

**The Limited Issue Focused Examination
Process Has Merit, but Its Use and
Productivity Are Concerns**

February 2005

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DEPARTMENT OF THE TREASURY
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INSPECTOR GENERAL
for TAX
ADMINISTRATION

February 18, 2005

MEMORANDUM FOR COMMISSIONER, LARGE AND MID-SIZE BUSINESS
DIVISION

Pamela J. Gardiner

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report - The Limited Issue Focused Examination
Process Has Merit, but Its Use and Productivity Are Concerns
(Audit # 200330034)

This report presents the results of our review of the Internal Revenue Service's (IRS) Limited Issue Focused Examination (LIFE) process. The objective of this review was to assess the effect the LIFE process has on the outcomes of the IRS' Large and Mid-Size Business (LMSB) Division¹ examinations. To meet our objective, we determined the progress that has been made towards incorporating the LIFE process into examinations and the potential it has for reducing the length of examinations, generating higher degrees of productivity, and minimizing taxpayer burden. We also assessed the status of ongoing changes, if any, to improve the process.

In summary, the LIFE process has merit for reducing the length of examinations. With increasing workloads and a renewed emphasis on enforcing compliance, using methods and techniques that reduce the length of examinations by focusing on a few material issues and resolving them as early as possible is a sound business decision. Estimates were not available on the extent to which the LIFE process saved large businesses money because taxpayer burden reduction data were not tracked or evaluated in LIFE cases.² However, representatives from large businesses that we spoke with believed the process produced savings in terms of reducing the length of examinations. Moreover, our analysis of LMSB Division statistics showed that LIFE cases, on average, were completed in 236 fewer days than non-LIFE cases.

¹ The LMSB Division is one of four IRS operating divisions. It is responsible for examining the tax returns of large businesses (those corporations and partnerships reporting more than \$10 million in assets) to determine if they have paid the proper amount of tax.

² For purposes of this report, a case refers to an examination of one or more returns unless otherwise noted.

Introduced publicly in December 2002, the LIFE process was announced by the LMSB Division as a major cultural shift and significant change to the way examinations are conducted. The goals of the LIFE process include restricting examinations of large businesses to the few issues on their tax returns that pose the greatest compliance risk. The underlying concept for the LIFE process is based on the assumption that, by focusing on a few critical issues, the scope, depth, length, and burden of examinations can be reduced while higher degrees of productivity³ are realized.

While the LIFE process has merit, efforts to incorporate it into the examination process of large businesses have made little progress. As of September 2004, approximately 4.2 percent of the examinations initiated for large businesses involved the LIFE process. The business results from these cases are a concern because the statistics show LIFE cases are generating significantly less additional recommended taxes than other large business examinations, which could affect tax revenues. Our analysis indicates if the IRS allocated 5 percent of the available examinations of large businesses to the LIFE process over the next 5 years, the amount of recommended additional taxes could drop an average of \$349 million a year (\$1.7 billion over 5 years).

The limited progress and productivity from LIFE cases were caused, in large part, by implementing the LIFE process nationally before demonstrable results were obtained from a pilot project⁴ that supported full-scale implementation. Our onsite visits and other work show that this approach is proving too ambitious and difficult to manage considering the significance of the change and its near simultaneous introduction to over 5,400 examiners⁵ located in offices throughout the nation. Successful organization best practices suggest that significant work process changes, such as the LIFE process, have a greater potential for success when they are piloted before wide implementation.⁶

We found, for example, the progress of implementing the LIFE process was hindered by a new initiative, the Currency and Cycle Time Improvement Initiative (Currency Initiative), that overlapped with the implementation of the LIFE process and was more aggressive in holding examiners accountable for closing examinations. As a result, examiners gave the Currency Initiative a higher priority than the LIFE process, which had the effect of reducing the number of LIFE cases. Additionally, our review of

³ Productivity measures the efficiency with which an organization uses resources; the measures generally take the form of the ratio of outputs to inputs. In IRS examinations, a productivity measure is the amount of recommended assessments (output) per direct examination time (input). This measure is commonly referred to as dollars per hour.

⁴ Pilot projects are essentially trial runs of process changes that are typically conducted on a small scale and at a limited number of sites. Their purpose is to evaluate the soundness of the proposed changes and to identify trouble spots so corrective actions can be taken before full-scale implementation.

⁵ As discussed in this report, the term examiner encompasses front-line managers who supervise the teams of examiners in the LMSB Division. We included front-line managers under the term "examiner" because of the significant amount of involvement they should have in LIFE cases. Among other things, in LIFE cases they are responsible for approving risk assessments, executing the LIFE agreement with large businesses, approving the expansion of examination scopes, and terminating the LIFE process if that becomes necessary.

⁶ Government Accountability Office (GAO) documents entitled, *Business Process Reengineering Assessment Guide* (GAO/AIMD-10.1.15, dated May 1997) and *Tax Administration: Planning for IRS's Enforcement Process Changes Included Many Key Steps but Can Be Improved* (GAO-04-287, dated January 2004).

24 LIFE cases found that important procedures were not always followed in conducting the risk assessment portion of the LIFE process. The risk assessment, from a productivity and compliance risk standpoint, is critical to the success of the LIFE process because it incorporates materiality considerations in ultimately determining the large, unusual, and questionable tax issues that will be examined. Consequently, if risk and materiality are not adequately and effectively assessed, significant tax issues may be overlooked that could reduce the amount of recommended additional taxes from examinations. To its credit, the LMSB Division has already begun to take steps in response to this problem and is enhancing the training of examiners.

While the training is important, in our opinion training, alone, will not ensure the success of the LIFE process. The LMSB Division will need to closely monitor risk assessments in LIFE cases to pinpoint and correct trouble spots that could arise as examiners begin applying their training in the “real world” environment. Further, in terms of productivity and compliance risk, the LMSB Division will need to ensure two major procedural requirements are followed. First, specialists such as engineers and international examiners need to be involved in determining the scope and depth of LIFE cases. Second, the mandatory tests of income, inventory, and related returns need to be properly addressed.

Although the LIFE process presents some real opportunities for the LMSB Division to reduce the length of examinations, limited progress has been made to incorporate it into large business examinations, and there are significant uncertainties surrounding the impact it could have on tax revenues. Because of these and other concerns, we recommended the Commissioner, LMSB Division, (1) develop and implement a plan for analyzing data on LIFE examinations that is reliable and can serve as the basis for correcting any problems identified, (2) clarify if and how the LMSB Division’s Currency Initiative is to be integrated with the LIFE process, and (3) ensure that mid-level managerial reviews include evaluating open cases and assessing whether the LIFE process is being properly considered for and used in examinations.

Management’s Response:

The Commissioner, LMSB Division, is taking corrective action on all but one of our three recommendations. The LMSB Division is changing its approach for collecting and analyzing data on LIFE examinations by including the results of subsequent year and related examinations in program monitoring. The LMSB Division will also develop a set of review procedures involving at least six items related to the LIFE process. However, the Commissioner, LMSB Division, responded there will not be a need to clarify for examiners the integration of the Currency Initiative with the LIFE process since the Currency Initiative was substantially completed by April 2004.

The Commissioner, LMSB Division, also did not agree with our estimates of the benefit that could be realized by implementing our recommendations. The response suggested that our approach did not fully consider certain types of examinations that the LMSB Division believes distort business results when comparing LIFE examinations to the

other returns closed during the same period. Management's complete response to the draft report is included as Appendix VI.

Office of Audit Comment:

We agree that there will not be a need to clarify for examiners the integration of the Currency Initiative with the LIFE process since the Currency Initiative was substantially completed by April 2004, according to the Commissioner, LMSB Division. The Currency Initiative was originally scheduled to be implemented in two phases and would have likely extended it well beyond the time period covered by this review, hence, the reason for the recommendation.

With respect to our estimate of the benefit that could be realized by implementing our recommendations, the Commissioner, LMSB Division, recognized in the response that initial results of the LIFE process are not impressive, but recent results have improved. The Commissioner also implies that results from certain types of examinations in the IRS databases should have been eliminated from and/or added to our estimate. We agree eliminating results from certain types of examinations and adding results from others can affect the calculation. However, we chose to use the complete examination results as they were reflected in the IRS databases and continue to believe that our estimate sufficiently quantifies the benefit.

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

**The Limited Issue Focused Examination Process Has Merit,
but Its Use and Productivity Are Concerns**

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Background

The Large and Mid-Size Business (LMSB) Division is one of four Internal Revenue Service (IRS) operating divisions. It is responsible for examining the tax returns of large businesses (those corporations and partnerships reporting more than \$10 million in assets) to determine if they have paid the proper amount of tax. Because of the size and complexity of the large businesses examined under the jurisdiction of the LMSB Division, engineers, economists, international examiners, and other specialists provide assistance with these examinations. IRS data show that, in Fiscal Year (FY) 2004, the LMSB Division completed examinations of 19,452 returns and recommended large businesses pay \$18.2 billion in additional taxes.

The Limited Issue Focused Examination (LIFE) process was introduced publicly in December 2002 as a streamlined alternative to the traditional full-scope examination process. As summarized in Table 1, it involves six key elements and includes a requirement that examiners and large businesses enter into a Memorandum of Understanding (MOU).

Table 1: Key Elements of the LIFE Process

Steps	Description
1. Engaging the taxpayer.	The possibility of using the LIFE process should be discussed in the early stages of the examination.
2. Conducting a risk analysis.	The tax return and records are reviewed to identify large, unusual, and questionable tax issues.
3. Considering the materiality of tax issues.	Large, unusual, and questionable tax issues are prioritized for examination.
4. Reducing the scope of the examination.	The prioritized large, unusual, and questionable tax issues are pared down to the critical few.
5. Executing the MOU.	The MOU is required and signed by both the taxpayer and the IRS.
6. Terminating the LIFE process.	Either the taxpayer or the LMSB Division may terminate the LIFE process.

Source: *The IRS Internal Revenue Manual (IRM)*.¹

The purpose of the LIFE process MOU is to control key aspects of the examination by outlining mutually agreed on time periods for requesting and submitting tax records,

¹ The IRM serves as the official compilation of procedures, instructions, and guidelines that govern operations in the IRS.

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discussing the progress of the examination, and presenting and responding to examination results. Additional details on the MOU used in LIFE examinations can be found in Appendix V, where it has been reprinted.

When compared to the traditional full-scope examination, the LIFE process has similarities and important differences. In both types of examinations, an examiner² usually starts by reviewing the tax return of the large business to identify large, unusual, or questionable tax issues (e.g., income, deductions, credits) that should be examined. Once the large, unusual, or questionable tax issues are identified, the examiner collects and evaluates information that was used to support these tax issues on the tax return. If the examiner determines the information collected from the large business is insufficient to support the tax issues, the examiner recommends an adjustment and computes a new tax liability. Conversely, if the information supports the tax issues, the examiner recommends no change to the originally reported tax liability.

The procedures for a traditional full-scope examination require that examiners complete numerous mandatory tests in addition to examining large, unusual, or questionable tax issues. For example, examiners are required to document the results of as many as 13 tests in verifying whether inventories and income were correctly reported on the tax returns of large businesses. Reviews are also made of all other tax returns related to the one being examined.

While the LIFE process follows steps similar to those in a traditional full-scope examination in terms of collecting and evaluating information from large business, there are important differences. These differences should result in

² As discussed in this report, the term “examiner” encompasses front-line managers who supervise the teams of examiners in the LMSB Division. We included front-line managers under the term “examiner” because of the significant amount of involvement they should have in LIFE cases. Among other things, in LIFE cases they are responsible for approving risk assessments, executing the LIFE agreement with large businesses, approving the expansion of examination scopes, and terminating the LIFE process if that becomes necessary.

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LIFE cases³ taking less time to complete than full-scope examinations. In LIFE cases, for example, there should be fewer tax issues involved in the examination since the LIFE process incorporates risk analysis and materiality considerations to limit the number of large, unusual, and questionable tax issues that will be examined. Moreover, most mandatory tests can be waived, including those involving inventory and income. Unlike the traditional full-scope examination process, the LIFE process also seeks to lessen the natural tension that exists between examiners and large business taxpayers by jointly holding both parties responsible for the timely completion of the examination.

This review was performed at the LMSB Division Headquarters in Washington, D.C., and IRS offices in the San Francisco, California; Chicago, Illinois; and Boston, Massachusetts, metropolitan areas during the period October 2003 through May 2004. 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.

The Issue Focused Approach to Compliance Shows Promise in Addressing Concerns

We believe the LIFE process has merit for reducing the length of examinations. With increasing workloads and a renewed emphasis on enforcing compliance, using methods and techniques that reduce the length of examinations by focusing on a few material issues and resolving them as early as possible is a sound business decision. Since stand-up⁴ nearly 4 years ago, the LMSB Division has been emphasizing a more issue focused approach to encourage and enforce compliance. This approach, which is embodied in the LMSB Division Issue Management Strategy, is shifting the emphasis away from lengthy examinations and towards processes that are focused on resolving tax issues earlier in the process.

³ For purposes of this report, a case refers to an examination of one or more returns unless otherwise noted.

⁴ The IRS defines “stand up” as the establishment of a new organization with at least the minimum requirement of operating including a finance office, separate budget, key management positions filled, temporary solutions to problems, personnel actions for realignment completed, and necessary business authorities in place.

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IRS and LMSB Division strategic planning documents show that there are at least two factors driving this change. First, issue-driven processes create opportunities for the LMSB Division to enhance service to and reduce burden on large businesses. Large businesses have long complained about the time, costs, and hence burdens, associated with lengthy examinations of their tax returns. In recent testimony before the United States Senate Finance Committee, the IRS Commissioner stated:

It currently takes two years on average before complicated corporate returns find their way into the hands of the assigned examiner, and it takes five years from the date the return is filed for us to complete the audit [examination] of a large, complex corporation. (These figures do not include the appeals process, which may take another two years before the matter is settled or goes to court.)

Second, by focusing on the high-risk, significant issues and resolving them sooner, the LMSB Division anticipates that examiners will have more time to better meet the demands of a growing workload with increasing complexity. This is important because, among other things, the number of returns being filed by large businesses is increasing and there is a renewed emphasis on enforcing compliance due, in part, to the promotion and use of abusive tax shelters. By nature, abusive tax shelters are complex and difficult to detect on tax returns because steps are generally taken to hide them within transactions reported on the returns. According to the IRS and others, abusive tax shelters involve billions of dollars and therefore deserve substantially increased attention.

As we have previously reported,⁵ the LMSB Division has successfully designed, tested, and implemented under its Issue Management Strategy processes that are encouraging the early resolution of tax issues in both the pre-filing and

⁵ Treasury Inspector General for Tax Administration reports entitled, *The Pre-Filing Agreement Pilot Project Was Successful, But Faces Challenges in Converting to an Operational Program* (Reference Number 2001-30-125, dated August 2001) and *The Fast Track Dispute Resolution Pilot Program Was Successful, but Some Challenges Remain* (Reference Number 2004-30-119, dated July 2004).

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postfiling stages of the tax return. For example, a prefiling agreement process was introduced through a pilot project⁶ in Calendar Year 2001 and subsequently converted to a permanent program. The program permits a taxpayer to resolve, before the filing of a return, the treatment of an issue that otherwise would likely be disputed in a postfiling examination. A “fast track” process for resolving disputes that surface in examinations has also been piloted and converted to a permanent program. The goal of the program is to expedite the entire postfiling issue resolution process by bringing in the IRS Office of Appeals to resolve disputes concurrent with, rather than subsequent to, an examination.

As a component of the Issue Management Strategy, the LIFE process was announced by the LMSB Division as a major cultural shift and significant change to the way examinations are conducted. The goals of the LIFE process include restricting examinations of large businesses to the few issues on their tax returns that pose the greatest compliance risk. The underlying concept for the LIFE process is based on the assumption that, by focusing on a few critical issues, the scope, depth, length, and burdens of examinations can be reduced while higher degrees of productivity⁷ are realized.

Estimates were not available on the extent to which the LIFE process saved large businesses money because burden reduction data were not tracked or evaluated in LIFE cases. However, representatives from large businesses we spoke with believe the process produced savings in terms of reducing the length of examinations. As shown in Table 2, our analyses of LMSB Division statistics show that LIFE cases, on average, were completed in 236 fewer days than non-LIFE cases.

⁶ Pilot projects are essentially tests or trial runs of process changes that are typically conducted on a small scale and at a limited number of sites. Their purpose is to evaluate the soundness of the proposed changes and to identify trouble spots so corrective actions can be taken before full-scale implementation.

⁷ Productivity measures the efficiency with which an organization uses resources; the measures generally take the form of the ratio of outputs to inputs. In IRS examinations, a productivity measure is the amount of recommended assessments (output) per direct examination time (input). This measure is commonly referred to as dollars per hour.

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Table 2: Comparison Between the Length of Non-LIFE and LIFE Cases (FY 2003 – 2004)

Type of examination	Average days between examination start date and closure date
Non-Life	579
LIFE	343
Difference	236

Source: Treasury Inspector General for Tax Administration (TIGTA) analysis of the IRS' Audit Information Management System (AIMS)⁸

Statistical Trends Raise Questions About the Limited Issue Focused Examination Process

While the LIFE process has merit, efforts to incorporate it into the examination process of large businesses have made little progress. As of September 2004, approximately 4.2 percent of the examinations initiated of large businesses involved the LIFE process. This is well below the LMSB Division's initial goal of having at least 25 percent of its examinations using the LIFE process in FY 2006. While discussing the issues in this report with IRS officials, we learned officials now see the LIFE process being used in about 6 percent of examinations. Nevertheless, the business results from these cases are a concern since the statistics show LIFE cases are generating less additional recommended taxes than other large business examinations, which could impact tax revenues.

To illustrate the potential revenue effect, we analyzed a hypothetical allocation of 5 percent of the available examinations to LIFE cases over the next 5 years. The estimate is based on 677 LIFE cases closed in FY 2004 and the average amount of additional taxes that were recommended for each hour spent on an examination in FY 2004. Assuming this data remains constant, our analysis indicates that by allocating 5 percent of the available examinations to LIFE cases over the next 5 years, the amount of recommended additional taxes could drop an

⁸ The AIMS is a computer system used to control returns, input assessments/adjustments to the Master File, and provide management reports. The Master File is the IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organization data.

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average of \$349 million a year (\$1.7 billion over 5 years). Appendix IV contains additional details on our analysis.

The limited progress and productivity from LIFE cases was caused, in large part, by implementing the LIFE process nationally before demonstrable results were obtained from a pilot project that supported full-scale implementation. As described in more detail below, our onsite visits and other work show this approach is proving too ambitious and difficult to manage considering the significance of the change and its near simultaneous introduction to over 5,400 examiners located in offices throughout the nation. The LMSB Division's past experiences and best practices of other organizations suggest that significant work process changes, such as the LIFE process, have a greater potential for success when they are piloted before wide implementation.⁹

The progress of the LIFE process was hindered by an aggressive new initiative that overlapped with its implementation

In September 2003, the LMSB Division moved forward with a Currency and Cycle Time Improvement Initiative¹⁰ (Currency Initiative) that overlapped with the implementation of the LIFE process and was more aggressive in holding examiners accountable for closing examinations. It was more aggressive than the LIFE process because it directed examiners to meet specific dates for closing open examinations by establishing specific time periods for requesting and submitting tax records and

⁹ Government Accountability Office (GAO) documents entitled, *Business Process Reengineering Assessment Guide* (GAO/AIMD-10.1.15, dated May 1997) and *Tax Administration: Planning for IRS's Enforcement Process Changes Included Many Key Steps but Can Be Improved* (GAO-04-287, dated January 2004).

¹⁰ For examination purposes, a large business taxpayer is considered current in the LMSB Division if each of its returns filed for the last 2 years is either under examination or is no longer being considered for examination. The LMSB Division uses cycle time to measure the timeliness of examinations, which is defined as the average number of months from when a return is filed until the examination process is completed. In FY 2004, Industry Case and Coordinated Industry Case examinations were considered timely if, on average, they were completed within 34 and 58 months, respectively.

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presenting and responding to examination results. As a result, examiners gave the Currency Initiative a higher priority than the LIFE process, which potentially had the effect of reducing the number of LIFE cases.

During our interviews with examiners involved in 33 non-LIFE cases, we were told the Currency Initiative essentially required restricting examination scopes to meet the deadlines established for closing examinations. They also expressed concern that the LIFE process could inhibit their ability to meet deadlines because of the additional time that could be involved in negotiating the various items in the MOU. Consequently, examiners saw limited benefit in using the LIFE process.

Examiners could have been better prepared to conduct examinations using the LIFE process

From a productivity and compliance standpoint, the risk assessment is critical to the success of the LIFE process. The risk assessment incorporates materiality considerations in ultimately determining the large, unusual, and questionable tax issues that will be examined. Consequently, if risk and materiality are not adequately and effectively assessed, significant tax issues may be overlooked that could reduce the amount of recommended additional taxes from examinations.

Although mandatory LIFE process training and risk analysis instructions had been provided, we found examiners had difficulty consistently completing required steps in the risk assessment. We briefed officials in the LMSB Division about our findings in this area during a meeting in February 2004. To its credit, the LMSB Division has already taken steps to address the problem and is enhancing the training of examiners.

A course that is standardizing the risk assessment process was developed and offered to all examiners beginning on June 10, 2004. While the training is important, in our opinion training, alone, will not ensure the success of the LIFE process. The LMSB Division will need to closely monitor risk assessments in LIFE cases to pinpoint and correct trouble spots that could arise as examiners begin applying their training in the “real world” environment.

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Management controls could have been stronger to ensure required procedures were followed

During our onsite visits, we found mid-level managers had conducted 17 operational reviews of the examination teams they supervised. According to the IRM, these reviews are required to be performed at least annually and serve as a mechanism (control) for ensuring work is being done in conformance with procedures and standards.

Although not specifically required by the IRM, the LMSB Division Headquarters Office assembled review teams consisting of managers and analysts that also conducted onsite visits to seven offices in conjunction with the Currency Initiative. The purpose of the visits was to identify barriers and concerns with the Currency Initiative and to serve as a basis for taking needed corrective actions. However, none of the managerial reviews included evaluating open examination cases and assessing how well, or if, the LIFE process was being incorporated into the examinations. As a result, opportunities to ensure important procedures were followed in LIFE cases were missed in three areas. Two of the three areas could have lowered the assessments from LIFE cases, while the third area made the results from LIFE cases less reliable.

The first area that could have lowered the assessments from LIFE cases entailed the mandatory use of specialists, such as engineers, economists, and international examiners. Because of the complexity of examinations in the LMSB Division, examiners are required to call upon specialists who have the technical training needed to assist in the identification, selection, and examination of tax issues that pose the highest compliance risk. However, our review of 24 LIFE cases found 11 did not include the involvement of 1 or more specialists, which raises questions about whether the tax issues that pose the highest compliance risk are being included in examinations. We previously reported that approximately \$1.9 billion of potential tax adjustments

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were overlooked because specialists had not been involved in examinations.¹¹

Another area that could have lowered the recommended assessments from LIFE cases involved the mandatory tests of inventory, income, and related returns. In terms of dollars and compliance risk, these items, including those reported on investment schedules and on the related returns of key executives of large businesses, can be significant. Because of the dollars and risk involved, the IRM requires that examiners document in the examination case files the results of numerous tests in each of the three areas to identify potential tax issues. Our review of 24 LIFE cases found 9 cases in which there was little or no evidence documenting whether the tests were considered, how they were completed, and what conclusions were reached. Without adequate documentation in examination case files, the LMSB Division cannot ensure significant tax issues were not overlooked.

The last area involved information in the databases used by the LMSB Division to track and evaluate the results from LIFE cases. As part of our assessment, we electronically analyzed the databases containing information from 808 LIFE cases and found questionable data that could impact the reliability of the LIFE results for decision-making purposes. For example, the databases had 52 LIFE cases with \$35.6 million of additional recommended assessments in which at least 1 of the returns in the LIFE case indicated the examination was started more than a year before the LIFE process was offered to taxpayers. Because the examination start dates on the cases were so far in advance of implementing the LIFE process, traditional examination procedures could have been used to

¹¹ TIGTA reports entitled, *Controls Over the Identification and Selection of Foreign Controlled Corporations for Examination Need Improvement* (Reference Number 2001-30-119, dated July 2001), *The Engineer Specialist Program Controls Could Be Improved to Ensure More Timely and Accurate Examinations of Large Corporations* (Reference Number 2002-30-149, dated September 2002), and *The Financial Products Specialist Program Controls Could Be Improved to Ensure More Timely and Accurate Examinations of Large Corporations* (Reference Number 2002-30-147, dated September 2002).

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determine the scope and depth of the examination and not the LIFE process.

Alternatively, LMSB Division officials told us there were valid reasons why some LIFE cases were started more than a year before the process was offered to taxpayers. Among others, examiners may have spent relatively little time on the examinations and did not decide on the scope and depth of the examination until after the LIFE process was introduced. Due to the shortcomings with the database we were working with, we were not able to determine the amount of examiner time that was applied to the case before the LIFE process was offered to taxpayers. However, we realize there can be valid explanations for some of the conditions we identified. Consequently, our recommendations recognize that monitoring mechanisms need to identify and evaluate if the LIFE process is being considered and used appropriately in examinations.

Recommendations

We recommend the Commissioner, LMSB Division:

1. Develop and implement a plan for collecting and analyzing data on LIFE examinations that is reliable, can be used for monitoring how well the LIFE process is meeting its performance goals, and can serve as the basis for correcting any problems identified.

Management's Response:

The Commissioner, LMSB Division, is changing its approach for collecting and analyzing data on LIFE examinations by including the results of subsequent year and related examinations in program monitoring.

2. Clarify for examination personnel if and how the LMSB Division's Currency Initiative is to be integrated with the LIFE process.

Management's Response:

The Commissioner, LMSB Division, responded there will not be a need to clarify for examiners the integration of the Currency Initiative with the LIFE process since the

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Currency Initiative was substantially completed by April 2004.

Office of Audit Comment:

We agree that there will not be a need to clarify for examiners the integration of the Currency Initiative with the LIFE process since the Currency Initiative was substantially completed by April 2004, according to the Commissioner, LMSB Division. The Initiative was originally scheduled to be implemented in two phases and would have likely extended it well beyond the time period covered by this review, hence, the reason for the recommendation.

3. Ensure that mid-level managerial reviews are conducted periodically as part of the quality assurance process and that the reviews include evaluating open cases and assessing whether the LIFE process is being properly considered for and used in examinations.

Management's Response:

The Director, Performance Management, Quality Assurance, and Audit Assistance, LMSB Division, will develop a set of review procedures involving at least six items related to the LIFE process. The items will include documentation of a full and robust risk assessment and documentation of consideration of the LIFE process, among others.

Office of Audit Comment:

With respect to our estimate of the benefit that could be realized by implementing our recommendations, the Commissioner, LMSB Division, recognized in the response that initial results of the LIFE process are not impressive, but recent results have improved. The Commissioner also implies that results from certain types of examinations in the IRS databases should have been eliminated from and/or added to our estimate. We agree eliminating results from certain types of examinations and adding results from others can affect the calculation. However, we chose to use the complete examination results as they were reflected in the IRS databases and continue to believe that our estimate sufficiently quantifies the benefit.

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Appendix I

Detailed Objective, Scope, and Methodology

Our objective was to assess the effect the Limited Issue Focused Examination (LIFE) process has on the outcomes of Internal Revenue Service (IRS) Large and Mid-Size Business (LMSB) Division examinations. To meet our objective, we determined the progress that has been made towards incorporating the LIFE process into examinations; the potential it has for reducing the length of examinations, generating higher degrees of productivity, and minimizing taxpayer burden; and the status of any ongoing changes to improve the process. To meet our objective, we relied on the IRS' internal management reports and databases. We did not establish the reliability of these data because extensive data validation tests were outside the scope of this audit and would have required a significant amount of time. To accomplish our objective, we:

- I. Assessed the need and rationale for the LIFE process and verified if a plan was developed to implement the process.
- II. Compared the characteristics of the LMSB Division's full-scope examination process to the LIFE process to assess the potential the LIFE process offered for reducing the length of examination, generating higher degrees of productivity, and minimizing taxpayer burden.
- III. Evaluated a judgmental sample of 33 opened non-LIFE cases out of a population of 4,291 non-LIFE cases that were opened on or after March 1, 2003, to determine the reasons the LIFE process was not used in the examinations. We used judgmental sampling due to resource and time constraints.
- IV. Reviewed a judgmental sample of 24 opened LIFE cases out of a population of 272 LIFE cases that were opened after January 1, 2003, to determine if examiners followed required LIFE procedures. We used judgmental sampling due to resource and time constraints.
- V. Computed the potential drop in additional recommended assessments that could be avoided by scaling back the implementation of the LIFE process until demonstrable results are obtained from a pilot project that supported full-scale implementation.
- VI. Interviewed IRS officials and representatives of large businesses who were involved with or affected by the LIFE process to obtain their opinions about how well the process was working.

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but Its Use and Productivity Are Concerns**

- VII. Used the “best practices” outlined in the Government Accountability Office (GAO) *Business Process Reengineering Assessment Guide*¹ to assess the need for scaling back the implementation of the LIFE process.
- VIII. Electronically matched and analyzed a database of 808 LIFE cases closed in Fiscal Years (FY) 2003 and 2004 with the Audit Information Management System (AIMS)² closed case database for FYs 2003 and 2004 to assess reliability of data for decision-making.

¹ GAO/AIMD-10.1.15, dated May 1997.

² The AIMS is a computer system used to control returns, input assessments/adjustments to the Master File, and provide management reports. The Master File is the IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organization data.

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Appendix II

Major Contributors to This Report

Parker Pearson, Director
Philip Shropshire, Director
Frank Dunleavy, Audit Manager
Earl Charles Burney, Lead Auditor
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Ali Vaezazizi, Auditor

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Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Deputy Commissioner for Services and Enforcement SE
Deputy Commissioner, Large and Mid-Size Business Division SE:LM
Director, Quality Assurance and Performance Management SE:LM:Q
Chief Counsel CC
National Taxpayer Advocate TA
Director, Office of Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis RAS:O
Office of Management Controls OS:CFO:AR:M
Audit Liaison: Commissioner, Large and Mid-Size Business Division SE:LM

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Appendix IV

Outcome Measures

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

Type and Value of Outcome Measure:

Increased Revenue – Potential: An average of \$349 million a year; \$1.7 billion over 5 years. This represents the drop in additional recommended assessments that could be avoided by minimizing the uncertainties surrounding the impact the Limited Issue Focused Examination (LIFE) process could have on tax revenues (see page 6). It is important to recognize additional recommended assessments can significantly differ from the amount of additional assessments that are ultimately collected. For example, when taxpayers dispute additional assessments recommended by examiners, they can challenge the assessments in the Internal Revenue Service’s (IRS) Office of Appeals. If examiners do not adequately support their recommended assessments, the Office of Appeals may concede the assessments. The Office of Appeals may also concede the assessments in full or in part on the basis of considering the hazards of litigating the recommended assessments.

Methodology Used to Measure the Reported Benefit:

To estimate the potential funds that could be put to better use in future years, we used Fiscal Year (FY) 2004 data and assumed this data would remain constant over the next 5 years. The first step in estimating the potential funds that could be put to better use involved matching two IRS databases. The first database contained 678 returns that were examined which the Large and Mid-Size Business (LMSB) Division had identified as using the LIFE process. The second database, the Audit Information Management System (AIMS),¹ contained information on the amount of hours spent on each LIFE and non-LIFE examination closed in FY 2004 and the accomplishments from those examinations, including the amount of additional taxes recommended by the examiner.

The data from the resulting match was next summarized by the type and size of large business tax return, and the LMSB Division program² under which the return was examined. We then recomputed the amount of additional recommended assessments in FY 2004 by assuming that the:

¹ The AIMS is a computer system used to control returns, input assessments/adjustments to the Master File, and provide management reports. The Master File is the IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organization data.

² The LMSB Division examines large business tax returns under two programs. The largest of the large businesses are examined using a team approach in the Coordinated Industry Case Program while all other large business tax returns are examined in the Industry Case Program where one examiner is generally responsible for examination.

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1. Distribution of LIFE examinations would equal 5 percent of the returns examined in the Coordinated Industry Case program and 5 percent in the Industry Case program.
2. Distribution of LIFE examinations by type, size, and number of large business that were closed in each program during FY 2004 would remain constant in the next 5 years.
3. Hours spent on examining the LIFE and non-LIFE returns that were closed in FY 2004 would remain constant in the next 5 years.

As summarized in Table 1 below, our analysis indicates by allocating 5 percent of the available examinations to LIFE cases over the next 5 years, the amount of recommended additional taxes could drop an average of \$349 million a year (\$1.7 billion over 5 years).

Table 1: Estimated Decrease in Recommended Additional Taxes Based on Allocating 5 Percent of Examination Hours to LIFE Cases					
	A	B	C	D	
LMSB Division Programs	LIFE Recomputed Recommended Assessments	Non-LIFE Recomputed Recommended Assessments	Total Recomputed Recommended Assessments (A + B)	FY 2004 Actual Recommended Assessments	Estimated Revenue Gain/(Loss) (C – D)
Industry Case	\$238,475,116	\$3,700,154,888	\$3,938,630,004	\$3,948,872,606	(\$10,242,602)
Coordinated Industry Case	\$705,508,934	\$14,414,763,662	\$15,120,272,596	\$15,458,595,736	(\$338,323,140)
Totals	\$943,984,050	\$18,114,918,550	\$19,058,902,600	\$19,407,468,341	(\$348,565,741)

Source: Treasury Inspector General for Tax Administration analysis of the IRS AIMS.

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Appendix V

Memorandum of Understanding for Limited Issue Focused Examinations

This appendix shows a copy of the template Memorandum of Understanding (MOU) used in Limited Issue Focused Examinations. It was obtained from the Large and Mid-Size Business (LMSB) Division. Among other things, use of an MOU allows large businesses and the LMSB Division to document mutually agreed-upon time periods for requesting and submitting tax records, to discuss the progress of the examination, and to present and respond to examination results.

**MEMORANDUM OF UNDERSTANDING
between
INTERNAL REVENUE SERVICE
and**

LIMITED ISSUE FOCUSED EXAMINATION (LIFE)

_____, hereinafter referred to as "the Taxpayer," and the Internal Revenue Service (IRS) desire to enter into this Memorandum of Understanding (MOU) for a Limited Issue Focused Examination (LIFE). The Taxpayer and IRS have indicated their good-faith intentions to work diligently towards the timely completion of a LIFE examination.

Scope of the LIFE Examination:

In the mutual spirit of accomplishing these objectives, the IRS has provided a list of the full scope of issues identified in the risk analysis of this (these) return(s). Unless worker classification is specifically listed as a LIFE issue, it will not create a safe harbor under Section 530.

Based upon the following understandings and agreements, the IRS will limit the examination to the LIFE issues identified in the attached list. Any expansion of scope will require approval of the team manager.

(A) Periods to be Examined and Targeted Timeframe

This LIFE MOU will cover the examination of the following returns and does not include employment tax returns unless specifically identified below:

Form	Type of Tax	Period(s) Ending

It is expected that any Revenue Agents' Report(s) will be issued on or before _____. If a significant event arises which could impact this date, it should be discussed immediately.

(B) Improved Understanding of the Taxpayer's Business and Tax Return

The Taxpayer should provide, and/or continue to provide, the IRS with briefings to include items such as: overview of the industry, company structure, financial performance, accounting records, significant events or transactions occurring during the periods under examination, flow of relevant information from divisions and subsidiaries into the return preparation process, and other information that would facilitate the audit process. The Taxpayer should provide workpapers and supporting documentation for selected transactions, accounts and/or Schedule M items.

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The IRS should provide the Taxpayer with a listing of the identified accounts, transactions and/or Schedule M items that are expected to be examined by _____ so that they may be included in the briefings.

(C) Schedules of Agreed Rollover and Recurring Adjustments

The Taxpayer will provide the IRS with schedules and computations for all agreed rollover and recurring adjustments from any previously examined period, including the impact of any closing agreements or Appeals settlements. These items will be provided by _____.

(D) Establishing and Adhering to Materiality Thresholds for Scope Expansion

The IRS has determined the scope of the LIFE examination. To maintain the focus of the examination, the IRS and the Taxpayer agree that new issues should not be raised. The IRS will not expand the scope to new issues and the Taxpayer will not cause scope expansion through the submission of claims or affirmative issues unless the following thresholds are met:

The following issues will not be subject to a materiality threshold(s) and can be examined regardless of when they are identified: tax shelters, coordinated issues, fraudulent items, items contrary to public policy, worker classification issues, executive compensation, and LMSB Field Directive issues. The establishment of a materiality threshold will not impact the requirement to verify the correct tax liability computation and the correlative adjustments.

Although every attempt should be made to adhere to the materiality thresholds, both parties reserve the right to correct obvious computational/mathematical or accounting errors/omissions. These corrections must not be technical or legal in nature and should require little time to resolve.

Both parties recognize that the materiality thresholds set for this cycle or tax period cannot be automatically utilized in another cycle or tax period. If during the course of the examination, it is found that a stated accounting policy or practice has not been followed, the scope of the examination may be expanded for this issue without regard to the materiality threshold(s).

If a non-disclosed abusive tax shelter or listed transaction is discovered during the course of the examination, the IRS will expand the scope of the examination to include the issue.

(E) Identification of Claims and Affirmative Issues

All claims or affirmative issues exceeding the materiality threshold established in (D) above must be submitted by _____ and will be accompanied by supporting documentation.

(F) Communication

Communication is a key factor to the successful completion of a LIFE examination. In recognition of this, the Taxpayer and the IRS will schedule regular _____ meetings to discuss the status of the examination and to resolve any problems.

Any resolution of prior cycle/tax years will be shared as soon as it becomes available and its impact on the current examination will be discussed.

(G) Information Document Request (IDR) Management Process

The IRS and the Taxpayer recognize that it is generally beneficial to discuss requests for information before a formal IDR (Form 4564) is issued. The IRS and the Taxpayer will make a concerted effort to meet and discuss the purpose of the request, the specific records required, correct terminology and any other recommendations to assist the Taxpayer in satisfying the request efficiently and effectively.

All IDRs will contain a notation showing the due date of the IDR response. Unless the examiner and the Taxpayer agree on a specific date for answering a particular IDR, all IDRs will be due within ____ days of the issuance. If for any reason this date cannot be met, the Taxpayer should notify the IRS immediately.

The IRS should timely review IDR responses for completeness and discuss with the Taxpayer, if necessary.

The provisions of the IRS's IDR Management Process, Internal Revenue Manual (IRM 4.45.13), will be followed.

(H) Resolution of Notices of Proposed Adjustment – Form 5701 (NOPA)

The IRS and the Taxpayer recognize that both parties benefit from meaningful discussions of facts and technical positions prior to the issuance of a NOPA. The IRS will issue NOPA(s) as soon as reasonable grounds have been established. The Taxpayer agrees to respond to all NOPA(s) within ____ days of issuance, indicate agreement or disagreement, and state all relevant facts and legal arguments. The IRS and the Taxpayer will continually engage in discussions for the purpose of resolving factual or technical differences.

The IRS and the Taxpayer recognize the benefit of resolving issues at the earliest opportunity and commit to exploring the use Alternative Dispute Resolution tools.

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(I) Termination of the LIFE Process

The LIFE process is a mutual undertaking and requires a great deal of cooperation and commitment by both parties. Significant or consistent failures by either party to adhere to the agreements set forth in this MOU may result in termination of the LIFE process.

Such failures include, but are not limited to:

- 1) Not adhering to IDR response times or providing incomplete responses
- 2) Not entering into issue resolution discussions
- 3) Filing claims below the materiality threshold or the filing of claims without supporting documentation
- 4) Filing claims above the materiality threshold(s) after the date specified
- 5) Not disclosing an abusive tax shelter or listed transaction
- 6) Not adhering to any other commitment(s) included in this MOU

Termination of this agreement may result in a reversion to a traditional, full scope examination. The scope may be expanded to include any or all of the issues identified in the list of full scope issues identified for this (these) return(s). This may extend the estimated completion date of the examination.

The undersigned representatives of the Taxpayer and the IRS hereby indicate their mutual agreement to the objectives and procedural guidelines established herein. It is understood by both parties that this document is intended to govern the conduct of the examination, but is not a legally enforceable agreement.

Signatures and date:

For the Taxpayer:

Title: _____
Date _____

For the IRS:

LMSB Team Manager
Date _____

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Appendix VI

Management's Response to the Draft Report

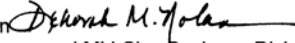


DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

RECEIVED
FEB - 4 2005

February 4, 2005

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

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

SUBJECT: Draft Audit Report - The Limited Issue Focused Examination
Process Has Merit, but Its Use and Productivity Are
Concerns (Audit # 2003-30-034)

I am pleased to offer the Large and Mid-Size Business (LMSB) Division's management response to your draft audit report on the Limited Issue Focused Examination (LIFE) process. The LIFE process is one of LMSB's primary issue management strategies. Other strategies include Fast Track Settlement, Industry Issue Resolution, Pre-filing Agreements, Joint Audit Planning, and the Currency and Cycle Time Initiative. LMSB has successfully implemented these strategies to significantly improve audit currency and cycle time, audit coverage, and other key business results.

The LIFE process provides a formalized structure for conducting limited scope examinations. It also reflects demonstrated best practices used by examination teams conducting limited scope examinations. Because the LIFE process was based on a sound foundation of pre-existing best practices, LMSB decided to implement LIFE on a full-scale basis rather than as a pilot program.

Your report correctly stresses the importance of conducting a comprehensive risk analysis as an early step in the LIFE process before establishing an appropriate Memorandum of Understanding (MOU) between IRS and the taxpayer. We agree with these findings. The LIFE process requires that the examination team perform a "full and robust" risk analysis of all large, unusual, or questionable items. Such items are to be evaluated and materiality thresholds established. Once this initial analysis is complete, the MOU governs and describes key phases of the examination process, and promotes the uniform and consistent application of the process across the LMSB Division.

Since the completion of your research, LMSB has conducted Standardized Risk Analysis training for all examiners, and we expect to see improvement in the quality and proper application of risk analysis on future examinations. We will continue to monitor its use on all examinations through the LMSB Quality Management System. Additionally, we have conducted two formal reviews by two separate review teams of the LIFE process since its implementation. The second team, whose recommendations

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were approved in November 2004, found many positive trends. We are completing plans to incorporate their recommendations in the LIFE process.

While I agree with your overall assessment on the merits of the LIFE process to reduce the length of examinations, I am not in agreement with the Outcome Measures as stated in your audit report. The Outcome Measures found in Appendix IV of your audit report and summarized in Table 1, page 17, indicate the amount of recommended taxes could drop an average of \$349 million per year or \$1.7 billion over a five-year period.

I would like to share the rationale on why we differ with your findings. The LIFE process includes criteria which guide examiners in making a determination on whether the process is appropriate for the examination of a given taxpayer. One of these standards is the requirement that the return include only a few material issues. Conversely, the process is not appropriate where there are a significant number of material issues identified during the risk analysis. You also reported that the LIFE process has merit for reducing the length of examinations. We agree and believe this will enable LMSB to apply valuable resources to additional examinations, thereby increasing overall audit coverage.

After reviewing the methodology considered in your report, relative to "potential" revenue loss, we are concerned the approach may not fully consider all factors. The methodology should evaluate tax shelters, Joint Committee cases, those cases started before the LIFE process was initiated, and related returns. Ignoring these factors will substantially affect your revenue loss methodology. We acknowledge a transition window does exist for LIFE cases. However, we have seen the business results of the LIFE Program continue to increase as demonstrated during March 2004 through December 2004, where there was a substantial increase. In comparing the first quarter business results for FY 2005 to the last quarter of FY 2004, the average dollars per hour more than doubled. With this continuing trend, the overall business results for FY 2005 will surpass that of FY 2004, which were greater than the results of FY 2003. Therefore, with the risk management approach for LIFE, we feel a revenue loss effect is neutralized.

Attached is a detailed response outlining our planned corrective actions to address your recommendations and our comments regarding the Outcome Measures. If you have any questions, please contact me at (202) 283-8710 or Kelly Cables, Director, Performance Management, Quality Assurance, and Audit Assistance at (202) 283-8334.

Attachment

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Attachment

RECOMMENDATION 1

Develop and implement a plan for collecting and analyzing data on LIFE examinations that is reliable, can be used for monitoring how well the LIFE process is meeting its performance goals, and serve as the basis for correcting any problems identified.

CORRECTIVE ACTION(S):

Since the inception of the LIFE Program, the LMSB Division has monitored the number of LIFE examinations started and completed each month, as well as the recommended dollars generated from those examinations. This data is tracked monthly and cumulatively for each fiscal year. We collect and assemble various numerical elements from individual case information using our Servicewide Audit Information Management System (AIMS) and the Examination Returns Control System (ERCS). Each month these results are reviewed by analysts dedicated to the program, and by LMSB headquarters and industry leadership. We believe that these systems are reliable and adequate for the ongoing monitoring of the LIFE Program.

Our second LIFE Review Team noted that our evaluation of the program included only the results from the examination of primary returns (the returns that were initially the subject of the examinations). We did not include the results from the examinations of subsequent year returns or those of related examinations even though the examinations of the LIFE returns revealed that adjustments to those returns were necessary. We are changing our approach to include the results of subsequent year and related examinations in our program monitoring.

IMPLEMENTATION DATE:

The LMSB Division will start including the results of subsequent year returns and related examinations in the monthly program monitoring by March 31, 2005.

RESPONSIBLE OFFICIAL(S):

Director, Performance Management, Quality Assurance, and Audit Assistance

CORRECTIVE ACTION(S) MONITORING PLAN:

Results of LIFE examinations will continue to be monitored monthly.

RECOMMENDATION 2

Clarify for examination personnel if and how the LMSB Division's Currency and Cycle Time Initiative is to be integrated with the LIFE process.

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CORRECTIVE ACTION(S):

The Currency and Cycle Time Initiative (hereafter referred to as the Currency Initiative) and the LIFE process had similar objectives that were intended to compliment each other. Although LIFE cases were listed as an exception to this initiative, the second LIFE Review Team conducted a survey, which found that Phase I of the Currency Initiative may have overshadowed the LIFE process in the field. The Currency Initiative was substantially completed by April 2004. Therefore, there is no need to clarify for examiners the integration of the Currency Initiative with the LIFE process.

IMPLEMENTATION DATE:

N/A

RESPONSIBLE OFFICIAL(S):

N/A

CORRECTIVE ACTION(S) MONITORING PLAN:

N/A

RECOMMENDATION 3

Ensure that mid-level managerial reviews are conducted periodically as part of the quality assurance process; and that the reviews include evaluating open cases, and assessing whether the LIFE process is being properly considered for and used in examinations.

CORRECTIVE ACTION(S):

The Director, Performance Management, Quality Assurance, and Audit Assistance will continue to monitor the application of the LIFE process using the self-certification Administrative Procedures checklist in LMSB Quality Reviews. In addition, the PQA Director will develop a set of review procedures specifically related to the LIFE process. These procedures should be used by the Industries and field specialists in their operational reviews to verify that the LIFE process is properly considered and used in examinations. These items will include (but are not limited to):

- Documentation of a full and robust risk analysis
- Documentation of consideration of the LIFE process
- Proper completion of the Memorandum of Understanding (MOU)
- Accountability for timely completion of items specified in the MOU
- Consideration of termination where appropriate
- Proper use of ERCS codes for tracking the results

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IMPLEMENTATION DATE:

The LMSB Division will implement a set of review procedures specifically related to the LIFE process by March 31, 2005.

RESPONSIBLE OFFICIAL(S):

Director, Performance Management, Quality Assurance, and Audit Assistance

CORRECTIVE ACTION(S) MONITORING PLAN:

We will monitor these corrective actions through Quality Reviews, Operational Reviews, Employee Satisfaction Surveys, Customer Satisfaction Surveys, and LIFE Team Reviews, where appropriate.

OUTCOME MEASURES:

While I agree with your overall assessment on the merits of the LIFE process to reduce the length of examinations, I am not in agreement with the Outcome Measures as stated in your audit report. The Outcome Measures found in Appendix IV of your audit report and summarized in Table 1, page 17, indicate the amount of recommended taxes could drop an average of \$349 million per year or \$1.7 billion over a five-year period.

I would like to share the rationale on why we differ with your findings. The LIFE process includes criteria which guide examiners in making a determination on whether the process is appropriate for the examination of a given taxpayer. One of these standards is the requirement that the return include only a few material issues. Conversely, the process is not appropriate where there are a significant number of material issues identified during the risk analysis. You also reported that the LIFE process has merit for reducing the length of examinations. We agree and believe this will enable LMSB to apply valuable resources to additional examinations, thereby increasing overall audit coverage.

As noted earlier, as a result of our second LIFE Review Team findings, we are changing our reporting to include the subsequent year results, and related return examinations that were not previously included in our results. This will result in an increase in the revenue captured as related to these examinations.

Additionally, our analyses of LIFE cases closed during FY 2004 reveal several complexities that dramatically affect business results. We have identified the three types of complex examinations that distort business results when comparing LIFE examinations to the other returns closed during this same period. These are tax shelters, Joint Committee cases, and those cases started before the LIFE process was

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initiated. The most dramatic difference in business results was derived from closed tax shelter cases. During FY 2004, there were 1,458 returns closed with tax shelter project codes. While these returns accounted for only 7.45 percent of total returns closed, the recommended assessments were 41.3 percent of the total recommended assessments. Whereas, there were only 12 LIFE returns closed with tax shelter features, 1.77 percent of the total number of LIFE returns closed, and 1.03 percent of the total recommended assessments for LIFE cases.

Joint Committee returns represent the second category of complex returns. By definition, these returns generally result in refunds of at least \$2,000,000. The percentage of Joint Committee returns included in the LIFE closings for FY 2004 is greater than in the population of overall LMSB examinations completed in FY 2004, 21.83 percent and 16.3 percent respectively. This has the effect of reducing the average dollars assessed for LIFE returns closed.

In addition, non-LIFE examinations that were started prior to the introduction of the LIFE process should be eliminated. We reviewed the 52 LIFE cases you identified on page 10 of your report. These were LIFE examinations that had been started over a year before LIFE or were closed at about the same time as a related return that had been started over a year before LIFE. We determined that the vast majority of these start dates related to prior examination activity that was not updated when they were reconsidered for claims and carrybacks filed by the taxpayers. As a result, we did not remove this class of returns from the LIFE inventory.

In conclusion, after reviewing the methodology considered in your report relative to "potential" revenue loss, we are concerned the approach may not fully consider all factors as stated above. The methodology should evaluate tax shelters, Joint Committee cases, those cases started before the LIFE process was initiated, and related returns. Ignoring these factors will substantially affect your revenue loss methodology. We acknowledge a transition window does exist for LIFE cases. However, we have seen the business results of the LIFE Program continue to increase as demonstrated during March 2004 through December 2004, where there was a substantial increase. In comparing the first quarter business results for FY 2005 to the last quarter of FY 2004, the average dollars per hour more than doubled. With this continuing trend, the overall business results for FY 2005 will surpass that of FY 2004, which were greater than the results of FY 2003. Therefore, with the risk management approach for LIFE, we feel a revenue loss effect is neutralized.

An expected future key benefit of LIFE that is difficult to measure is the opportunity to redeploy saved resources to other high-risk inventory. Although we are not able to quantify the impact in terms of coverage and revenue, we intended this long-term benefit when LIFE was implemented two years ago.

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We acknowledge that the initial results of LIFE are not impressive. However, many of the initial case closures were work-in-process where significant amounts of time had been invested before the application of the LIFE principles. Our recent results have demonstrated a significant upward trend in productivity as measured by the dollar per hour yield of LIFE cases. Additionally, the LIFE inventory should be distinguished from the non-LIFE inventory, which has a greater concentration of tax shelters. We have weighed the risks and benefits of the LIFE Program and are continuing to evaluate the results to ensure that the process is achieving our intended results. However, we are aware of the risks of applying LIFE inappropriately. Therefore, we have management oversight, control checks, monitoring systems, and training plans in place to ensure its responsible use.

The LIFE process has value to the LMSB Division and the taxpayers we serve beyond these numbers. Our reviews indicate that the LIFE examination process improved communication between the taxpayers and the examiners and will help reduce taxpayer burden in situations where its application is appropriate. Most importantly, as a collection of "best practices," it has helped LMSB to train our personnel in the use of these practices, which will improve the quality of all of our examinations, whether designated as LIFE examinations or not.