



## Treasury Inspector General for Tax Administration Office of Audit

### POTENTIAL OPPORTUNITIES EXIST TO ENHANCE THE FAVORABLE PRODUCTIVITY TRENDS FOR AUDITS INITIATED BY THE UPDATED RETURN SELECTION FORMULAS

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## Highlights

Highlights of Report Number: 2009-30-105 to the Internal Revenue Service Commissioner for the Small Business/Self-Employed Division.

### IMPACT ON TAXPAYERS

Fewer examinations initiated by the updated Discriminant Index Function (DIF) formulas are being closed with no recommended tax changes, which indicates that the Internal Revenue Service (IRS) is better focusing its examination resources on returns posing the greatest compliance risk and not burdening compliant taxpayers with an examination. Small Business/Self-Employed (SB/SE) Division statistics also indicate that taxpayers are agreeing with more of the additional taxes recommended in examinations initiated by the updated DIF formulas. This is important because the additional taxes owed from agreed examinations are far more likely to be collected than those that are assessed by default or disputed and appealed through the IRS administrative processes or the courts.

### WHY TIGTA DID THE AUDIT

The objectives of this review were to determine the status of using National Research Program data to select individual returns for examination in the SB/SE Division and the impact the data are having on examination results. The review was part of our risk-based audit coverage under the major management challenge of Tax Compliance Initiatives.

### WHAT TIGTA FOUND

The IRS considers the National Research Program very important, and the SB/SE Division reflected this priority in the emphasis given to using the updated DIF formulas developed from National Research Program data to select returns for examination. The updated formulas were first used to score individual tax returns in Processing Year 2006, and by the end of Fiscal Year 2008 SB/SE Division statistics show

the number of DIF initiated examinations is increasing, especially among Revenue Agents.

TIGTA found that while overall examination productivity is trending favorably for DIF initiated examinations, the results are mixed for those closed by Revenue Agents. In general, Revenue Agents conduct more complex examinations than Tax Compliance Officers, such as those involving issues related to business individuals and those of individuals with higher income levels. Before the updated formulas were introduced, DIF initiated examinations closed by Revenue Agents generated more recommended additional taxes and lower no-change rates for most of the 5 previous periods analyzed. Comparatively, Tax Compliance Officer results show higher recommended additional taxes on a return and hourly basis and a lower no-change rate after the updated DIF formulas were introduced. The differences noted in the productivity trends between Revenue Agents and Tax Compliance Officers suggest there may be opportunities to improve how effectively returns are screened once delivered to Revenue Agent groups in the field.

### WHAT TIGTA RECOMMENDED

TIGTA recommended that the Director, Examination, SB/SE Division, establish a process, at least on a test basis, to evaluate the quality and appropriateness of the survey decisions made by Revenue Agents and their managers on DIF selected returns so that corrective actions, if needed, can be identified and taken.

In their response to the report, IRS officials agreed with our recommendation and plan to conduct a review of surveyed DIF returns using a modified Income Tax Survey After Assignment (Form 1900). The IRS also noted that our recommendation will strengthen the SB/SE Division's understanding of the reasons DIF returns are surveyed.

### READ THE FULL REPORT

To view the report, including the scope, methodology, and full IRS response, go to:

<http://www.treas.gov/tigta/auditreports/2009reports/200930105fr.pdf>.

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