.9%
88	Partially Agreed (Statutory Notice of Deficiency)	18	0.1%
90	Assessed by Default	15,394	58.7%
94	Default Assessments (Revision to Statutory Notice of Deficiency)	56	0.2%
*	Adjustment Rate Less Than 0.1 Percent	34	
Total		26,207	

Source: Internal Revenue Service Reports and Extracts from the Internal Revenue Service Computer System.

* Total for Process Codes with a reconsideration adjustment rate of less than 0.1 percent.

The Wage and Investment Division Does Not Have a Reliable System for Identifying Trends Related to Automated Underreporter Reconsideration Cases

Appendix VIII

Management's Response to the Draft Report



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

RECEIVED
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DEC 05 2003

MEMORANDUM FOR PAMELA J. GARDINER
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Henry O. Lamar, Jr. *Henry O. Lamar, Jr.*
Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report: The Wage and Investment Division Does Not Have A Reliable System for Identifying Trends Related to Automated Underreporter Reconsideration Cases (Audit # 200340032)

Thank you for the opportunity to comment on the report containing the results of your review of our efforts to automate the Automated Underreporter (AUR) Reconsideration cases. While we developed an AUR Reconsideration Management Information System (MIS) Report in response to your prior audit, we now acknowledge it has not proven to be useful or reliable. We partnered with the IRS' Office of Revenue Analysis (ORA) to modify a prototype of the MIS report, and this prototype would have conformed to your recommendation. However, we encountered several difficulties in arriving at the optimum data set necessary to create a viable MIS report. We continue to partner with ORA to refine the data set that would allow the generation of a satisfactory MIS report, as well as to resolve other systemic issues that may impede our progress.

We agree that many AUR employees are not using reason codes appropriately in reconsideration cases. This makes it difficult to identify tax adjustments related to AUR reconsideration closures. The relative newness of this required case action seems to have caused some employees to overlook this important step in the work process. We will perform an extensive review of reconsideration case work, including a review of IRM instructions and training materials to ensure the correct usage of reason codes.

As your report acknowledges, the total number of reported adjustments include "quick closures" that are not considered AUR reconsideration cases. Since quick closures are primarily taxpayer correspondence that seldom results in an adjustment to the account, it is necessary to separate these closures to arrive at an accurate volume of abatements. We have established separate Organization Function and Program (OFP) codes to report quick closure volumes and hours. OFP codes were used throughout FY-03. Analyzing a year's worth of data will assist us in perfecting these codes.

The Wage and Investment Division Does Not Have a Reliable System for Identifying Trends Related to Automated Underreporter Reconsideration Cases

2

It is important to recognize that the total number of AUR reconsideration cases that result in a change to the AUR assessment is relatively low when compared to the overall AUR annual inventory. Of the 1,586,362 AUR cases in FY-03, approximately 26,000 or less than 1.7 percent resulted in a change to the AUR assessment. Although we agree there is value in tracking AUR reconsiderations, and will partner with ORA to refine the MIS report, the cost of building a perfect AUR reconsideration tracking system will not result in a comparable return on investment, either in increased productivity or from a decrease in taxpayer burden. Therefore, we must continue to search for alternatives to building a totally new automated system.

While we concur with your outcome measure relative to Reliability of Information, we cannot concur with your outcome measure related to Inefficient Use of Resources. We need to conduct an extensive analysis of the Work Planning and Control (WP&C) data, individual case reviews, and cases in the data set used to compile the report in order to make these determinations. We will also attempt to determine specific reasons why some taxpayers do not respond during the initial processing of their AUR case. We will employ a survey or other instrument for data gathering, and use the information to partner with other IRS organizations to develop taxpayer outreach programs.

We thank you for your proposals and recommendations. We are always striving to improve our work processes, and will work diligently to implement your recommendations, and determine if your proposals have a favorable outcome.

Attached is a detailed response outlining corrective actions that we will take to address your recommendations. If you have any questions, please contact Jim Grimes, Director, Reporting Compliance, at (404) 338-7643.

Attachment

The Wage and Investment Division Does Not Have a Reliable System for Identifying Trends Related to Automated Underreporter Reconsideration Cases

Attachment

RECOMMENDATION #1

The Commissioner, W&I Division, should ensure that the Reconsideration MIS Report captures the correct W&I AUR Program information. This would include:

1. Ensuring W&I AUR employees follow existing case closing procedures by using the appropriate reason codes.
2. Working with the ORA to capture information on those cases from other Business Operating Divisions (BODs) worked by the W&I AUR Program; eliminate the tentative allowance adjustment cases; and capture the W&I AUR reconsideration abatements processed by other IRS functions.

CORRECTIVE ACTIONS

We agree with these recommendations.

1. We will ensure that AUR employees use the correct reason codes on reconsideration cases as a means toward obtaining correct MIS reports. We will do this by including reviews of closed reconsideration cases during FY-04 Site Reviews at W&I AUR campuses; reviewing the reconsideration instructions in IRM 4.19.2 (IMF Automated Underreporter Program); and ensuring that reporting and closing procedures are stated clearly. We will also develop quality review requirements for reconsideration casework for routine reviews by the Quality function. We will ensure training materials are updated, and that the training sessions are scheduled and conducted.
2. We will work with the ORA to capture information on those cases from other BODs worked by the W&I AUR Program, eliminate the tentative allowance adjustment cases, and capture the W&I AUR reconsideration abatements processed by other IRS functions. We note that BOD is not income category driven as indicated in your report, but rather by type of return filed.

IMPLEMENTATION DATE

Action 1 - 9/30/04

Action 2 - 6/30/05

RESPONSIBLE OFFICIAL

Director, Reporting Compliance, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

Implementation of these corrective actions will be monitored through our internal control system and managerial oversight.

The Wage and Investment Division Does Not Have a Reliable System for Identifying Trends Related to Automated Underreporter Reconsideration Cases

2

RECOMMENDATION #2

The Commissioner, W&I Division, should ensure that W&I Division Compliance coordinates with the ORA to determine if the Reconsideration MIS Report can be modified to provide sufficient information to enable the W&I AUR Program to identify specific causes or trends and to develop effective corrective actions.

CORRECTIVE ACTIONS

We agree with this recommendation. We will work with ORA to determine if the MIS Report can be modified to capture the recommended information. If the existing report cannot be modified to include the necessary information to identify trends and develop corrective actions, we will explore other systemic methods such as Desktop Integration to capture this information.

IMPLEMENTATION DATE

Proposed: 06/30/2005

RESPONSIBLE OFFICIAL

Director, Reporting Compliance, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

Implementation of these corrective actions will be monitored through our internal control system and managerial oversight.