Treasury Inspector General for Tax Administration
Office of Audit

TESTS FOR UNREPORTED INCOME DURING SOLE PROPRIETOR FIELD AUDITS CAN BE STRENGTHENED

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Highlights

Highlights of Report Number: 2010-30-105 to the Internal Revenue Service Commissioner for the Small Business/Self-Employed Division.

IMPACT ON TAXPAYERS

Tests for unreported income during Internal Revenue Service (IRS) audits of sole proprietors are a key part of a process designed to verify that the correct amount of tax is reported. In turn, the audit process helps remedy the noncompliance that can create unfair burdens on honest taxpayers and diminish the public's respect for the tax system.

WHY TIGTA DID THE AUDIT

This audit was initiated to determine whether minimum probes for unreported income during sole proprietor audits are conducted in accordance with IRS policies and procedures. This audit was conducted as part of our Fiscal Year 2010 Annual Audit Plan and addresses the major management challenge of Tax Compliance Initiatives. Tax gap estimates created after the National Research Program for Tax Year 2001 showed that unreported business income by sole proprietors accounted for $68 billion (20 percent) of the estimated $345 billion gross tax gap. Despite the size of the tax gap attributed to sole proprietors, the IRS audits only a relatively small portion of these individuals each year.

WHAT TIGTA FOUND

As called for in IRS policies and procedures, field examiners are generally checking for unreported income during audits of sole proprietors. However, steps could be taken to increase the consistency and accuracy of preliminary cash transaction analyses. A preliminary cash transaction analysis provides the basis for performing more indepth audit testing by identifying differences between expenditures and income. If considerable, the differences should be addressed during the audit because it raises questions such as whether there are additional sources of income that should have been reported, if expenses are overstated, or if the taxpayer had a source of non-taxable income.

TIGTA found 30 audits where sole proprietors may have avoided tax and interest assessments totaling $289,251 because of quality problems with the preliminary cash transaction analyses. The majority of the quality problems involved examiners not considering applicable personal living expense data in their preliminary cash transaction analyses.

The 30 audits were identified from a statistical sample of 227 audits closed by field examiners in Fiscal Year 2008. When projected to the population of 6,438 closed audits from which the sample was selected, our results indicate that 851 sole proprietors may have avoided tax and interest assessments of approximately $8.2 million in Fiscal Year 2008.

WHAT TIGTA RECOMMENDED

TIGTA recommended that the Director, Exam Policy, Small Business/Self-Employed Division, issue guidance to group managers to increase the specific written performance feedback given to examiners on the adequacy of their tests for unreported income. In addition, TIGTA recommended that the Director, Exam Policy, issue guidance to group managers and examiners to reinforce the requirement and importance of using appropriate personal living expense data in preliminary cash transaction analyses.

IRS management agreed with the recommendations and plans to issue a memorandum emphasizing the importance of providing specific evaluative feedback on the adequacy of minimum income probes. IRS management also plans to issue a memorandum emphasizing the importance of using appropriate personal living expense data in preliminary cash transaction analyses.

READ THE FULL REPORT

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

http://www.treas.gov/tigta/auditreports/2010reports/201030105fr.pdf.

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