



*The Initiative to Reduce Compliance Risks  
Associated With Delinquent Income Tax  
Returns Filed After a Substitute for Return  
Assessment Could Be Enhanced*

**March 21, 2011**

**Reference Number: 2011-30-026**

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

### **THE INITIATIVE TO REDUCE COMPLIANCE RISKS ASSOCIATED WITH DELINQUENT INCOME TAX RETURNS FILED AFTER A SUBSTITUTE FOR RETURN ASSESSMENT COULD BE ENHANCED**

## Highlights

**Final Report issued on March 21, 2011**

Highlights of Reference Number: 2011-30-026 to the Internal Revenue Service Commissioner for the Small Business/Self-Employed Division.

### **IMPACT ON TAXPAYERS**

The Internal Revenue Service (IRS) identifies billions of dollars in additional taxes owed from audits of nonfilers in which it estimates the taxes owed and prepares “substitute” returns after not receiving responses to contact letters. While billions of dollars are assessed, the amount ultimately collected is considerably lower because many assessments are abated after taxpayers file delinquent returns claiming much less is owed. Ensuring that these delinquent returns receive greater scrutiny might discourage taxpayers, who believe that they can avoid paying taxes and not get caught, from filing delinquent returns to abate assessments.

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

This audit was initiated to determine whether the IRS effectively addresses the compliance risks associated with delinquent income tax returns received from individuals following a Substitute for Return assessment. The review was part of our planned Fiscal Year 2011 audit coverage and addresses the major management challenge of Tax Compliance Initiatives.

### **WHAT TIGTA FOUND**

New basis information reporting on stock sales and a multiyear initiative to enhance tax return screening techniques should help the IRS to more effectively address the compliance risk on delinquent returns filed in response to a Substitute for Return assessment. Specifically, recent legislation to include stock cost basis

data in the information return reporting system should help the IRS more effectively detect, prioritize, and pursue those individuals who owe a large amount of taxes from stock sales and are not filing tax returns.

The IRS also has an initiative underway to improve the screening criteria for selecting delinquent returns filed in response to a Substitute for Return assessment. The multiyear initiative is aimed at reducing the compliance risk for delinquent returns that do not contain stock transactions. To their credit, the team evaluating opportunities to improve delinquent return screening criteria recognized the importance of including a pilot test in their effort. While the IRS should be commended for reviewing and evaluating opportunities to improve its delinquent return screening criteria, TIGTA has two recommendations that the IRS may find useful in this initiative as well as in undertaking others in the future.

### **WHAT TIGTA RECOMMENDED**

TIGTA recommended that the Director, Exam Policy, Small Business/Self-Employed Division, ensure a framework with detailed steps is established for personnel to follow and document in designing and implementing future process improvement initiatives. In addition, an evaluation plan should be established and executed to accurately and reliably assess the results of this and future pilots.

IRS management agreed with both recommendations and will emphasize the use of existing systems and processes to ensure initiatives are appropriately planned and evaluated. However, IRS management did not specifically commit to evaluating the results from the multiyear initiative discussed in this report. Such an evaluation can provide important information for understanding performance and identifying improvement options. The information would also benefit IRS management in efforts to deal with the challenge of reducing the compliance risk posed by delinquent returns.



TREASURY INSPECTOR GENERAL  
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C. 20220

March 21, 2011

**MEMORANDUM FOR** COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED  
DIVISION

*Michael R. Phillips*

**FROM:**

Michael R. Phillips  
Deputy Inspector General for Audit

**SUBJECT:**

Final Audit Report – The Initiative to Reduce Compliance Risks  
Associated With Delinquent Income Tax Returns Filed After a  
Substitute for Return Assessment Could Be Enhanced  
(Audit # 200930040)

This report presents the results of our review to determine whether the Internal Revenue Service effectively addresses the compliance risks associated with delinquent income tax returns received from individuals following a Substitute for Return assessment. The review was part of our planned Fiscal Year 2011 audit coverage and addresses the major management challenge of Tax Compliance Initiatives.

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

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*

AUR	Automated Underreporter
FMV	Fair Market Value
FY	Fiscal Year
GAO	Government Accountability Office
IRS	Internal Revenue Service
SB/SE	Small Business/Self-Employed
SFR	Substitute for Return



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## *Background*

Shortly after the end of each calendar year, billions of information returns are prepared and used to report a variety of transactions and payments to the Internal Revenue Service (IRS). For example, Federal law requires financial institutions to provide the IRS with Mortgage Interest Statements (Form 1098) detailing the amount of interest received from the mortgages they hold. Besides identifying the amount of mortgage interest received, the law requires financial institutions to identify the names and taxpayer identification numbers of the individual borrowers on the Form 1098 and provide a copy of the document to the borrower responsible for paying the interest.

***The role and benefits of third-party information reporting, such as Forms 1098, are central to the success of our Nation's tax system because information returns help assure taxpayers accurately report certain deductions and income.***

The role and benefits of third-party information reporting, such as Forms 1098, are critical to the success of our nation's tax system because information returns help assure taxpayers accurately report certain deductions and income. Because information reporting is generally required to take place shortly after the end of the calendar year, it provides a reliable information source taxpayers can use in preparing their annual tax returns. This reporting reduces the likelihood that taxpayers may inadvertently neglect to include items such as the mortgage interest paid on a vacation home or the interest income from a small savings account.

Besides assisting taxpayers with preparing their annual tax returns, information reporting is a key component in IRS compliance programs that are designed to detect and pursue noncompliant taxpayers who underreport income, overstate deductions, or fail to file tax returns. In the IRS's Automated Underreporter (AUR)<sup>1</sup> Program, computers match the items reflected on the information returns submitted by third parties to the related items on the filed tax returns of those who received the documents. If the match shows a discrepancy between income reported or deductions claimed, a potential underreporter case may be developed so the IRS can determine whether a taxpayer contact is warranted to resolve these potential issues. For Fiscal Year (FY) 2009, the IRS reported closing approximately 3.6 million underreporter cases and, in the process, assessed approximately \$6.3 billion of additional taxes.

For a match that shows no corresponding tax return, a potential nonfiler case could be initiated based on the information returns. Once initiated, the IRS attempts to secure the delinquent return

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<sup>1</sup> The AUR Program matches taxpayer income and deductions submitted on information returns (e.g., Proceeds From Broker and Barter Exchange Transactions (Form 1099-B) or Wage and Tax Statements (Form W-2)) by third parties such as banks, brokerage firms, and other payers against amounts reported on individual income tax returns.



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through a series of contact letters that request the nonfiler to either file a return or explain the reason for not filing. If the nonfiler does not respond to the letters or file a return if required, the IRS will typically prepare a “Substitute for Return” (SFR) for the tax return that the taxpayer should have filed voluntarily. When preparing an SFR, the IRS typically estimates the taxes owed using the income reflected on the information returns it has on the nonfiler, assesses the tax, and begins efforts to collect the tax. For FYs 2005 through 2009, the IRS assessed approximately \$60 billion from SFRs.

While the preparation of an SFR can generate a large assessment, the amount ultimately collected is usually considerably lower because many assessments are reduced (abated) after taxpayers file delinquent returns claiming far less is owed. We previously reported<sup>2</sup> working with IRS data to estimate a collection rate and found a 14 percent collection rate based on a statistically valid sample of SFR assessments involving high-income individuals.

Besides SFR assessments, the tax law allows the IRS to abate part or all of the tax, interest, and penalty assessments in certain other situations. For example, the IRS may abate tax assessments caused by a tax return preparation error, such as when a taxpayer overlooked a deduction on the original return and then subsequently included the additional deduction on an amended return. The IRS may also abate a penalty when a taxpayer provides reasonable cause, such as a hardship resulting from an unexpected event, for not meeting certain filing or payment obligations. Regardless of the reason for the abatement of a tax, interest, and/or penalty assessment, the IRS’s computers generally abate any other associated penalty and interest assessments automatically.

This review was performed in the IRS Small Business/Self-Employed (SB/SE) Division Headquarters Office in New Carrollton, Maryland, and the Campus Compliance Services function at the Brookhaven Campus<sup>3</sup> during the period November 2009 through September 2010. Except for not auditing IRS databases to validate the accuracy and reliability of the information, this performance audit was conducted 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> *While Examinations of High-Income Taxpayers Have Increased, the Impact on Compliance May Be Limited* (Reference Number 2006-30-105, dated July 25, 2006).

<sup>3</sup> 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.



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## *Results of Review*

The IRS has a multiyear initiative (the Initiative) underway to improve the screening criteria for selecting delinquent returns filed in response to an SFR assessment. To their credit, the team evaluating opportunities to improve delinquent return screening criteria recognized the importance of including a pilot test in their effort. An important next step for the team is to develop a plan for accurately and reliably evaluating the results of the pilot. This will help ensure that the sources and data necessary to determine whether desired results are being obtained are collected and if further improvements may be needed.

### ***Expanded Information Reporting on Stock Sales Has Benefits for Both Taxpayers and the Internal Revenue Service***

New basis information reporting on stock sales and the Initiative to enhance tax return screening techniques should help the IRS to more effectively address the compliance risk on delinquent returns filed in response to an SFR assessment. Once the stock basis data are included in the information return reporting system, the IRS should be able to more effectively detect, prioritize, and pursue those individuals who owe a large amount of taxes from stock sales and are not filing tax returns.

Under a provision in the Emergency Economic Stabilization Act of 2008,<sup>4</sup> brokers and mutual fund companies will be required to report the basis of most stock purchases in Calendar Year 2011 and all stock purchases in Calendar Year 2012 and later to investors (taxpayers) and the IRS. As stated in the following excerpt of an IRS press release, the IRS Commissioner expects that having stock basis data in the third-party information reporting system will benefit both taxpayers and the IRS.

*This important reporting change will improve tax compliance while reducing the recordkeeping and paperwork burden for millions of investors. These taxpayers will now receive the information they need to more easily report their gains and losses correctly.*

### ***Basis reporting will assist taxpayers in avoiding misreported gains and losses from stock sales when preparing their annual income tax return***

Stated simply, a taxpayer's basis in stock is the amount paid to purchase it plus brokerage commissions and fees, if any. When the stock is subsequently sold, the basis is subtracted from the gross sale proceeds to determine the gain or loss reported for income tax purposes. However,

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<sup>4</sup> Pub. L. No. 110-343, 122 Stat. 3765, 3854 (2008).



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specific events, such as corporate mergers, stock splits, and nontaxable dividends can make basis calculations complex for taxpayers, especially when the stock has been acquired over a long time period.

Calculations may also be complicated if stock was inherited or acquired by gift. For example, stock acquired as a gift assumes a dual basis that is not determined until the stock is sold. The tax rule limits the amount of loss that one individual (donor) can pass on to another individual (recipient). Specifically, to determine the loss of a stock sale, the tax rule requires the use of the lower of the donor's basis and the fair market value (FMV)<sup>5</sup> of the stock when received (i.e., when inherited or acquired as a gift). For determining the gain from a stock sale, the tax rule requires the use of the donor's basis.

Figure 1 shows the basis a gift recipient would need to calculate and use in four different scenarios to accurately determine the resulting gain or loss when selling stock acquired by a gift. The figure also shows two instances in which the stock sale would generate neither a gain nor loss for the recipient. This occurs in situations where the donor's basis generates a loss and a gain is produced using the FMV as the basis.

**Figure 1: Examples for Determining a Gain or Loss  
When Selling Stock Acquired as a Gift**

Example	Donor's Basis	FMV on Date Gift Acquired	Basis to Use	Gain or (Loss)
1. Stock sold for \$12,000	\$10,000	\$8,000	Donor's	\$2,000
2. Stock sold for \$7,000	\$10,000	\$8,000	FMV	(\$1,000)
3. Stock sold for \$9,000	\$10,000	\$8,000	N/A	-0-
4. Stock sold for \$8,500	\$10,000	\$8,000	N/A	-0-

Source: IRS Publication 17, *Your Federal Income Tax for Individuals* (2009).

**Basis reporting will help the IRS to more effectively identify and address misstated gains and losses from stock sales reported on tax returns**

One of the primary goals of the IRS is to ensure that everyone meets their obligation to pay taxes. To meet this goal, the IRS strives to allocate its enforcement resources and contacts to identify and address noncompliant taxpayers while avoiding contacts with compliant ones. However, the lack of information on stock basis has long hampered the ability of the IRS to identify and estimate taxes due from taxpayers who received proceeds from stock sales and misreported the sales on their tax returns. This lack of information, in turn, has resulted in the

<sup>5</sup> The FMV is the amount that a seller can receive for the item in the normal marketplace from an unrelated third party.



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IRS and taxpayers dealing with potentially misreported stock sales that produce no tax change<sup>6</sup> during an audit.

IRS statistics show that in FYs 2005 through 2009, the IRS closed approximately 16.6 million discrepancy cases in its AUR Program and, in the process, assessed approximately \$25.8 billion in additional taxes that were due after returns were filed. These statistics indicate that for each case closure, the AUR Program generated, on average, about \$1,556 in additional taxes.

Despite the seemingly high return from the AUR Program, Tax Year 2007<sup>7</sup> IRS data show it did not assess additional taxes (no tax change) in 20 percent of the 800,000 cases initiated to address potentially misreported stock sales captured on tax returns. In comparison, the no-change percentage for other types of AUR Program case closures for Tax Year 2007 was 12.7 percent.

**Stock basis reporting should help the IRS reduce a common source of tax assessments it makes and subsequently abates**

Besides dealing with potentially misreported stock sales on tax returns, the IRS and taxpayers spend time, money, and resources on abating erroneous SFR assessments due to the absence of basis reporting. As shown in Figure 2, according to the IRS, during FYs 2005 through 2009 the IRS abated billions of dollars of tax, penalty, and interest assessments from SFRs after delinquent income tax returns were filed by individuals showing far less, or nothing, was owed. It is costly to the IRS to record, begin collection action, and abate tax assessments.

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<sup>6</sup> No tax change indicates that the tax return was examined but there was not a change in the tax liability or any adjustments.

<sup>7</sup> Tax Year 2007 was the most recent data available from the IRS.



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**Figure 2: FYs 2005–2009 Examination Function SFR Assessments and Abatements for Individual Tax Returns**

Fiscal Year	2005	2006	2007	2008	2009
<b>Number of Cases Closed</b>	136,365	151,733	190,100	176,393	219,600
<b>Tax Assessments</b>	\$5,231,784,418	\$6,406,977,239	\$7,748,885,093	\$5,129,094,381	\$6,138,740,713
<b>Penalty Assessments</b>	\$2,120,926,623	\$2,393,206,860	\$2,782,279,382	\$1,755,911,430	\$2,222,435,860
<b>Interest Assessments</b>	\$1,190,989,852	\$1,531,887,789	\$1,789,292,097	\$1,254,021,578	\$1,422,496,367
<b>Decrease Tax Amount</b>	\$1,932,053	\$1,969,522	\$3,556,141	\$3,396,139	\$4,714,611
<b>Total Assessments</b>	<b>\$8,545,632,946</b>	<b>\$10,334,041,410</b>	<b>\$12,324,012,713</b>	<b>\$8,142,423,528</b>	<b>\$9,788,387,551</b>
<b>Tax Abatement</b>	\$2,275,267,649	\$2,367,892,076	\$2,822,275,967	\$1,330,793,681	\$257,309,166
<b>Penalty Abatement</b>	\$1,108,631,817	\$1,029,553,915	\$1,194,104,686	\$564,090,855	\$108,523,017
<b>Interest Abatement</b>	\$533,150,866	\$589,233,391	\$728,306,377	\$384,407,612	\$63,627,248
<b>Total Abatements</b>	<b>\$3,917,050,332</b>	<b>\$3,986,679,382</b>	<b>\$4,744,687,030</b>	<b>\$2,279,292,148</b>	<b>\$429,459,431</b>
<b>Net Tax Assessed</b>	\$2,956,516,769	\$4,039,085,163	\$4,926,609,126	\$3,798,300,700	\$5,881,431,547
<b>Net Penalty Assessed</b>	\$1,012,294,806	\$1,363,652,945	\$1,588,174,696	\$1,191,820,575	\$2,113,912,843
<b>Net Interest Assessed</b>	\$657,838,986	\$942,654,398	\$1,060,985,720	\$869,613,966	\$1,358,869,119
<b>Net Assessments</b>	<b>\$4,626,650,561</b>	<b>\$6,345,392,506</b>	<b>\$7,575,769,542</b>	<b>\$5,859,735,241</b>	<b>\$9,354,213,509</b>

Source: Unaudited IRS data from the IRS SB/SE Division Examination function.

Besides IRS costs, the abatement process can be time consuming and expensive for the taxpayers involved. For example, taxpayers need to prepare and submit one or more tax returns, which may require the expense of hiring a paid tax return preparer. Taxpayers may also need to have multiple contacts with the IRS and supply information to support one or more items on the tax return.

According to IRS officials, the lack of information on basis reporting for stock sales is a common reason for abating SFR assessments that occur when an individual is involved in numerous stock sales and does not file a tax return. Because the IRS does not have basis information for the stock sold, it has no option other than assessing taxes based on the information returns that report the gross proceeds from the stock sales so collection actions can begin. Because SFR assessments based on the gross proceeds from numerous stock sales can be significantly overstated, many individuals choose to file a tax return that provides basis information to reduce their tax liability after receiving these assessments.

In addition to new legislation, the Initiative should help improve the screening criteria for selecting delinquent returns filed in response to an SFR assessment. The Initiative was implemented in response to findings we reported in an earlier report<sup>8</sup> and is aimed at reducing the

<sup>8</sup> *Opportunities Exist to Improve the Correspondence Examination Process for High-Income Nonfilers* (Reference Number 2008-30-156, dated September 16, 2008).



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compliance risk for delinquent returns that do not contain stock transactions. While the IRS should be commended for reviewing and evaluating opportunities to improve its delinquent return screening criteria, we have two observations that the IRS may find useful for strengthening the approach it is taking in the Initiative.

***The Approach Taken to Identify Ways of Reducing the Risk Posed by Delinquent Returns Could Be Strengthened***

One of the best practices for developing and implementing new business processes, or for improving existing ones, is to establish an overall approach that contains detailed steps for carrying out the various phases of an initiative. For example, the Government Accountability Office (GAO) developed and used a 20-step approach to evaluate earlier improvement initiatives in the IRS SB/SE Division. The approach is based on its *Business Process Reengineering Assessment Guide*<sup>9</sup> and discussions with managers in private industry as well as in other Federal agencies. According to the GAO, the 20 steps included in its approach help ensure potential obstacles are considered in planning, problems are pinpointed and addressed through pilot testing, and results are evaluated accurately.

We used GAO's 20-step approach as criteria to assess how closely the team considered each of the recommended steps in planning and implementing the Initiative. We used the GAO framework because the SB/SE Division could not provide documentation during our review that it had a standardized framework in place for the Initiative. In making our assessment, it is important to recognize that because a standardized framework was not in place, we used IRS statistics, the Internal Revenue Manual, strategic planning documents, and discussions with IRS officials to make our judgment about whether each of the 20 steps were addressed during the Initiative.

We believe it is equally important to recognize that, according to the GAO, a degree of discretion is involved in making judgments about each of the steps, and some steps will not be appropriate for every project. As shown in Figure 3, the team has yet to fully address several key issues needed to help make a more informed decision about how best to enhance the screening process for delinquent returns and minimize the compliance risk they pose. Appendix IV provides additional details for each of the items in the GAO approach.

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<sup>9</sup> *Tax Administration: Planning for IRS's Enforcement Process Changes Included Many Key Steps but Can Be Improved* (GAO-04-287, dated January 2004).



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**Figure 3: Assessment of SB/SE Division’s Initiative Using Key Best Practices**

<i>Best Practices Advocated by the GAO</i>	<i>Included in Initiative</i>	<i>Comments</i>
<i>Identify productivity baseline.</i>	○	<i>No baseline data established to help measure improvement gains.</i>
<i>Include complexity and quality in productivity measures.</i>	◐	
<i>Compare productivity to internal and external benchmarks.</i>	◐	
<i>Map process.</i>	●	
<i>Identify causes of poor performance.</i>	●	
<i>Measure gap between current and desired productivity.</i>	○	<i>The gap between what the current process delivered and what the new process will be expected to deliver has yet to be quantified.</i>
<i>Used best practices.</i>	◐	
<i>Analyze alternatives.</i>	◐	
<i>Design new process to close productivity gap.</i>	◐	
<i>Obtain executive support.</i>	●	
<i>Assess barriers to implementing changed process.</i>	●	
<i>Assess resource needs and availability.</i>	●	
<i>Conduct pilot tests.</i>	●	
<i>Adjust process based on pilot.</i>	◐	
<i>Define roles and responsibilities.</i>	●	
<i>Establish employee expectations.</i>	N/A	<i>Expectations not anticipated to change.</i>
<i>Monitor and evaluate new process.</i>	○	<i>Plans not established to determine how well the process is performing.</i>
<i>Establish a change management strategy.</i>	◐	
<i>Establish a transition team.</i>	◐	
<i>Develop workforce training plans.</i>	◐	
● Yes   ○ No   ◐ Partial		

Source: Our analysis of the SB/SE Division Initiative.

To their credit, the team recognized the importance of including a pilot test in the Initiative. This step is critical to complete before full-scale implementation of a new process because, according to the GAO, pilot testing is designed to evaluate the soundness of the proposed process, pinpoint



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and correct problems, and help secure support from key stakeholders. Since starting the pilot in January 2009, the team has:

- Defined a broad goal for the Initiative, which is to reduce the noncompliance that contributes to the Federal tax gap by enhancing the screening criteria used to select delinquent returns for audit.
- Used the experience and judgment of examiners to screen delinquent returns that were submitted in response to an SFR assessment for areas of noncompliance.
- Selected 1,285 delinquent returns, which had areas of noncompliance unrelated to stock transactions, for audit during the screening process.
- Identified specific tax issues on each of the delinquent returns selected for examiners to audit.
- Introduced the delinquent returns into the audit stream with special tracking codes so closed cases can be retrieved and analyzed to help make decisions about the level of compliance risk posed by the delinquent returns audited.

Important next steps for the team include establishing measurable objectives for assessing the results from the pilot and developing a plan for accurately and reliably evaluating the results. According to the GAO, making plans early for measuring and evaluating outcomes from a pilot helps ensure that the data necessary for the assessment are collected and that accomplishments can be objectively measured to determine whether desired results are being obtained and whether further improvements may be needed. Such determinations can also enhance the credibility of the results while helping avoid any perception bias in the outcomes.

***IRS productivity indicators and closed audit case files may provide data sources for assessing results and determining if any improvements may be needed***

Given the team's stated goal, measurable objectives might include what amount of additional assessments would indicate progress is being made to reduce the noncompliance detected on delinquent returns. The SB/SE Division obtained data for the pilot which show that, as of September 30, 2010, examiners had closed 897 (70 percent) of the 1,285 delinquent return audits and recommended about \$20.2 million in additional taxes that is potentially owed by the taxpayers who filed the delinquent returns.

As summarized in Figure 4, our review of a judgmental sample of 85 of the closed audits showed that the IRS is in the position to potentially reassess about 30 percent of the \$3.2 million in SFR assessments that had been abated. Moreover, the results further illustrate the need to ensure delinquent returns are closely screened for areas of noncompliance and selected for audit when warranted. Further, the audit results should send a strong signal to taxpayers who may believe they can avoid paying taxes and not get caught by filing delinquent returns to abate SFR assessments.



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**Figure 4: Results of 85 Closed Audits of Delinquent Tax Returns**

Tax Periods	Number of SFRs	SFR Assessments	Delinquent Return Abatements	Delinquent Return Audit Assessments	Percentage of No-Change Audits
2000-2002	17	\$ 624,925	\$ (538,700)	\$ 203,426	59%
2003-2004	38	\$ 2,506,391	\$ (2,111,555)	\$ 590,710	18%
2005-2006	22	\$ 64,127	\$ -	\$ 91,537	59%
2007-2008	8	\$ 12,250	\$ -	\$ 63,677	63%
<b>Totals</b>	<b>85</b>	<b>\$ 3,207,693</b>	<b>\$ (2,650,255)</b>	<b>\$ 949,350</b>	<b>41%</b>

Source: Our analysis of audit results from the Initiative.

Besides summarizing audit results, we reviewed 85 of the 897 closed audit case files and found that examiners adhered to the audit scopes established by classifiers by addressing each of the issues the classifiers identified for audit. The audits involved sole proprietor business expenses and rental real estate expenses that classifiers identified for audit because they appeared large, unusual, or questionable.

Although we did not perform an indepth quality review of all aspects of the audits, we did conduct a preliminary Financial Statement Analysis (commonly referred to as a preliminary Cash-T analysis) for each of the 85 audits. The Cash-T analysis is based on the assumption that taxpayers need to pay a certain amount of money to cover their expenses, including basic living expenses and, absent other information, should be reporting an income that is large enough to cover the expenses.

Our Cash-T analyses showed that 42 (49 percent) of 85 audits were closed with the taxpayers' expenditures exceeding their income by more than \$10,000. In 12 of these 42 audits, the expenses exceeded the income on the return by more than \$50,000. The gaps noted between expenditures and income raise questions about whether the individuals may owe taxes in addition to those identified in the audits because the expenses on the return may still be overstated and/or there may be additional sources of income that should have been reported. While the gaps identified between expenditures and income in these audits suggest there may be deficiencies in how examiners audited the delinquent returns, the work necessary to make this conclusion was outside the scope of our audit.

Our results indicate it may be worthwhile for the team to explore the benefits as well as the costs of incorporating a preliminary Cash-T analysis in the screening process for selecting delinquent returns for audit. Like identifying other large, unusual, or questionable items for examiners to audit, this effort would better ensure significant differences between expenditures and reported income are identified for examiners early in the process so they can be addressed during the audit. Currently, IRS procedures generally require examiners to conduct preliminary Cash-T analysis during audits. However, this procedure is not always properly followed, as evidenced by our case reviews.



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## **Recommendations**

The Director, Exam Policy, SB/SE Division, should:

**Recommendation 1:** Ensure a framework with detailed steps is established for personnel to follow and document in designing and implementing future process improvement initiatives.

**Management's Response:** IRS management agreed with this recommendation. The Director, Examination Policy, SB/SE Division, will issue a memorandum to promote employee awareness of existing frameworks and system requirements for designing and implementing future process improvement initiatives.

**Recommendation 2:** Ensure an evaluation plan is established and executed to accurately and reliably assess the results of this and future pilots. These plans and the related assessments should include performance measures. Such measures are needed to objectively define what will constitute a success and determine whether desired results are being obtained and if further improvements may be needed. The results of this and future pilots should also be thoroughly documented to ensure that IRS personnel can incorporate the results into future efforts to enhance the screening criteria for selecting delinquent returns to audit.

**Management's Response:** IRS management agreed with this recommendation. Results, going forward, will be documented using an existing evaluation plan and established measures to ensure that IRS personnel can incorporate the results into future projects. The Director, Examination Policy, SB/SE Division, will issue a memorandum to emphasize the importance of using existing evaluation plans and measures to document results.

**Office of Audit Comment:** Although IRS management agreed with both recommendations and will emphasize the use of existing systems and processes to ensure initiatives are appropriately planned and evaluated, they did not specifically commit to evaluating the results from the Initiative discussed in this report. Such an evaluation can provide important information for understanding performance and identifying improvement options. The information would also benefit IRS management in efforts to deal with the challenge of reducing the compliance risk posed by delinquent returns.



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## Appendix I

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

Our overall objective was to determine whether the IRS effectively addresses the compliance risks associated with delinquent income tax returns received from individuals following an SFR assessment. To accomplish our objective, we:

- I. Determined if delinquent income tax returns received from high-income taxpayers are screened for noncompliance in accordance with IRS policies and procedures.
  - A. Reviewed the Internal Revenue Code, Internal Revenue Manual, Department of the Treasury Regulations, training materials, and publications; interviewed personnel at the IRS Campus<sup>1</sup> Compliance Services, Brookhaven Campus; and conducted a walkthrough of the High Income Non-Filer Unit.
  - B. Reviewed recent tax legislation<sup>2</sup> requiring brokers and mutual fund companies to report the basis of most stock purchases and the effect it will have in addressing some high income delinquent tax returns.
  - C. Evaluated the methodology of the Initiative underway to improve the screening criteria for selecting for review delinquent returns filed in response to an SFR assessment.
    1. Assessed the Initiative using GAO's 20-step approach based on its *Business Process Reengineering Assessment Guide*<sup>3</sup> to determine if a framework was in place to accurately and reliably evaluate the results
    2. Reviewed documentation for the Tax Compliance Officer Correspondence Exam Pilot which was to address concerns with the Automated SFR Program.
      - a. Obtained a judgmental sample of 85 from the 897 pilot case files closed as of September 30, 2010. A judgmental sample was selected because we did not plan to project our findings.
      - b. Summarized audit results and determined whether the current screening matrix would have identified noncompliant delinquent tax returns for examination.

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<sup>1</sup> 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.

<sup>2</sup> Pub. L. No. 110-343, 122 Stat. 3765, 3854 (2008).

<sup>3</sup> *Tax Administration: Planning for IRS's Enforcement Process Changes Included Many Key Steps but Can Be Improved* (GAO-04-287, dated January 2004).



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- c. Prepared a Cash-T analysis for each of the 85 cases to determine if examiners adequately probed for unreported income and overstated expenses.

**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 identifying and selecting tax returns for examination when a taxpayer submits a “new” return or request for audit reconsideration after an SFR has been prepared by the IRS. We evaluated these controls by reviewing source materials, interviewing management, and reviewing a sample of examined closed cases from the pilot program.



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## **Appendix II**

### *Major Contributors to This Report*

Margaret Begg, Assistant Inspector General for Audit (Compliance and Enforcement Operations)  
Frank Dunleavy, Director  
Michelle Philpott, Audit Manager  
Lisa Stoy, Audit Manager  
Carole Connolly, Lead Auditor  
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Joan Floyd, 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, Campus Compliance Services, Small Business/Self-Employed Division SE:S:CCS  
Director, Communications, Liaison, and Disclosure, Small Business/Self-Employed Division  
SE:S:CLD  
Director, Examination, Small Business/Self-Employed Division SE:S:E  
Director, Campus Reporting Compliance, Small Business/Self-Employed Division  
SE:S:CCS:CRC  
Director, Exam Policy, Small Business/Self-Employed Division SE:S:E:EP  
Director, Exam 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**

*Summary Assessment of the Initiative*

This appendix compares and contrasts the approach used by the IRS in its Initiative and the criteria the GAO recommends using when considering, planning, and implementing new business processes or improving existing business processes. The GAO developed its approach based on its *Business Process Reengineering Assessment Guide*<sup>1</sup> and discussions with top-level managers in private industry as well as in other Federal agencies.

**Figure 1: Considering a Potential Process Change**

<i>Description of GAO's Recommended Steps</i>	<i>Approach Used by the IRS</i>
<b>Map current process.</b> Similar to flowcharting, the purpose is to help present a clear picture of the current processes, help identify the root causes for underperformance, and achieve the desired level of improvement.	The process targeted for improvement is outlined and described in the Internal Revenue Manual and was used to determine that the current criteria for selecting delinquent tax returns for audit may need improvement.
<b>Identify productivity baselines.</b> Baseline data are needed to provide measures from the current processes to use in comparing the level of improvement achieved by the new process.	Productivity baselines were not established.
<b>Identify causes of poor performance.</b> This step involves identifying the factors or combination of factors that are causing the poor performance in the current process. Examples could include a lack of resources and regulatory requirements.	Identified resource constraints, training weaknesses, conflicting workload priorities, and outdated audit selection methods as potential causes for the need to improve performance.
<b>Include complexity and quality in productivity measures.</b> Productivity measures the efficiency with which a process uses resources to produce a product or service, such as the number of audits an IRS examiner completes in a month. To be accurate, a combination of measures is generally needed, and consideration needs to be given to the level of difficulty involved.	A partial quality assessment is planned that will measure compliance with audit procedures and guidelines. However, the degree of difficulty associated with the audits has not been considered.

<sup>1</sup> *Tax Administration: Planning for IRS's Enforcement Process Changes Included Many Key Steps but Can Be Improved* (GAO-04-287, dated January 2004).



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<i>Description of GAO's Recommended Steps</i>	<i>Approach Used by the IRS</i>
<p><b>Measure gap between current and desired productivity.</b> Ideally, the level of performance improvement desired should be achievable and based on empirical data that define where a particular performance level is and the level of improvement sought.</p>	<p>Identified the need to expand audit coverage over delinquent returns but did not quantify productivity outcome goals.</p>
<p><b>Compare current productivity to internal and external benchmarks.</b> Benchmarks are measures from which performance improvement can be quantified. They provide reference points that can be used to help identify and close performance gaps between processes used in other organizations and/or in different functions within the same organization.</p>	<p>Collectively reviewed audit coverage and results within the IRS campus<sup>2</sup> environment but did not analyze potential differences in audit productivity outside the campuses.</p>

Source: The GAO's 20-step approach and our analysis of SB/SE Division's Initiative.

<sup>2</sup> 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.



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**Figure 2: Planning a Process Change**

<i>Description of GAO's Recommended Steps</i>	<i>Approach Used by the IRS</i>
<b>Used best practices.</b> Identifying and using best practices is a form of benchmarking that involves adapting practices of others to reach new improvement levels. It is especially recommended that government agencies use business organizations in private industry for this purpose.	Reviewed practices for selecting and auditing returns in the IRS campus environment but did not identify potential best practices outside the campus or outside of the IRS.
<b>Design new process to close productivity gap.</b> Quantitative data are needed to support changing to a new process that shows the change will narrow the gap between current performance and the desired level of performance. To add credibility and avoid any perception of bias in making the change, the desired level of performance sought should be specified.	At the time of our review, no quantitative data analysis had been conducted nor had plans been developed to show how the new process improvement might resolve performance weaknesses.
<b>Analyze Alternatives.</b> Alternative process changes that may produce the same level of improvement should be explored in terms of their relative costs and benefits. Such exploration can be done through limited testing and may identify a more cost-effective approach to achieving the same or similar results.	Reviewed the possibility of having tax compliance officers conduct additional audits of delinquent returns submitted in response to an SFR assessment.
<b>Obtain executive support.</b> Executive support and oversight throughout a process change is important for a number of reasons that include ensuring resources are available, securing support from internal and external stakeholders, and approving proposed recommendations for implementation.	The Director, Campus Reporting Compliance, and the Director, Field Exam Planning, SB/SE Division, were involved with approving and implementing pilot testing.
<b>Assess barriers to implementing changes.</b> Identifying and assessing the costs of overcoming potential barriers to implementing a change is important because it may ultimately prove to be too great a burden.	Identified and assessed how to overcome the barriers associated with resource constraints, training issues, conflicting workload priorities, and outdated audit selection methods.
<b>Assess resource needs and availability.</b> Before initiating a process improvement project, it is important to ensure the resources are available to design and plan and implement the change. Otherwise, there is a risk the new change will be only partially implemented.	Considered using a combination of examiners in both the IRS campus and office environments to handle the additional workload as well as the additional training that may be needed for some or all of the examiners and their immediate supervisors.

Source: The GAO's 20-step approach and our analysis of SB/SE Division's Initiative.



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**Figure 3: Implementing a Process Change**

<b>Description of GAO's Recommended Steps</b>	<b>Approach Used by the IRS</b>
<b>Conduct pilot tests.</b> Pilot testing is designed to show intended benefits from a change can, in fact, be realized. It involves evaluating how well the process change works in practice and pinpointing and correcting problems.	A pilot test spanning multiple years was ongoing at the time of our review. It included auditing about 1,280 individual tax returns reporting sole proprietor and/or rental activities.
<b>Adjust process based on pilot.</b> This step is designed to incorporate and test needed changes to the new process based upon lessons learned in earlier pilot testing.	Pilot testing results were underway at the time of our review, and adjustment, if any, will be made once results are finalized.
<b>Define roles and responsibilities.</b> To ensure accountability, it is vital to designate the specific personnel who will be responsible for making the process improvement.	Examiners located in the IRS campuses and their immediate supervisors will be primarily responsible for implementing any new process improvements.
<b>Establish employee expectations.</b> Developing and issuing new performance expectations needs to be considered and developed if the new process causes traditional roles, responsibilities, and expectations to change for employees.	Employee performance plans and expectations are not anticipated to change significantly.
<b>Monitor and evaluate the new process.</b> An evaluation plan is needed for evaluating the success of the process change and needs to include a combination of performance measures for weighing the costs of the new process against expected benefits, determining whether the process is achieving desired results, and assessing if further improvements are needed. To enhance credibility and avoid potential bias, the criteria about what would constitute a success needs to be defined.	A monitoring and evaluation plan had not been completed at the time of our review that would determine how well the process is performing and if further improvements may be needed.
<b>Establish a change management strategy.</b> Change management is a structured approach for how best to address the transitional issues associated with moving to a new process. These issues, among others, include addressing resistance that may be encountered within a work unit to a new way of conducting business.	An approach for handling potential transitional issues, if any, will be developed once pilot test results are finalized.
<b>Establish a transition team.</b> Typically, a transition team is responsible for managing the implementation of a new process. As such, the team should develop a plan that communicates the various aspects of the new process, its goals, and how it will implemented.	The need for a transitional team will be evaluated once pilot test results are finalized.



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<b><i>Description of GAO's Recommended Steps</i></b>	<b><i>Approach Used by the IRS</i></b>
<b><i>Develop workforce training plans.</i></b> In general, employee training plans need to be considered and developed if the change is going to significantly alter traditional roles and responsibilities. For example, employees may need training to learn new technical skills if they are going to successfully take on new responsibilities.	Plans for additional training, if any, will be considered and developed once pilot test results are finalized.

*Source: The GAO's 20-step approach and our analysis of SB/SE Division's Initiative.*



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**Appendix V**

*Management's Response to the Draft Report*



COMMISSIONER  
SMALL BUSINESS/SELF-EMPLOYED DIVISION

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

February 25, 2011



MEMORANDUM FOR MICHAEL R. PHILLIPS  
DEPUTY INSPECTOR GENERAL FOR AUDIT

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

SUBJECT: Draft Audit Report – The Initiative to Reduce Compliance Risks  
Associated with Delinquent Income Tax Returns Filed After a  
Substitute for Return Assessment Could be Enhanced  
(Audit # 200930040)

We have reviewed your draft report, "The Initiative to Reduce Compliance Risks Associated with Delinquent Income Tax Returns Filed After a Substitute for Return Assessment Could be Enhanced." We agree with the recommendations contained in the report.

We are pleased that your report commends the efforts of the Small Business/Self-Employed (SB/SE) Division to seek opportunities to improve the delinquent return screening criteria. The SB/SE Division is committed to effectively improving our processes within the limitations of available resources. We have systems and processes in place, such as the Exam Compliance Initiative Projects and the Vision and Strategy Process to ensure initiatives are appropriately planned and evaluated.

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 Division, Small Business/Self-Employed Division, at (202) 283-2659.

Attachment



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Attachment

**RECOMMENDATION 1:**

Ensure a framework with detailed steps is established for personnel to follow and document in designing and implementing future process improvement initiatives.

**CORRECTIVE ACTION:**

We agree with this recommendation. The Director, Examination Policy, will issue a memorandum to promote employee awareness of existing frameworks and system requirements for designing and implementing future process improvement initiatives.

**IMPLEMENTATION DATE:**

November 15, 2011

**RESPONSIBLE OFFICIAL:**

Director, Examination Policy, Small Business/Self-Employed Division

**CORRECTIVE ACTION(S) MONITORING PLAN:**

We will monitor this action as part of our internal management control process.

**RECOMMENDATION 2:**

Ensure an evaluation plan is established and executed to accurately and reliably assess the results of this and future pilots. These plans and the related assessments should include performance measures. Such measures are needed to objectively define what will constitute a success and determine whether desired results are being obtained, and if further improvements may be needed. The results of this and future pilots should also be thoroughly documented to ensure that IRS personnel can incorporate the results into future efforts to enhance the screening criteria for selecting delinquent returns to audit.

**CORRECTIVE ACTION:**

We agree with this recommendation. Results, going forward, will be documented using an existing evaluation plan and established measures to ensure that IRS personnel can incorporate the results into future projects. The Director, Examination Policy, will issue a memorandum to emphasize the importance of using existing evaluation plans and measures to document results.

**IMPLEMENTATION DATE:**

November 15, 2011.

**RESPONSIBLE OFFICIAL:**

Director, Examination Policy, Small Business/Self-Employed Division

**CORRECTIVE ACTION(S) MONITORING PLAN:**

We will monitor this action as part of our internal management control process.