



*Internal Controls for Surveying Tax Returns  
With Abusive Tax Avoidance Transactions  
Need to Be Strengthened*

**September 28, 2010**

**Reference Number: 2010-30-118**

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

### **INTERNAL CONTROLS FOR SURVEYING TAX RETURNS WITH ABUSIVE TAX AVOIDANCE TRANSACTIONS NEED TO BE STRENGTHENED**

## Highlights

**Final Report issued on September 28, 2010**

Highlights of Reference Number: 2010-30-118 to the Internal Revenue Service Commissioners for the Large and Mid-Size Business Division and the Small Business/Self-Employed Division.

### **IMPACT ON TAXPAYERS**

Combating Abusive Tax Avoidance Transactions (ATAT) is one of the Internal Revenue Service's (IRS) highest priorities. There are tax returns with ATAT issues that do not warrant examination and are surveyed prior to taxpayer contact. Surveying tax returns with an ATAT issue without proper justification or approval could be counterproductive to the IRS' goal to combat abusive schemes. In addition, this approach can erode the public's confidence in the IRS' ability to enforce tax laws in a fair, equitable, and consistent manner.

### **WHY TIGTA DID THE AUDIT**

This audit was initiated because identifying tax avoidance schemes is one of the IRS' major initiatives. Our objective was to evaluate the effectiveness of controls and procedures used by the Large and Mid-Size Business and the Small Business/Self-Employed Divisions to ensure tax returns with ATAT issues are properly examined for abusive tax avoidance schemes.

### **WHAT TIGTA FOUND**

IRS employees made decisions to survey tax returns without proper approval. From a statistical sample of 311 surveyed tax returns, TIGTA determined that 246 required the Planning and Special Programs function to concur with the group manager's decision to survey the tax return. However, group managers did not follow guidelines and surveyed 238 (97 percent) tax returns without approval from the Planning and Special Programs function. Additionally, in 88 instances, TIGTA could not determine why the tax returns were surveyed

because justification was not included in the case files or did not support the decisions to survey the tax returns. TIGTA projected the IRS could have examined 840 additional tax returns and proposed additional tax assessments totaling \$1.7 million over a 5-year period.

For 278 (89 percent) of the 311 surveyed tax returns, TIGTA found IRS employees did not follow procedures when surveying tax returns with ATAT issues. TIGTA projected 196 taxpayers' rights could have been jeopardized under Internal Revenue Code Section 7605(b) because the IRS surveyed tax returns after contacting taxpayers. Furthermore, surveyed tax returns with ATAT issues are not subject to the quality review process.

### **WHAT TIGTA RECOMMENDED**

TIGTA recommended that the Commissioner, Large and Mid-Size Business Division, and the Commissioner, Small Business/Self-Employed Division, develop internal controls and provide employee training to ensure that justification is in the case files to survey tax returns with an ATAT issue. Also, the tax return should be reviewed by an independent function for concurrence with the group manager's decision. In addition, the Small Business/Self-Employed Division should ensure tax returns with ATAT issues (surveyed as excess inventory) can be readily identified and examinations are completed once taxpayers are contacted. Furthermore, procedures should be developed to ensure surveyed tax returns are included as part of the quality review process.

IRS management agreed with two and disagreed with two recommendations. TIGTA continues to believe the breakdown in controls for the approval process indicated that tax returns surveyed without documentation may have yielded examination results.

The IRS also disagreed with our outcome measures. TIGTA computed the outcomes conservatively using historical data from the Examination program. TIGTA maintains that the potential \$1.7 million of increased revenue and 840 impacted taxpayers is reasonable considering the assumptions used to calculate the estimate. TIGTA also maintains 196 taxpayers' rights may have been jeopardized.



TREASURY INSPECTOR GENERAL  
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

September 28, 2010

**MEMORANDUM FOR** COMMISSIONER, LARGE AND MID-SIZE BUSINESS DIVISION  
COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED  
DIVISION

*Michael R. Phillips*

**FROM:**

Michael R. Phillips  
Deputy Inspector General for Audit

**SUBJECT:**

Final Audit Report – Internal Controls for Surveying Tax Returns  
With Abusive Tax Avoidance Transactions Need to Be Strengthened  
(Audit # 200930031)

This report presents the results of our review to evaluate the effectiveness of controls and procedures used by the Large and Mid-Size Business Division and Small Business/Self-Employed Division to ensure tax returns with Abusive Tax Avoidance Transactions are properly examined for abusive tax shelter and tax avoidance schemes. This audit was included in 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*

ATAT	Abusive Tax Avoidance Transaction
FY	Fiscal Year
IRM	Internal Revenue Manual
IRS	Internal Revenue Service
LMSB	Large and Mid-Size Business
PSP	Planning and Special Programs
SB/SE	Small Business/Self-Employed



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## *Background*

The Internal Revenue Service (IRS) defines an Abusive Tax Avoidance Transaction (ATAT) as “a specific tax transaction/promotion that reduces a tax liability by taking a tax position that is not supported by tax law or manipulates the law in a way that is not consistent with the intent of the law (tax evasion).” An ATAT scheme may be marketed to participants by a promoter, such as an accounting or law firm, and is often referred to as an abusive tax shelter. Combating ATATs is one of the IRS’ most important commitments and is considered priority work. For example, the IRS includes the following goal in its Strategic Plan 2009–2013:

*The proliferation of tax avoidance schemes is a special challenge. New schemes arise every tax cycle and can spread faster as technology makes it easier to propagate them. We will address tax avoidance schemes through prompt and decisive action, combined with educational activities for taxpayers and practitioners. We will leverage technology, communications, and collaboration among IRS offices and with other government agencies to quickly identify and confront emerging schemes.<sup>1</sup>*

The primary goal of the ATAT Program is to stop the marketing and promotion of abusive transactions or strategies. To accomplish this practice, the ATAT program completes investigations of individuals or businesses that promote schemes and complete examinations of tax returns of promoter clients who participate in the scheme. During Fiscal Year (FY) 2009, the IRS completed the examination of 25,105 tax returns that had an ATAT issue and made additional tax assessments totaling over \$1 billion.

Funding for the ATAT Program is earmarked in the annual plans of the Large and Mid-Size Business (LMSB) Division and the Small Business/Self-Employed (SB/SE) Division. Both operating divisions have demonstrated their commitment by establishing offices dedicated to the ATAT Program (the Office of Tax Shelter Analysis in the LMSB Division and the Office of Abusive Transactions and Technical Issues in the SB/SE Division.)

Tax returns with an ATAT issue may be filed by promoters and participants in abusive schemes or abusive tax shelters, as well as paid preparers who were previously investigated by the IRS but continue to submit egregious tax returns. As priority workload, it is generally expected that tax returns selected for examination will be worked to completion and could result in assessing additional tax and bringing the taxpayer into compliance. However, the decision by



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<sup>1</sup> IRS Strategic Plan 2009–2013, (Publication 3744, dated April 2009)



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group managers to survey<sup>2</sup> examinations with an ATAT issue without proper justification or approval could be counterproductive to the IRS' efforts in achieving its strategic goal and the operating divisions' commitments. Also, this decision does not ensure equitable treatment of taxpayers who participate in similar transactions, may have a corrosive effect on tax administration, and could erode the public's confidence in the IRS' ability to enforce tax laws in a fair, equitable, and consistent manner.

The IRS does provide guidelines to its examiners and recognizes that a limited number of tax returns with ATAT issues, in the judgment of the group manager and the examiner, may not warrant an examination. When a decision is made to survey a tax return, the case is closed in one of the following manners:

- Survey Before Assignment – a tax return selected for examination is considered as surveyed before assignment if it is disposed of without contact with taxpayers, or their representatives, and before assignment to an examiner.
- Survey After Assignment – a tax return is considered as surveyed after assignment if the examiner, after consideration of the return and without contact with taxpayers or their representatives, believes that an examination of the return would result in no material change in tax liability.
- Excess Inventory – a tax return has audit potential but time prohibits initiating the examination.

This review was performed at the IRS' Office of Abusive Transactions and Technical Issues, SB/SE Division, in Lanham, Maryland, and the Office of Tax Shelter Analysis, LMSB Division, in Washington, D.C., during the period March 2009 through June 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 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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<sup>2</sup> A survey is a determination by the examiner's group manager that examination of the tax return is not warranted and the taxpayer has not yet been contacted.



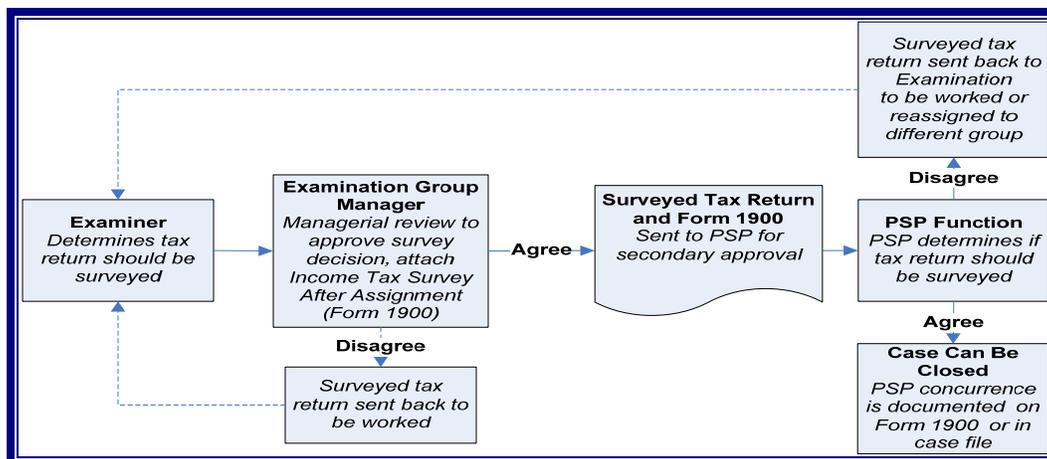
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*Results of Review*

**Decisions to Survey Tax Returns With Abusive Tax Avoidance Transactions Were Made Without Proper Approval**

The decision to survey the SB/SE Division’s examination of a tax return with an ATAT issue is subject to two levels of approval—first by the Examination function group manager and then by the Planning and Special Programs (PSP) function.<sup>3</sup> From a statistical sample<sup>4</sup> of 311 tax returns with ATAT issues surveyed during FYs 2006 through 2008, we determined that 246 tax returns required the PSP function to concur with the group managers’ decisions to survey the tax returns. However, group managers did not always follow these IRS guidelines and surveyed 238 (97 percent) tax returns without the second-level approval from the PSP function. Figure 1 shows the required SB/SE Division approval process to ensure the decision to survey a tax return with an ATAT issue is justified.

**Figure 1: Surveying a Tax Return With an ATAT Issue**<sup>5</sup>



Source: Our analysis of the Internal Revenue Manual (IRM).

<sup>3</sup> The PSP function is responsible for planning, ordering, and delivering tax returns for examination to the field examination groups.

<sup>4</sup> We selected our sample from a population of 4,091 tax returns with the most commonly used project codes, types of returns, and three specific disposal codes. The IRS uses project codes to group tax returns selected for examination with similar issues. Disposal codes are used to document the results of an examination or how the case was closed.

<sup>5</sup> Please see Appendix V for an exhibit of Form 1900.



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Group managers use the Income Tax Survey After Assignment (Form 1900) to document the justification for surveying a tax return. Form 1900 is required for tax returns surveyed before or after assignment. Examiners in the PSP function are required to review the Form 1900 and annotate if they agree with the group manager's decision to survey the tax return. If the PSP function disagrees with the recommendation to survey, the tax return is either returned to the group manager or reassigned to another group to conduct the examination. The Form 1900 was not required for the remaining 65 tax returns because current guidelines do not require the PSP function to document the decision to survey tax returns as excess inventory.

Due to the structure of the IRS, all surveyed tax returns cannot be physically reviewed by the PSP function because the offices may not be located in the same geographical area as the Examination group. For the SB/SE offices, the IRS requires group managers or examiners to document, in the case file, that the decision to survey the tax return was discussed with and approved by the PSP function. Although this practice is a deviation from guidelines, we agree that it is more efficient and provides documentation and concurrence to survey the tax return. The LMSB Division does not require the PSP function to review and concur with the group manager's decision to survey tax returns with an ATAT issue. However, when there is inconsistency among the IRS' operating divisions or when employees bypass these controls, the IRS is at risk of missing opportunities to assess additional taxes and meet its strategic goal of combating abusive tax transactions.

**Justification for surveying tax returns is not always provided in the case file**

For 88 (36 percent) of the 246 tax returns, we could not determine why the tax returns were surveyed because the Forms 1900 were not included in the case files or the justifications provided did not warrant surveying the tax returns. As part of their managerial review, group managers are required to ensure that justifications to survey tax returns are annotated on the Forms 1900 and forwarded or discussed with the PSP function for concurrence.

Without the Form 1900 or adequate justification, the PSP function does not have the necessary information to evaluate and approve the group manager's decision to survey a tax return. If the PSP function disagrees with the decision to survey, the tax return is returned to the group manager for further clarification or to be worked. When a decision to survey a tax return is approved, another tax return will be examined in its place. Based on these results, we project the IRS could have increased its proposed assessments by \$1.7 million over a 5-year period if they had continued the examination of 840 tax returns the employees decided to survey.

**Tax returns with imminent statutes of limitations are not reviewed by the Office of Chief Counsel**

The decision to pursue examination activity on a tax return with an ATAT issue that has an imminent statute of limitations resides with the Office of Chief Counsel. For 11 (4 percent) of the 311 tax returns in our sample, the Office of Chief Counsel was not contacted to determine if



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actions should be taken to pursue a tax assessment or if the statute of limitations should be allowed to expire. The decision to survey these tax returns was made by the group manager.

On February 5, 2004, the IRS issued guidance advising managers and examiners of the following policy regarding the statutes of limitations on tax returns with an ATAT issue:

*Identification of investors can not always be done in a timely manner due to late receipt of investor lists from promoters. The Internal Revenue Manual provides that normally we would not pursue "old" year returns at a late date but these cases are a serious detriment to compliance. Therefore, the Service will pursue the examination of these returns even when there is an impending statute of limitations.<sup>6</sup>*

*When a return is identified through classification or assignment that has an abusive transaction, that issue must be considered. In no event should a short statute be the reason for survey or other non-examination activity on that return.*

This guidance ensures that the IRS is prioritizing ATAT issues over imminent statutes of limitations. It is designed to facilitate prompt, consistent, and decisive actions to confront existing or emerging schemes. When group managers bypass the Office of Chief Counsel, the IRS is at risk of inequitably treating taxpayers involved in these schemes. For example, an examiner who is advised by the Office of Chief Counsel to pursue a tax assessment will continue the examination whether or not the taxpayer agrees to extend the statute of limitations. However, if the Office of Chief Counsel is not contacted, a taxpayer may benefit by not being assessed additional tax because the tax return was surveyed.

**Tax returns with an ATAT issue are being surveyed subsequent to taxpayer contact**

For 9 (3 percent) of the 311 tax returns, examiners made the decision to survey the tax returns after calling or issuing contact letters to advise taxpayers or their representatives that their tax returns had been selected for examination. A surveyed tax return is not considered an examination because the taxpayer has not been contacted or the taxpayer's books and records have not been inspected. However, once taxpayers have been contacted, the tax return cannot be surveyed and it is considered an open examination case.

Guidelines state that a tax return cannot be surveyed if any of the following conditions exist:

- The taxpayer (or representative) has been contacted.
- Taxpayer records have been inspected.

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<sup>6</sup> Examination of Short Statute Abusive Transaction Cases; Commissioners, LMSB Division, SB/SE Division, and Tax Exempt/Government Entities Division; February 5, 2004.



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- The examiner determined an examination will most likely result in a significant change in the taxpayer's liability.

When taxpayers are initially contacted for an examination, they are advised of their rights either verbally from the tax examiner or provided with *Your Rights as a Taxpayer* (Publication 1). In addition to advising taxpayers of their most common rights, Publication 1 provides guidance on the examination, collection, and refund processes.

In the Examination section of Publication 1, taxpayers are advised of the repeat examination<sup>7</sup> process. It states:

*If we examined your return for the same items in either of the two previous years and proposed no change to your tax liability, please contact us as soon as possible so we can see if we should discontinue the examination.*

The policies and procedures that the IRS established were meant to ensure that taxpayers' rights are protected. These rights are guaranteed by laws which are contained within Internal Revenue Code Section 7605(a), which protects taxpayers from unnecessary audits, and Section 7605 (b), which safeguards against repeat examinations. The code section stipulates:

*No taxpayer shall be subjected to unnecessary examination or investigation, and only one inspection of a taxpayer's books of account shall be made for each taxable year...*

For all nine cases, the manager did not direct the employee to continue the examination, even if the end result would not have changed the taxpayer's tax liability. Therefore, taxpayers' rights have been placed in jeopardy because guidelines allow for a surveyed tax return to be reopened for examination for non-ATAT related issues at a later date, which means these taxpayers could again be contacted about an examination. The projected number of taxpayers whose rights were jeopardized as a result of the decision to survey the tax returns after the examiner initiated contact is 196 taxpayers over a 5-year period.

## ***Recommendations***

**Recommendation 1:** The Commissioner, LMSB Division, and the Commissioner, SB/SE Division, should develop consistent internal controls and provide training to ensure employees adhere to guidelines that require group managers to: 1) include the Form 1900, or comparable process, to ensure adequate justification is included in the case files for decisions to survey tax returns with an ATAT issue and 2) ensure surveyed tax returns with an ATAT issue are reviewed by an independent function for concurrence with the group manager's decision.

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<sup>7</sup> Repeat examination (repetitive audit) allows for limiting the scope of the examination when the same issues were examined and no-changed in either of the 2 preceding years. If the same issues under examination were no-changed in either of the 2 preceding years, those issues should be eliminated from the scope of the examination unless information in the case file indicates the issue is worthy of examination.



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**Management's Response:** IRS management agreed with this recommendation. The IRS will consider procedural changes to ensure that internal controls and documentation are in place that reflect consistency in decisions to survey ATAT cases, while allowing the operating divisions to maintain flexibility in operating procedures and systems. The IRS will also issue memoranda emphasizing the importance of adhering to procedures for review and documentation of determinations to survey cases.

However, IRS management does not agree with the related outcome measure. The Increased Revenue outcome measure is based on potential revenue had the surveyed return been audited. A properly surveyed abusive ATAT case would not generally yield the same tax revenues, if examined, as a selected ATAT case. The IRS' review of the surveyed cases indicated that the surveys were appropriate. The decision to survey a case does not change the overall number of cases examined; i.e., when one tax return is surveyed, a different tax return with greater audit potential is placed in the audit stream. Therefore, the IRS disagrees with the assumption that the IRS improperly surveyed 840 cases and, instead, examined 840 less productive cases.

**Office of Audit Comment:** Our evaluation of surveyed tax returns was based on the documentation provided in the administrative files. Our results showed for 88 (36 percent) of the 246 tax returns, we could not determine why the tax returns were surveyed because the Forms 1900 were not included in the case files or the justifications provided did not warrant surveying the tax returns. Without this information, it is not clear how the IRS can justify the decision to survey the tax return was appropriate. We continue to believe the breakdown in controls for the approval process indicated that tax returns surveyed without documentation may have yielded examination results. We computed this outcome conservatively, applying historical data from the general Examination program. Based on our analyses, the financial outcome as shown in Appendix IV is reasonable and appropriate.

**Recommendation 2:** The Director, Exam Planning and Delivery, SB/SE Division, should develop controls to ensure tax returns with an ATAT issue that are surveyed as excess inventory can be readily identified as being surveyed by the PSP function.

**Management's Response:** IRS management agreed with this recommendation. The Director, Exam Planning and Delivery, SB/SE Division, will issue a memorandum emphasizing the importance of adhering to procedures for review and documentation of determinations to survey cases, including procedures that ensure that cases surveyed as excess inventory can be readily identified.

**Recommendation 3:** The Director, Examination, SB/SE Division, should strengthen existing controls to protect the rights of taxpayers by ensuring examinations of ATAT cases are completed once taxpayers, or their representatives, have been contacted by IRS employees.



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**Management's Response:** IRS management disagreed with this recommendation and the outcome measure regarding Taxpayer Rights and Entitlements. In those circumstances permitted by IRM Section 4.10.2.5.1(3), a tax return can be surveyed after taxpayer or representative contact where the books and records have not been requested or inspected or where other extraordinary circumstances exist.

**Office of Audit Comment:** The tax returns in our sample were surveyed during FYs 2006 through 2008, prior to the revision of IRM section 4.10.2.5.1(3). The IRM guidelines in effect at the time of our sample stated tax returns could not be surveyed once the taxpayer or the taxpayer's representative was contacted. Furthermore, there was no reference to request the taxpayer's books or records. During our review, the IRS revised the IRM. This revision became effective April 2, 2010, and broadens the definition of taxpayer contact to allow the IRS more flexibility in surveying returns. The clarification to the IRM was necessary to allow the surveying of tax returns after taxpayer contact but before requesting books and records. We continue to believe the recommendation supports the action taken by the IRS during our review and does not affect the Taxpayer Rights and Entitlement outcome measure in Appendix IV.

### ***Better Oversight of Surveyed Tax Returns With Abusive Tax Avoidance Transactions Would Reduce Procedural Errors***

**The IRM instructs employees to complete the following steps when a decision is made to survey ATAT cases:**

1. The tax return must be stamped with the appropriate survey stamp for "Survey Before Assignment," "Survey After Assignment," or "Survey-Excess Inventory."
2. The examiner and the group manager must sign the stamped tax return.
3. The survey stamp and disposal code for the tax return must be in agreement.

From a statistical sample of 311 FYs 2006 through 2008 tax returns with an ATAT issue, we determined that employees did not properly follow procedures when deciding to survey 278 (89 percent) of the tax returns selected for examination. From our review of 311 tax returns, the most common processing errors<sup>8</sup> were:

- 82 (26 percent) tax returns were not signed by the group manager.
- 34 (11 percent) tax returns did not have a survey stamp.
- 25 (8 percent) tax returns were closed with the incorrect disposal code. For example, the tax return was stamped "Survey Before Assignment" but closed with a disposal code for "Survey After Assignment."

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<sup>8</sup> Some cases had more than one error.



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Our test results showed that the Examination and PSP functions do not have a quality review process to review tax returns surveyed by group managers. Both functions only review closed cases and use these quality and product review results to identify error trends, develop program improvements, and identify training opportunities. However, since surveyed tax returns with an ATAT issue are not part of a product review, procedural errors go unchecked, and the IRS cannot ensure that priority tax returns with ATAT issues are correctly processed.

### **Recommendation**

**Recommendation 4:** The Director, Planning, Quality, Analysis, and Support, LMSB Division and the Director, Exam Operations Support, SB/SE Division, should develop procedures to include surveyed tax returns as part of the quality review process.

**Management's Response:** IRS management disagreed with this recommendation. The quality review process should not include surveyed tax returns. When a case is surveyed, the only issue to review is whether the survey was proper. The current practice often involves ATAT specialists in the survey decision and the current procedures, per IRM 4.1.3.5.1, provide that PSP will review and concur in instances where a case has been surveyed. Any additional review would slow the process of quality review and be ministerial in nature. The IRS believes it would add very limited value to the compliance process and review resources are best used otherwise.

**Office of Audit Comment:** We maintain that the quality review process is necessary. Since the PSP or ATAT specialists do not always receive the case files when determining to survey a tax return, there are no controls in place to ensure the tax return was properly reviewed prior to being surveyed. A quality review process would confirm the tax return was properly surveyed by verifying documentation (from the PSP or ATAT specialist) is present, the tax return was stamped, managerial concurrence is documented, and the appropriate closing code is used. We identified many of these types of errors when reviewing surveyed tax returns. The IRS has these controls in place because they are equally as important as the current process to only review cases to determine whether the survey was proper. We continue to believe that employee errors and oversights can best be identified and corrected through a quality review program.



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## Appendix I

### *Detailed Objective, Scope, and Methodology*

Our objective was to evaluate the effectiveness of controls and procedures used by the LMSB and SB/SE Divisions to ensure ATAT tax returns are properly examined for abusive tax shelter and abusive tax avoidance schemes. To accomplish our objective, we:

- I. Determined what controls and procedures the IRS has in place to ensure ATAT tax returns are examined.
  - A. Researched the IRM to identify Examination function procedures to survey tax returns with an ATAT issue.
  - B. Held discussions with management from the LMSB and SB/SE Divisions to determine the controls and procedures used to ensure tax returns with ATAT issues are examined.
- II. Selected a statistically valid sample of 311 FYs 2006 through 2008 nonexamined closed tax returns. These tax returns were selected from a population of 4,091 tax returns that had 2 specific project codes (indicating they contained ATAT issues). The sample had a confidence level of 95 percent, a reliability factor of  $\pm 5.58$  percent, and an expected error rate of 50 percent. We reviewed the original tax returns and examination files to determine if employees adhered to existing procedures when decisions were made to survey the tax returns. To validate our sample cases, we:
  - A. Verified the information from the Audit Information Management System<sup>1</sup> to the Integrated Data Retrieval System.<sup>2</sup>
  - B. Compared taxpayer's information documented in the original case file to ensure it matched data on the Integrated Data Retrieval System.
- III. For the tax returns selected in Step II, we determined:
  - A. Why ATAT tax returns were surveyed.
  - B. If employees followed procedures to properly survey the tax returns.
  - C. If the tax returns should have been examined and the potential examination results.

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<sup>1</sup> The Audit Information Management System is a computer system used by the Examination functions in the LMSB Division, SB/SE Division, and Wage and Investment Division to control tax returns, input assessments/adjustments, and provide management reports.

<sup>2</sup> The Integrated Data Retrieval System is the IRS computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer's account records.



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- IV. Held discussions with management from the LMSB and SB/SE Divisions to determine causes for any identified weaknesses or breakdown of internal controls.

**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: the LMSB and SB/SE Divisions' procedures and practices for ensuring employees followed procedures when the decision is made to survey tax returns with ATAT issues. We evaluated these controls by interviewing management and reviewing a statistical sample of tax returns.



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**Appendix II**

*Major Contributors to This Report*

Margaret E. Begg, Assistant Inspector General for Audit (Compliance and Enforcement Operations)  
Frank W. Jones, Director  
Marybeth Schumann, Director  
L. Jeff Anderson, Audit Manager  
Bernard F. Kelly, Audit Manager  
Earl Charles Burney, Acting Audit Manager  
Gail Schuljan, Lead Auditor  
Carol Gerkens, Senior Auditor  
Gwendolyn Green, Senior Auditor  
Nancy Van Houten, Senior Audit Evaluator



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**Appendix III**

*Report Distribution List*

Commissioner C  
Office of the Commissioner – Attention: Chief of Staff C  
Deputy Commissioner for Services and Enforcement SE  
Deputy Commissioner, Large and Mid-Size Business Division SE:LM  
Deputy Commissioner, Small Business/Self-Employed Division SE:S  
Director, Examination, Small Business/Self-Employed Division SE:S:E  
Director, Planning, Quality, Analysis, and Support, Large and Mid-Size Business Division  
SE:LM:Q  
Director, Pre-Filing and Technical Guidance, Large and Mid-Size Business Division  
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Director, Abusive Transactions, Small Business/Self-Employed Division SE:S:E:AT  
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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 Liaisons:  
Deputy Commissioner for Services and Enforcement SE  
Commissioner, Large and Mid-Size Business Division SE:LM  
Commissioner, Small Business/Self-Employed Division SE:S



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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. These benefits will be incorporated into our Semiannual Report to Congress.

#### **Type and Value of Outcome Measure:**

- Increased Revenue – Potential; \$1.7 million; 840 impacted taxpayers (see page 3). The outcome includes \$1,031,184 and 504 impacted taxpayers for FYs 2006 through 2008. It also includes projected increased revenue of \$687,456 and 336 impacted taxpayers from tax returns with an ATAT issue that could have been audited instead of being surveyed for FYs 2009 through 2010.

#### **Methodology Used to Measure the Reported Benefit:**

We determined from a statistical sample of 311 examinations that employees did not follow procedures when deciding to survey tax returns with ATAT issues selected for examination. Our results showed that for FYs 2006 through 2008, the IRS could have completed additional examinations of tax returns with ATAT issues had they not been surveyed by group managers. Income Tax Survey After Assignment (Form 1900)<sup>1</sup> was required for 246 of our sampled tax returns. For 88 (36 percent) tax returns, we could not determine why the tax returns were surveyed because the Forms 1900 did not provide adequate justification or were not attached to the tax returns.

When a tax return is surveyed, another tax return will be examined in its place. However, when tax returns are surveyed without justification or approval, the IRS cannot ensure that the next tax return examined would not have the same results as the tax return surveyed. To quantify this outcome, we calculated the potential increased revenue the IRS could have realized from completing the examinations instead of surveying the tax returns in our sample.<sup>2</sup> We also calculated the potential increased revenue the IRS could have realized from the tax returns that were examined in replacement of the tax returns surveyed. The difference between these two

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<sup>1</sup> Group managers and the PSP function use Form 1900 to approve justification for surveying a tax return with ATAT issues.

<sup>2</sup> We selected our sample from a population of 4,091 tax returns with the most commonly used project codes, types of returns, and three specific disposal codes. The IRS uses project codes to group tax returns selected for examination with similar issues. Disposal codes are used to document the results of an examination or how the case was closed.



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figures represented the net increased revenue the IRS could have realized. We used the following FYs 2006 through 2008 ATAT data to determine the number of tax returns that would have resulted in a tax assessment if the tax returns had not been surveyed:

- Percentage of ATAT tax returns surveyed = 26 percent.
- No-change rate<sup>3</sup> = 27 percent.
- No-change with adjustments rate<sup>4</sup> = 3 percent.
- No additional tax/refund<sup>5</sup> rate = 11 percent.
- Average tax assessment for ATAT cases = \$61,676.

For the FYs 2006 through 2008, we determined that 88 (28.3 percent) of the 311 sampled tax returns should have been examined. We projected the error rate from our sample across the total population of 4,091 surveyed ATAT tax returns to estimate that 1,158 tax returns did not justify being surveyed. The following factors were used in calculating the number of estimated tax returns that should have been examined:<sup>6</sup>

**The number of cases that had no justification for being surveyed was calculated as follows:**

- $88 / 311 = 28.3$  percent of tax returns in sample.
- Total population of 4,091 x 28.3 percent = 1,158 tax returns.

**The number of cases that should have been surveyed was calculated as follows:**

- $1,158 \times 26$  percent (percentage of ATAT tax returns correctly surveyed) = 301.
- $1,158 - 301 = 857$  tax returns.

**The number of remaining tax returns that would not have resulted in a tax assessment was calculated as follows:**

- $857$  tax returns x percentage of cases that would be no-changed, no-changed with an adjustment, and resulted in no additional tax/refund (41 percent (27% + 3% + 11%)) = 351 cases (rounded).

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<sup>3</sup> No-change applies to examinations for which there were no adjustments and no changes to tax liability.

<sup>4</sup> No-change with adjustments applies to examined tax returns for which there is an adjustment to the tax base data such as income or deduction items, but no change to tax liability.

<sup>5</sup> These are cases that do not reflect additional tax on the Audit Information Management System Table 37 (which is used by management to monitor examination results) but are not no-change or no-change with adjustments closures. For example, examinations resulting in a refund would fall into this category.

<sup>6</sup> The calculated financial outcomes and number of impacted taxpayers will not equal due to rounding.



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**The number of remaining tax returns that would have been examined and resulted in a tax assessment was calculated as follows:**

- $857 - 351 = 506$  tax returns.

**The number of annual ATAT tax returns with a tax assessment was calculated as follows:**

- $506 / 3$  (FYs 2006 through 2008) = 168 tax returns per year (This should round to 169; however, the actual number of tax returns is 168).
- **The projected annual tax assessments that could have been made was calculated as follows:**
  - $\$61,676 \times 168$  tax returns =  $\$10,361,568$  per year.
    - For FYs 2006 through 2008, the projected assessments could have totaled  $\$31,084,704$  ( $\$10,361,568 \times 3$  years), impacting 504 taxpayers (168 x 3 years).
    - For FYs 2009 through 2010, the projected tax assessment could have totaled  $\$20,723,136$  ( $\$10,361,568 \times 2$  years), impacting 336 taxpayers (168 x 2 years).

**The projected tax assessments for ATAT tax returns that should not have been surveyed:**

- $\$31,084,704 + \$20,723,136 = \$51,807,840$  for the 5-year period.
- $504 + 336 = 840$  impacted taxpayers.

To calculate the potential increased revenue the IRS could have realized from the tax returns that were examined in replacement of the tax returns surveyed, we used the following FYs 2006 through 2008 historical ATAT data provided by IRS.

**The number of actual ATAT tax returns with a tax assessment for FYs 2006 through 2008 was:**

- 76,135 examinations resulted in assessments totaling  $\$4,539,907,146$ .
- $\$4,539,907,146 / 76,135$  examinations =  $\$59,630$  average assessment per return.
- $\$59,630 \times 840$  tax returns =  $\$50,089,200$  over a 5-year period.

**To compute the financial outcome, we:**

- **Calculated the difference between the average projected assessments for surveyed cases and the average annual assessments for the examined cases with ATAT issues.**
- **$\$51,807,840 - \$50,089,200 = \$1,718,640$**



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**Type and Value of Outcome Measure:**

- Taxpayer Rights and Entitlements – Potential; 196 taxpayers (see page 3). The outcome includes 118 actual taxpayers whose rights were in jeopardy for FYs 2006 through 2008. The outcome also includes the 78 (39 x 2) projected taxpayers whose rights may be jeopardized for FYs 2009 through 2010.

**Methodology Used to Measure the Reported Benefit:**

For FYs 2006 through 2008, test results showed the IRS surveyed 9 (2.9 percent) of 311 ATAT examination tax returns after the taxpayer was contacted. For these taxpayers, their rights are in jeopardy because their tax returns with an ATAT issue were improperly surveyed after they were contacted by the IRS. As a result of their returns not being examined, these taxpayers could have their returns selected for examination again, thus being contacted again by the IRS regarding an examination of the same tax returns. We projected the error rate from our sample across the total population of ATAT tax returns to compute 196 taxpayers whose rights could have been in jeopardy had their returns been surveyed after they were contacted by the IRS, leaving them open to a second contact for the same tax returns. The following factors were used in calculating the number of taxpayers estimated:<sup>7</sup>

- Multiplied the 4,091 ATAT tax returns in our population by 2.9 percent = 118 taxpayers (39 annually (118 / 3) for FYs 2006 through 2008).
- Projected for an additional 2 years of taxpayers whose rights could be jeopardized (39 x 2 = 78).
- Total taxpayers whose rights could have been jeopardized is 118 + 78 = 196.

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<sup>7</sup> The calculation for the number of impacted taxpayers will not equal due to rounding.





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**Appendix VI**

*Management's Response to the Draft Report*



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

SEP 8 2010  
BY: *[Signature]*

September 8, 2010

MEMORANDUM FOR MICHAEL R. PHILLIPS  
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Christopher Wagner  
Commissioner, Small Business/Self Employed Division

SUBJECT: Draft Audit Report – Internal Controls for Surveying  
Returns with Abusive Tax Avoidance Transactions Need  
to Be Strengthened (Audit # 200930031)

Thank you for the opportunity to review your draft report titled: "Internal Controls for Surveying Tax Returns with Abusive Tax Avoidance Transactions Need to Be Strengthened."

The Service agrees that decisions to survey should be properly documented and that such documentation reduces the risk that cases could be improperly surveyed. We acknowledge your finding that certain surveyed cases reviewed by TIGTA lacked proper documentation. The decision to survey a case resides with Compliance, even when the expiration of the period of limitations is imminent. Counsel is consulted only when Compliance would like to pursue an examination beyond the normal period of limitations and will need to rely on exceptions to that normal period.

Cases are surveyed for a variety of reasons and this process allows us to direct resources to our highest priorities and most significant compliance challenges. For the cases in your sample, the survey decisions were made in conjunction with the Abusive Transactions and Technical Issues (ATTI) staff and an Issue Management Team (IMT). An IMT is a cross-divisional IRS Team chartered by the Servicewide Abusive Transaction (SAT) Executive Steering Committee (ESC) to develop a strategic response to a specific abusive tax transaction or promotion that involves either a highly technical transaction or has widespread applicability. The IMT works with Planning and Special Programs (PSP) to ensure that survey decisions are consistent.

While our cases did not always conform to the prescribed documentation procedures, we found no cases where the decision to survey was improper. Many of the cases reviewed during this audit involved highly complex transactions. As noted above, in



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these cases, the IMT and the ATTI staff worked closely with the area managers, examiners, and PSP staff to ensure survey decisions were consistent and appropriate. However, we do agree with your recommendations to ensure procedures are followed in the future and plan to take corrective actions.

We do not agree with your outcome measures. The Taxpayer Rights and Entitlements outcome measure is based on an assumption stated in your report that a tax return cannot be surveyed once a taxpayer has been contacted. According to the Internal Revenue Manual (4.10.2.5.1 (3)) a return may be surveyed after the taxpayer has been contacted, but before records have been requested or inspected. For the cases in your sample, the contacts did not constitute examinations, and the surveys complied with relevant IRM and Service policy. We found no instances of improper surveys or violations of taxpayer rights.

The Increased Revenue outcome measure is based on potential revenue had the surveyed return been audited. A properly surveyed abusive transaction case would not generally yield the same tax revenues, if examined, as a selected abusive transactions case. Our review of the surveyed cases indicated that the surveys were appropriate. In addition, as TIGTA acknowledges, the decision to survey a case does not change the overall number of cases examined; when one tax return is surveyed, a different return with greater audit potential is placed in the audit stream. Therefore, we disagree with the assumption that the Service improperly surveyed 840 cases and, instead, examined 840 less productive cases.

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 Monica Baker, Director, Examination, Small Business/Self-Employed Division, at (202) 283-2659 or Cheryl P. Claybough, Director, Pre-filing and Technical Guidance, Large and Mid-Sized Business Division, at (202) 283-8462.

Attachment



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Attachment

**RECOMMENDATION 1:** The Commissioner, LMSB Division, and the Commissioner, SB/SE Division, should develop consistent internal controls and provide training to ensure employees adhere to guidelines that require group managers to: 1) include the Form 1900, or comparable process, to ensure adequate justification is included in the case files for decisions to survey tax returns with an ATAT issue; and, 2) ensure surveyed tax returns with an ATAT issue are reviewed by an independent function for concurrence with the group manager's decision.

**CORRECTIVE ACTIONS:**

We concur with this recommendation. The Commissioner, LMSB Division, and the Commissioner, SB/SE Division, will consider procedural changes to ensure that internal controls and documentation are in place that reflect consistency in decisions to survey Abusive Tax Avoidance Transaction (ATAT) issues or cases, while allowing the Business Operating Divisions to maintain flexibility in operating procedures and systems.

The Commissioner, LMSB Division, and the Commissioner, SB/SE Division, will also issue memoranda emphasizing the importance of adhering to procedures for review and documentation of determinations to survey cases.

**IMPLEMENTATION DATE:**

March 15, 2011

**RESPONSIBLE OFFICIAL(S):**

Director, Pre-Filing and Technical Guidance, Large and Mid-Sized Business (LMSB) and Director, Abusive Transactions and Technical Issues, Small Business/Self-Employed Division (SB/SE)

**CORRECTIVE ACTION MONITORING PLAN:**

The IRS will monitor this corrective action as part of our internal management system of controls.

**RECOMMENDATION 2:**

The Director, Exam Planning and Delivery, SB/SE Division, should develop controls to ensure tax returns with an ATAT issue that are surveyed as excess inventory can be readily identified as being surveyed by the PSP function.

**CORRECTIVE ACTION:**

We concur with this recommendation. The Director, Exam Planning and Delivery, SB/SE Division, will issue a memorandum emphasizing the importance of adhering to procedures for review and documentation of determinations to survey cases, including procedures that ensure that cases surveyed as excess inventory can be readily identified.



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**IMPLEMENTATION DATE:**

March 15, 2011

**RESPONSIBLE OFFICIAL(S):**

Director, Exam Planning and Delivery, Small Business/Self-Employed Division (SB/SE)

**CORRECTIVE ACTION MONITORING PLAN:**

The IRS will monitor this corrective action as part of our internal management system of controls.

**RECOMMENDATION 3:**

The Director, Examination, SB/SE Division, should strengthen existing controls to protect the rights of taxpayers by ensuring examinations of ATAT cases are completed once taxpayers, or their representatives, have been contacted by IRS employees.

**CORRECTIVE ACTION:**

We disagree with this recommendation. In those circumstances permitted by IRM Section 4.10.2.5.1(3), a return can be surveyed after taxpayer or representative contact where the books and records have not been requested or inspected, or where other extraordinary circumstances exist.

**RECOMMENDATION 4:**

The Director, Planning, Quality, Analysis, and Support, LMSB Division and the Director, Abusive Transactions and Technical Issues, SB/SE Division, should develop procedures to include surveyed tax returns as part of the quality review process.

**CORRECTIVE ACTION:**

We disagree with this recommendation. The quality review process should not include surveyed returns, particularly in circumstances such as these where there has been review. When a case is surveyed, the only issue to review is whether the survey was proper. The current practice often involves ATAT specialists in the survey decision and the current procedures, per IRM 4.1.3.5.1, provide that PSP will review and concur in instances where a case has been surveyed. Any additional review would slow the process of quality review, and be ministerial in nature. We believe it would add very limited value to the compliance process. Our review resources are best used otherwise.