



*Classifiers Are Eliminating Less Productive
Tax Returns From the Audit Stream,
but Their Work Needs Closer Monitoring*

August 25, 2010

Reference Number: 2010-30-096

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.



HIGHLIGHTS

CLASSIFIERS ARE ELIMINATING LESS PRODUCTIVE TAX RETURNS FROM THE AUDIT STREAM, BUT THEIR WORK NEEDS CLOSER MONITORING

Highlights

Final Report issued on August 25, 2010

Highlights of Reference Number: 2010-30-096 to the Internal Revenue Service Commissioner for the Small Business/Self-Employed Division.

IMPACT ON TAXPAYERS

Internal Revenue Service (IRS) statistics show that fewer audits initiated by updated scoring formulas are being closed with no recommended tax changes. This indicates the IRS is better focusing its audit resources on tax returns posing the greatest compliance risk and not burdening compliant taxpayers with an audit.

WHY TIGTA DID THE AUDIT

The audit was initiated because the IRS is investing considerable effort to obtain current compliance data needed to update the Discriminant Index Function (DIF) formulas. Assigning a DIF score is the first part of a multistep process designed to select tax returns for which an audit is most likely to result in a material tax change. After the DIF assigns a score, the returns with the highest scores are reviewed by classifiers.

Classifiers have a critically important role in the process because they use their experience and judgment to determine which DIF-initiated tax returns warrant an audit and which can be accepted as filed. The objective of this audit was to determine how well classifiers in the Small Business/Self-Employed Division are assessing the compliance risk on individual tax returns selected by the updated DIF formulas.

WHAT TIGTA FOUND

Classifiers are doing a good job of eliminating less productive tax returns from the DIF audit stream. However, reviews to monitor the quality of their work were not always conducted in accordance with IRS procedures. This warrants

attention because the IRS is phasing out the manual classification process and moving to an automated process where classifiers will be widely dispersed across the country. As a result, these reviews will be important for assuring classifiers are learning and adapting to the new automated environment while consistently applying their expertise and skills during the classification process.

WHAT TIGTA RECOMMENDED

TIGTA recommended that the Director, Examination Planning and Delivery, Small Business/Self-Employed Division: 1) issue a memorandum to managers reemphasizing the existing requirements for controlling and monitoring the quality of the classification process, 2) establish a mechanism to monitor how well managers are complying with the existing requirements, and 3) develop and implement a data collection instrument to ensure an adequate sample of tax returns is reviewed.

IRS management agreed with the recommendations and plans to take appropriate corrective actions. The Director, Examination Planning and Delivery, Small Business/Self-Employed Division, plans to issue a memorandum to Examination Area Directors on the topic of sample return reviews to be done during the classification process. Also, the Director, Examination Planning and Delivery, Small Business/Self-Employed Division, plans to recommend that Examination Area Directors include a review of the quality of the classification process in their respective Examination Area Operational Reviews. To ensure an adequate sample of classified/selected returns is reviewed, IRS management plans to develop a data collection instrument to be used for collecting this information.



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

August 25, 2010

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED
DIVISION

Michael R. Phillips

FROM:

Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT:

Final Audit Report – Classifiers Are Eliminating Less Productive Tax Returns From the Audit Stream, but Their Work Needs Closer Monitoring (Audit # 201030025)

This report presents the results of our review to determine how well classifiers in the Small Business/Self-Employed Division are assessing the compliance risk on individual tax returns selected by the updated Discriminant Index Function formulas. This audit was conducted as part of our Fiscal Year 2010 Annual Audit Plan and addresses the major management challenge of Tax Compliance Initiatives.

Management's complete response to the draft report is included as Appendix VI.

Copies of this report are also being sent to the Internal Revenue Service managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Margaret E. Begg, Assistant Inspector General for Audit (Compliance and Enforcement Operations), at (202) 622-8510.



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Abbreviations

CDE	Compliance Data Environment
DIF	Discriminant Index Function
FY	Fiscal Year
IRM	Internal Revenue Manual
IRS	Internal Revenue Service
PSP	Planning and Special Programs
PY	Processing Year
SB/SE	Small Business/Self-Employed



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Background

The Internal Revenue Service (IRS) is investing considerable effort in obtaining current compliance data needed to measure voluntary compliance and update the Discriminant Index Function (DIF) formulas that are used to score individual tax returns according to their audit potential. Assigning a DIF score is the first part of a multistep process designed to select returns for which an audit is most likely to result in a material tax change. After the DIF assigns a score, the returns with the highest scores are reviewed by classifiers.

Assigning a DIF score is the first part of a multistep process designed to select returns for which an audit is most likely to result in a material tax change.

These classifiers, who are experienced examiners on a temporary assignment, have a critically important role in the process because they use their experience and judgment to determine which DIF-initiated returns will be selected for audit consideration (selected) and which can be accepted as filed (accepted). If a return is accepted by the classifier, it is eliminated from the DIF audit stream and returned to IRS storage files.

However, if the decision is made to select a return, the classifier makes a judgment call as to whether the audit should be done in the field or in an IRS office. In general, field audits involve more complex issues related to business individuals. When the decision is made that the return should be audited in an IRS office, the classifier will additionally identify the issues to be covered during the audit by completing an Examination Classification Checksheet (Form 6754).¹

After returns are selected, they are forwarded to audit groups for final review. During this final review, a decision is made to either initiate an audit or accept the return as filed, eliminate it from the DIF audit stream, and return it to IRS storage files. If an audit is initiated, the audit process typically involves the IRS notifying the taxpayer of the audit and its scope, evaluating the taxpayer's supporting information, and advising the taxpayer (or his or her representative) of the audit findings.

This review was performed in the IRS Small Business/Self-Employed (SB/SE) Division Headquarters Office in New Carrollton, Maryland; the Compliance Data Environment (CDE) Development Center in Brooklyn Center, Minnesota; and the Planning and Special Programs (PSP) offices in Laguna Niguel, California; Denver, Colorado; Boston, Massachusetts; Philadelphia, Pennsylvania; and Memphis, Tennessee, during the period December 2009 through February 2010. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to

¹ See Appendix V for a copy of Form 6754.



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obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.



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Results of Review

Classifiers are doing a good job of eliminating less productive returns from the DIF audit stream. However, reviews to monitor the quality of their work were not always conducted in accordance with IRS procedures. This situation warrants attention because the IRS is phasing out the manual classification process and moving to an automated process where classifiers will be widely dispersed across the country. As a result, these reviews will be important for assuring classifiers are learning and adapting to the new automated environment while consistently applying their expertise and skills during the classification process.

Classifiers Eliminated Less Productive Tax Returns From the Audit Stream

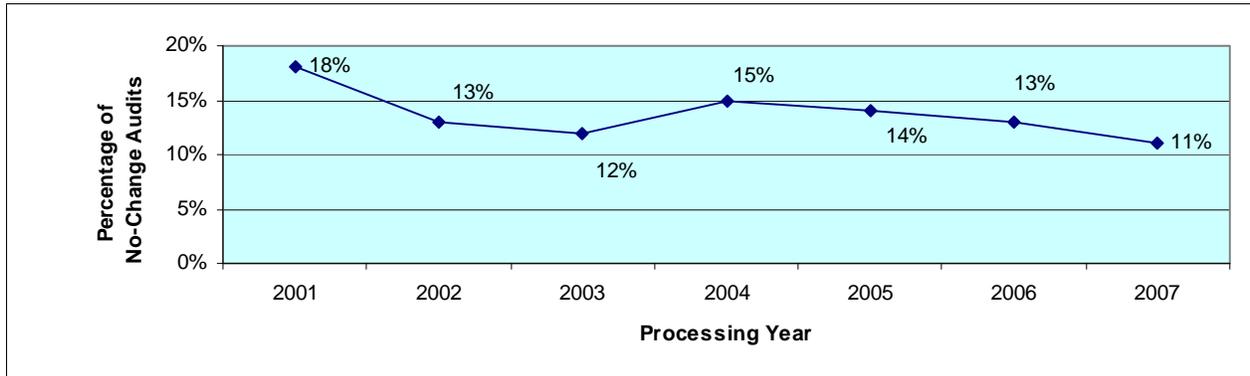
One measure of audit productivity that continues to trend favorably since the updated DIF formulas were introduced is the additional taxes recommended for each tax return audited. Since the updated formulas were introduced in Processing Year (PY)² 2006, the recommended additional taxes for DIF-initiated audits increased 72 percent from a low of \$4,753 in PY 2003 to \$8,193 in PY 2006. As reflected in Figure 1, SB/SE Division statistics additionally show the percentage of no-change audits initiated under the new formulas is declining. The reduction in the percentage of no-change audits is noteworthy because it indicates that the IRS is better focusing its audit resources on returns posing the greatest compliance risk and not burdening as many compliant taxpayers with an audit.

² The year in which tax returns and other tax data are processed.



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**Figure 1: SB/SE Division's Percentage of DIF-Initiated
No-Change Audits for PYs 2001 through 2007**



Source: Our analysis of closed audit data from the IRS Audit Information Management System.³

One factor likely contributing to the favorable productivity trends is the ability of classifiers to eliminate less productive returns from the audit stream. From a universe of 49,646 tax returns for sole proprietors and individuals, we analyzed a statistical random sample of 148 tax returns that were identified by the updated DIF formulas and subsequently accepted by classifiers during Fiscal Years (FY) 2008 and 2009. Our analysis showed that classifiers did a good job of eliminating less productive returns from the audit stream.

In evaluating the 148 tax returns, we followed a 3-step process. First, we reviewed the tax return and its individual line items to identify large, unusual, or questionable items. Second, we used the IRS' preliminary cash transaction analysis in comparing the taxpayer's expenditures to the income reported on the return. The preliminary cash transaction analysis is designed to identify differences between expenditures and income, which indicate expenses may be overstated on the return and/or there may be additional sources of income that should have been reported. Third, we made a judgment about whether the tax returns should have been selected or accepted by comparing the estimated additional taxes that may have resulted if the returns were audited to the average additional taxes recommended for audits closed by the SB/SE Division in FYs 2008 and 2009.

Figure 2 shows that the SB/SE Division closed 219,555 audits of various types of individual returns in FYs 2008 and 2009 and recommended an average of \$11,337 in additional taxes on a tax return basis. We concluded classifiers made the correct decision to accept 146 (99 percent) of the 148 tax returns analyzed because 1) we did not identify any large, unusual, or questionable

³ The Audit Information Management System is a computer system used by the IRS 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 organizations data.



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items and/or 2) the additional taxes that may have resulted if the tax returns were audited would not likely have exceeded the average yield of examined returns closed in FYs 2008 and 2009.

**Figure 2: SB/SE Division’s Additional Recommended Taxes for
Closed Audits Initiated by the Updated DIF Formulas in FYs 2008 and 2009⁴**

<i>Types of Tax Returns</i>	<i>Tax Returns Examined</i>	<i>Recommended Additional Taxes⁵</i>	
		<i>Total Dollars (millions)</i>	<i>Average Dollars Per Tax Return</i>
Nonbusiness – Total Positive Income ⁶ Less Than \$200,000	38,153	\$232	\$6,083
Sole Proprietor – Total Positive Income Less Than \$200,000	146,068	\$1,419	\$9,715
<u>Subtotal</u> – Total Positive Income Less Than \$200,000	184,221	\$1,651	\$8,962
Nonbusiness – Total Positive Income Between \$200,000 and \$999,999	7,481	\$118	\$15,771
Sole Proprietor – Total Positive Income Between \$200,000 and \$999,999	19,286	\$385	\$19,948
Nonbusiness and Sole Proprietor – Total Positive Income of \$1 Million or Greater	8,567	\$335	\$39,144
<u>Subtotal</u> – Total Positive Income of \$200,000 or Greater	35,334	\$838	\$23,718
<u>Grand Total</u>	219,555	\$2,489	\$11,337

Source: SB/SE analysis of closed audits from the IRS Audit Information Management System for the SB/SE Division.

In the near future, the IRS anticipates phasing out its manual classification process and moving to an automated process under its CDE project. The CDE project is a part of the IRS’ Business Systems Modernization Program, which intends to modernize outdated information systems and reduce labor- and paper-intensive work processes.

Although we did not review the CDE project in-depth, we did visit the project office where IRS officials demonstrated how the automated classification process is expected to function. They also provided us an overview of its expected benefits. One of the key benefits, according to

⁴ Totals do not include examinations conducted during training.

⁵ Total dollars and average dollars per tax return are rounded for presentation purposes. As a result, calculations using the numbers will not generate a precise answer.

⁶ In general, total positive income is calculated by adding the positive values from income items, such as wages, interest, and dividends reported on tax returns and counting losses as zero.



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officials, is that the CDE will provide classifiers with the ability to classify returns online from their individual workstations, which should produce savings since classifiers will no longer need to incur the time and costs of traveling to the IRS campuses⁷ to classify returns. In addition, campus personnel will no longer need to spend time retrieving and assembling paper returns and related return information for the classification process or returning paper documents to IRS storage files once the classification process is completed.

As the classification process becomes automated with classifiers widely dispersed across the country, it will be important to assure classifiers are learning and adapting to the new processes while consistently applying their expertise and skills during the classification process. Although the IRS already requires managers to review samples of returns selected and accepted by classifiers, we found the reviews were not always conducted in accordance with established procedures.

Reviews to Control and Monitor the Classification Process Need to Be Conducted in Accordance With Procedural Requirements

Since the updated DIF formulas were introduced, SB/SE Division statistics show that a substantial number of returns the DIF is identifying for audit are subsequently accepted as filed by classifiers. A large percentage (43 percent)⁸ of the returns that were accepted by classifiers involved returns reporting sole proprietor activities. In addition, approximately 49 percent⁹ of the returns reported income of \$200,000 or more, which is a segment of the return population (high-income individuals) the IRS believes needs more audit coverage (see Figure 3).

⁷ 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.

⁸ Percentage does not include sole proprietors with total positive income of \$1 million or more.

⁹ Percentage includes both high income nonbusiness and sole proprietors.



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Figure 3: Individual Returns Selected by the Updated DIF Formulas and Subsequently Accepted As Filed by Classifiers in FYs 2007–2009¹⁰

<i>Types of Tax Returns</i>	<i>Number of Tax Returns Accepted as Filed by Classifiers</i>
Nonbusiness – Total Positive Income Less Than \$200,000.	27,384
Sole Proprietor – Total Positive Income Less Than \$200,000	44,643
Subtotal – Total Positive Income Less Than \$200,000	72,027
Nonbusiness – Total Positive Income Between \$200,000 and \$999,999	29,054
Sole Proprietor – Total Positive Income Between \$200,000 and \$999,999	15,649
Nonbusiness and Sole Proprietor – Total Positive Income of \$1 Million or Greater	24,993
Subtotal – Total Positive Income of \$200,000 or Greater	69,696
Grand Total	141,723

Source: SB/SE analysis of closed nonexamined tax return data from the IRS Audit Information Management System for the SB/SE Division.

The primary technique used by the SB/SE Division to control and monitor the quality of the classification process is the review of returns by Territory managers in its Office of PSP. Among other things, the Internal Revenue Manual (IRM) recommends PSP Territory managers, or their designees, review a representative sample of returns selected and accepted as filed by each classifier. To supplement the IRM guidance, in Calendar Year 2007, the SB/SE Division developed and implemented a nationwide Classification Handbook that provides detailed instructions and explanations of the administrative and business procedures that are required to be followed during the classification process. The IRM and the Handbook also outline expectations and responsibilities for both classifiers and managers.

Included among the manager expectations and responsibilities is a requirement to document the results from reviewing a minimum of 10 percent of the returns classified by each classifier on the Classification Quality Review Record (Form 5126).¹¹ The purpose for the reviews is to provide assurances that:

- Returns are selected or accepted in accordance with established guidelines.
- Classification checksheets are properly completed.

¹⁰ Totals do not include examinations conducted during training.

¹¹ See Appendix IV for a copy of Form 5126.



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- The potential tax change is sufficient to warrant selection, especially on returns with a negative taxable income.
- Classifiers are maintaining a high level of technical proficiency, exercising good judgment in accepting and selecting returns, and utilizing their time effectively.

For FYs 2008 and 2009, the documentation maintained by the SB/SE Division for reviewing samples of returns classifiers selected and accepted was not always readily available. When the documentation was available, it lacked the information needed to control the quality of the classification process. Specifically, we conducted work at five of the seven PSP offices and found the following:

- No documentation that reviews were conducted in 1 of the 5 PSP offices where approximately 36,370 DIF returns and 41,030 DIF returns were classified in FY 2008 and FY 2009, respectively.
- Key information was missing from the Forms 5126 in four PSP offices that had documentation available. The missing information included items specifically designed to address the technical abilities of classifiers, such as the ability to identify potential unreported income and utilization of time.
- None of the 4 PSP offices that had documentation available met the requirement for reviewing 10 percent of the tax returns classified in FYs 2008 and 2009. Overall, we estimate that 196,772 returns were classified by these offices in FYs 2008 and 2009.

In a separate but related issue, the Form 5126 could be enhanced to capture the total number of returns selected and accepted by each classifier. Both items are critical for controlling and monitoring the quality of the classification process because they are needed to calculate the minimum number of classified returns that need to be reviewed and to assure that the requisite number of classified returns was, in fact, reviewed.

The Government Accountability Office *Standards for Internal Control in the Federal Government*¹² require that agencies establish controls to 1) enforce adherence to management policies and procedural requirements, 2) maintain records showing that controls are properly followed, and 3) assure that performance is assessed on an ongoing basis. If managers are not conducting reviews and not adequately documenting review results, the IRS cannot be assured that the controls over the classification process are being carried out effectively. This, in turn, increases the risk that the IRS may miss opportunities to make the most efficient use of audit resources and further reduce burden of audits on compliant taxpayers.

¹² (GAO/AIMD-00-21.3.1, dated November 1999).



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Recommendations

We recommended that the Director, Examination Planning and Delivery, SB/SE Division:

Recommendation 1: Issue a memorandum to PSP Territory managers that reemphasizes 1) the need to control and monitor the quality of the classification process by reviewing representative samples of returns selected and accepted by classifiers and 2) how the results of the reviews should be documented.

Management's Response: IRS management agreed with this recommendation. The Director, Examination Planning and Delivery, SB/SE Division, will issue a memorandum to the Examination Area Directors on the topic of sample return reviews to be done during the classification process. The memorandum will stress the importance of monitoring quality by reviewing representative samples of returns selected and accepted during classification, and explain how these reviews should be documented.

Recommendation 2: Establish a mechanism to monitor how well PSP Territory managers, or their designees, are complying with the existing requirements to control and monitor the quality of the classification process.

Management's Response: IRS management agreed with this recommendation. The Director, Examination Planning and Delivery, SB/SE Division, will recommend that the Examination Area Directors include a review of the quality of the classification process in their respective Examination Area Operational Reviews.

Recommendation 3: Develop and implement a data collection instrument to help ensure an adequate sample of tax returns is reviewed.

Management's Response: IRS management agreed with this recommendation. To ensure that an adequate sample of classified/selected returns is reviewed, the Director, Examination Planning and Delivery, SB/SE Division, will develop a data collection instrument to be used for collecting this information.



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Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine how well classifiers in the SB/SE Division are assessing the compliance risk on individual tax returns selected by the updated DIF formulas. To accomplish our objective, we:

- I. Determined the controls and procedures the IRS has in place to ensure quality selection and classification of DIF returns.
 - A. Reviewed the IRM, the National Office Examination Classification Guidelines, and local area classification instructions.
 - B. Discussed with the Staff Assistant to the Director, Examination Planning and Delivery, SB/SE Division, the controls and procedures in place to ensure classification is consistent nationwide and that returns with issues that are material in scope are selected for audit.
 - C. Reviewed FYs 2008 and 2009 documentation for classification details and management reviews for the PSP offices located in Laguna Niguel, California; Denver, Colorado; Boston, Massachusetts; Philadelphia, Pennsylvania; and Memphis, Tennessee.
 - D. Conducted a site visit to the CDE Development Center located in Brooklyn Center, Minnesota, to perform a walk through of controls and processes in place for classifying returns.
- II. Assessed how well classifiers evaluated the compliance risk posed for individual tax returns selected by the DIF formulas and subsequently accepted.
 - A. Selected a statistical sample of 148 individual tax returns for review from the 49,646 returns that were listed on the Audit Information Management System¹ as nonexamined closures (accepted as filed by classification) for FYs 2008 and 2009. The sample had a confidence level of 95 percent, a precision rate of ± 8 percent, and an expected error rate of 50 percent.

¹ The Audit Information Management System is a computer system used by the IRS 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 organizations data.



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- B. Tested the reasonableness of computer-processed data by matching a judgmental sample of 20 individual tax returns against the IRS Master File.
- C. Reviewed the sample of 148 individual tax returns to identify large, unusual, or questionable items that may have been missed by classifiers.
- D. Used a preliminary cash transaction analysis during the review of the 148 individual tax returns to identify potential overstated expenses and/or additional income sources that may not have been considered by the classifiers.
- E. Made a judgment about whether the 148 individual tax returns reviewed should have been selected or accepted by comparing the estimated additional taxes that may have resulted if the returns were audited to the average additional taxes recommended in audits closed by the SB/SE Division in FYs 2008 and 2009.

Internal controls methodology

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined the following internal controls were relevant to our audit objective: IRS policies, procedures, and practices for classifying and selecting tax returns for audit and the quality review system in place to evaluate the accuracy of the classification process. We evaluated these controls by reviewing source materials, interviewing management, and reviewing a sample of nonexamined closed cases and results from quality review records.



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Appendix II

Major Contributors to This Report

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Frank Dunleavy, Director
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Bernard Kelly, Senior Auditor
Debra Mason, Senior Auditor
William Tran, Senior 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, Small Business/Self-Employed Division SE:S
Director, Communications, Liaison, and Disclosure, Small Business/Self-Employed Division
SE:S:CLD
Director, Examination, Small Business/Self-Employed Division SE:S:E
Director, Examination Planning and Delivery, Small Business/Self-Employed Division
SE:S:E:EPD
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 Internal Control OS:CFO:CPIC:IC
Audit Liaison: Commissioner, Small Business/Self-Employed Division SE:S



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Appendix IV

Classification Quality Review Record (Form 5126)

Classification Quality Review Record				
Classifier's Name:		Grade:	RA <input type="checkbox"/>	Classifier's Number:
			TCO <input type="checkbox"/>	
Type of Returns:	Activity Code of Returns:	Area Office Reviewed:		
Did Classifier receive Classification Orientation? <input type="checkbox"/> Yes <input type="checkbox"/> No				
I. Returns Reviewed:		Selected	Accepted	
a. Number of Returns Reviewed				
b. Number of Returns Where Classification Was Questionable				
II. Classification Instructions and Procedures:		Met	Not Met	N/A
a. Classification Sheets Properly Prepared				
b. Returns Properly Stamped				
c. Follows IRM, Area Office, and Service Center Procedures				
d. Properly Identifies Training Returns				
e. Other:				
III. Technical Ability of Classifier:		Met	Not Met	N/A
a. Returns Properly Designated For Office or Field				
b. Good Application of Law				
c. Good Recognition of Issues				
d. Identifies Unusual Issues				
e. Utilization of Time				
f. Identifies Potential Unreported Income / Indirect Method Returns				
g. Other:				
IV. NARRATIVE: Each quality review record must contain a narrative. (In the space below, provide a narrative evaluation of the Classifier including ability to identify issues, application of classification instructions, utilization of time, and other appropriate factors.)				
V. Summary of Review:				
a. Overall Quality: <input type="checkbox"/> Outstanding <input type="checkbox"/> Exceeds Fully Acceptable <input type="checkbox"/> Fully Acceptable <input type="checkbox"/> Minimally Acceptable <input type="checkbox"/> Unacceptable				
b. Recommended for future classification assignment: <input type="checkbox"/> Yes <input type="checkbox"/> No				
Reviewer: (Signature & Title)	Date:	Routing Instructions:		Date:
		1. RA / TCO Manager: _____		
Classifier: (Signature)	Date:	2. Section Chief or TM PSP: _____		Date:

Source: The IRM.



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Appendix V

Examination Classification Checksheet (Form 6754)

Examination Classification Checksheet				B. Type of Examination			C. Special Inventory		
Service Center Code: _____		Tax Period: _____		1 <input type="checkbox"/> Correspondence	5 <input type="checkbox"/> Extended Time Slot	6 <input type="checkbox"/> Trainee Level 1	7 <input type="checkbox"/> Trainee Level 2	8 <input type="checkbox"/> Trainee Level 3	9 <input type="checkbox"/> GS-11 TCO / Local Option
A. Taxpayer Name and SSN				2 <input type="checkbox"/> Reserved	3 <input type="checkbox"/> Pre-Contact Analysis	4 <input type="checkbox"/> Field Examination	D. Priority No. <input type="checkbox"/>		
				E. POD Override <input type="checkbox"/>			F. Reserved <input type="checkbox"/>		
(Affix Label with Check Digit "Examination Label")				G. ADP Hash Total			0		
H. Issue Number	"X" If Quest.	Issue	Issue Number	"X" If Quest.			Issue		
				C 01	E 02	F 03			
04		Filing Status (Married Filing Separately)					Schedule C, E or F Issues		
05		Filing Status (Head of Household)							
		Exemptions	50				Gross Receipts		
06		Dependents Who Live with TP	40				Rental Income (Schedule E)		
07		Other Dependents	52				All Expenses		
		Income	53				Advertising		
08		Income W2/1099	54				Bad Debts From Sales or Services		
09		Other Income	55				Car & Truck Expenses		
10		IRMF - Blue Tab Criteria	41				Cleaning and Maintenance		
		Adjustments to Income	56				Commissions, Cost of Labor, Labor Hired		
11		Individual Retirement Arrangements	57				Cost of Goods Sold		
12		Alimony Payments	58				Cost of Livestock / Other Items Bought for Resale		
13		Self Employment Health Insurance	59				Depreciation / Section 179		
		Itemized Deductions - Schedule A	42				Employee Benefit Program		
14		Medical and Dental Expenses	43				Freight & Trucking		
47		Medical Savings Account	44				Feed Purchased		
15		State and Local Income Taxes/State Tax Refund	45				Seed and Plants Purchased		
16		Real Estate and Personal Property Taxes	61				Fertilizer, Lime, Chemicals		
17		Interest Expense	62				Gas, Oil, and Fuel		
18		Contributions	63				Insurance		
19		Casualty and Theft Losses	64				Depletion		
20		Moving Expenses	65				Interest Expense		
21		Miscellaneous Deductions (Other than EBE)	66				Legal and Professional Expenses		
46		Student Loan Interest	67				Custom Hire / Machine Work		
		Employee Business Expenses	68				Office Expenses		
22		All Employee Business Expenses	69				Office in the Home		
23		Automobile Expenses	70				Pension/Profit Sharing Plans		
24		Entertainment, Meals, Gifts and Other Expenses	71				Rent or Lease		
25		Travel, Lodging and Other Expenses	72				Repairs and Maintenance		
30		Business Use of Home	73				Wages		
31		Education Expenses	74				Self Employment Tax		
		Gains and Losses	75				Supplies		
26		Bad Debts	76				Taxes		
27		Stock Sales	77				Travel, Meals, and Entertainment		
28		Schedule D, Sales of Real and Personal Property	78				Utilities		
29		Sale of Personal Residence	79				Veterinary, Breeding, and Medicine		
60		Form 4797, Sale of Business Property	80				IRC 183 Business History		
		Other Taxes	81				Other Expenses		
32		Alternative Minimum Tax	82				Passive Activity Loss		
36		Self Employment Tax	Remarks: Classifier Comments (For Examiners Information Only)						
37		Other Taxes	<input type="checkbox"/> Secure IRPOL / IRSS Transcript						
		Tax Credits							
90		Child and Dependent Care Credit							
91		Foreign Tax Credit							
92		Earned Income Credit							
93		Child Tax Credit							
94		Education Credit							
95		Adoption Credit							
Other Issues (insert issue exactly as shown on return)									
33									
34									
35									

Source: The IRM.



*Classifiers Are Eliminating Less Productive Tax Returns
From the Audit Stream, but Their Work Needs Closer Monitoring*

Appendix VI

Management's Response to the Draft Report



COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

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

July 26, 2010

RECEIVED
JUL 26 2010

BY: *DAS*

MEMORANDUM FOR MICHAEL R. PHILLIPS
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Christopher Wagner *For C. Wagner for*
Commissioner Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – Classifiers Are Eliminating Less
Productive Tax Returns from the Audit Stream, but Their
Work Needs Closer Monitoring (Audit # 201030025)

Thank you for the opportunity to review your draft report titled, "Classifiers Are Eliminating Less Productive Tax Returns from the Audit Stream, but Their Work Needs Closer Monitoring" (Audit # 201030025). We agree with the recommendations contained in the report and appreciate your acknowledgment of the downward trend in no-change examinations that have been initiated under the new Discriminant Index Function (DIF) formulas. We are pleased that your audit work confirmed our classifiers are doing a good job of eliminating less productive tax returns from the DIF audit stream.

We recognize that improvements can be made in documenting and monitoring of the classification review process. It is important to monitor return classification to ensure that the most productive returns are being selected for examination. Additionally, as is noted, the manual classification process is being phased out as Small Business/Self-Employed moves toward an automated return classification process. Review and monitoring of the classification process is important to ensure that classifiers are adapting to the new automated process.

Attached is a detailed response outlining our corrective actions. If you have any questions, please contact me, or a member of your staff may contact Charlestine D. Hardy, Director, Examination Planning and Delivery, at 202-283-2288.

Attachment



*Classifiers Are Eliminating Less Productive Tax Returns
From the Audit Stream, but Their Work Needs Closer Monitoring*

Attachment

RECOMMENDATION 1:

The Director, Exam Planning and Delivery, Small Business/Self-Employed Division should issue a memorandum to PSP Territory managers that reemphasizes: 1) the need to control and monitor the quality of the classification process by reviewing representative samples of returns selected and accepted by classifiers and 2) how the results of the reviews should be documented.

CORRECTIVE ACTION:

We agree with this recommendation. We will issue a memorandum to the Examination Area Directors on the topic of sample return reviews to be done during the classification process. The memorandum will stress the importance of monitoring quality by reviewing representative samples of returns selected and accepted during classification and explain how these reviews should be documented.

IMPLEMENTATION DATE:

January 15, 2011

RESPONSIBLE OFFICIAL(S):

Director, Examination Planning and Delivery, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN:

The Director, Examination Planning and Delivery will advise the Director, Examination of any delays in implementing this corrective action.

RECOMMENDATION 2:

The Director, Exam Planning and Delivery, Small Business/Self-Employed Division should establish a mechanism to monitor how well PSP Territory managers, or their designees, are complying with the existing requirements to control and monitor the quality of the classification process.

CORRECTIVE ACTION:

We agree with this recommendation. We will recommend that the Examination Area Directors include a review of the quality of the classification process in their respective Examination Area Operational Reviews.

IMPLEMENTATION DATE:

January 15, 2011

RESPONSIBLE OFFICIAL(S):

Director, Examination Planning and Delivery, Small Business/Self-Employed Division



*Classifiers Are Eliminating Less Productive Tax Returns
From the Audit Stream, but Their Work Needs Closer Monitoring*

2

CORRECTIVE ACTION MONITORING PLAN:

The Director, Examination Planning and Delivery will advise the Director, Examination of any delays in implementing this corrective action.

RECOMMENDATION 3:

The Director, Exam Planning and Delivery, Small Business/Self-Employed Division should develop and implement a data collection instrument to help ensure an adequate sample of tax returns is reviewed.

CORRECTIVE ACTION:

We agree with this recommendation. In order to ensure that an adequate sample of classified/selected returns is reviewed, we will develop a data collection instrument to be used for collecting this information.

IMPLEMENTATION DATE:

April 15, 2011

RESPONSIBLE OFFICIAL(S):

Director, Examination Planning and Delivery, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN:

The Director, Examination Planning and Delivery will advise the Director, Examination of any delays in implementing this corrective action.