



*Actions Can Be Taken to Reinforce the  
Importance of Recognizing and Investigating  
Fraud Indicators During Field Audits*

**March 29, 2012**

**Reference Number: 2012-30-030**

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.

**Redaction Legend:**

1 = Tax Return/Return Information

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## HIGHLIGHTS

### **ACTIONS CAN BE TAKEN TO REINFORCE THE IMPORTANCE OF RECOGNIZING AND INVESTIGATING FRAUD INDICATORS DURING FIELD AUDITS**

## Highlights

### **Final Report issued on March 29, 2012**

Highlights of Reference Number: 2012-30-030 to the Internal Revenue Service Commissioner for the Small Business/Self-Employed Division.

### **IMPACT ON TAXPAYERS**

Penalties, such as for civil fraud, are designed to promote voluntary compliance by imposing an economic cost on taxpayers who choose not to comply with the tax law. Because indicators of fraud were not always recognized and properly investigated, the IRS may be missing opportunities to further promote voluntary compliance and enhance revenue for the Department of the Treasury.

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

This audit was initiated to determine whether fraud is recognized and pursued in accordance with IRS procedures and guidelines during field audits of individual tax returns. 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**

TIGTA's review of a statistical sample of 116 field audits closed between July 2009 and June 2010 found 26 audits with fraud indicators that were not recognized and investigated in accordance with some key IRS procedures and guidelines. Each of the field audits involved unreported income and/or overstated expenses that resulted in the taxpayers agreeing they owed additional taxes of at least \$10,000. TIGTA's evaluation indicates that a combination of factors caused the quality problems and that actions can be taken at the examiner and first-line manager levels to better ensure fraud

indicators are recognized and properly investigated.

### **WHAT TIGTA RECOMMENDED**

TIGTA recommended that the Director, Exam Policy, Small Business/Self-Employed Division: 1) enhance the job aid examiners are required to maintain in audit files related to documenting and investigating fraud indicators, and 2) provide specific examples in the Internal Revenue Manual for examiners and first-line managers to use in considering whether it would be beneficial to involve the IRS's technical advisors on fraud in field audits for which there are indications of fraud.

IRS officials did not agree with the first recommendation. They indicated that the job aid (*Fraud Development Lead Sheet*) was significantly enhanced in March 2011. In addition, IRS officials did not agree with the second recommendation, but do plan to take alternative corrective action. IRS officials will issue a memorandum to all Examination employees emphasizing the importance of involving the technical advisors in audits.

As discussed in this report, TIGTA evaluated the enhanced *Fraud Development Lead Sheet* during this review and continues to believe further enhancements would be beneficial. TIGTA also considered the alternative corrective action IRS officials plan to take and concluded that it is responsive to the recommendation. However, TIGTA encourages IRS officials to go beyond merely reiterating existing procedures in their memorandum by providing additional instructions and guidance to clarify when the assistance of a technical advisor should be sought.

Such clarification is important for two reasons. First, there is potential revenue at stake. As noted in their response, IRS officials agreed that the recommendations have the potential to increase revenue by some \$19.7 million over a year (\$98.5 million over five years) from approximately 1,872 field audits. Second, as discussed in the report, Small Business/Self-Employed Division Examination personnel and the technical advisors did not always agree with each other over the conclusions reached in our case reviews.



TREASURY INSPECTOR GENERAL  
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C. 20220

March 29, 2012

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

*Michael R. Phillips*

**FROM:**

Michael R. Phillips  
Deputy Inspector General for Audit

**SUBJECT:**

Final Audit Report – Actions Can Be Taken to Reinforce the  
Importance of Recognizing and Investigating Fraud Indicators During  
Field Audits (Audit # 201130021)

This report presents the results of our review to determine whether fraud is recognized and pursued in accordance with Internal Revenue Service procedures and guidelines during field audits of individual tax returns. The review was part of our Fiscal Year 2011 Annual Audit Plan and addresses the major management challenge area of Tax Compliance Initiatives.

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

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*

BSA	Bank Secrecy Act
FTA	Fraud Technical Advisor
FY	Fiscal Year
IRM	Internal Revenue Manual
IRS	Internal Revenue Service
NQRS	National Quality Review System
SB/SE	Small Business/Self-Employed
TIGTA	Treasury Inspector General for Tax Administration



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## *Background*

Tax fraud is a deliberate and purposeful violation of Internal Revenue laws by those who do not file and properly report their income and expenses. Tax fraud requires both an underpayment and fraudulent intent, and it can be considered one of the most egregious forms of noncompliance.

According to the Internal Revenue Manual (IRM), the discovery and development of fraud is the result of effective investigative techniques. The investigative techniques employed by examiners are designed to disclose not only errors in accounting and application of tax law, but also irregularities that indicate the possibility of fraud. At a minimum, the IRM indicates that examiners should exercise sound judgment and follow up on all fraud indicators by performing necessary investigative techniques, such as interviewing the taxpayer or substantiating information obtained from the taxpayer with third parties. The IRM emphasizes that fraud will not ordinarily be discovered when examiners readily accept the completeness and accuracy of the records presented and the explanation offered by the taxpayer. It is necessary for examiners to explore records and to probe beneath the surface to validate information provided and statements made in order to evaluate the creditability of evidence and testimony provided by the taxpayer.

During audits, Internal Revenue Service (IRS) examiners are largely focused on determining whether the correct tax liability has been reported. However, if an examiner suspects there are indications that a taxpayer may have committed tax fraud,<sup>1</sup> the examiner's first-line manager<sup>2</sup> and an IRS Fraud Technical Advisor (FTA) may become involved in the audit. Their involvement will be to determine whether to pursue imposing a civil fraud penalty or whether the audit file should be referred to Criminal Investigation for possible criminal prosecution. If imposed, the civil fraud penalty is equal to 75 percent of the tax owed that is attributable to fraud, plus interest on the penalty. Although civil and criminal tax fraud involves significant dollars in penalties and fines annually, criminal tax fraud is considerably more serious because it can involve prosecution costs and jail time.

IRS records show that Small Business/Self-Employed (SB/SE) Division field examiners recommended, on average, 1,175 civil fraud penalties during Fiscal Years (FY) 2008 through 2011. During this time period, SB/SE Division field examiners also coordinated with their first-line group managers and FTAs to complete, on average, 2,327 Forms 11661, *Fraud Development Recommendation – Examination*. Form 11661 is used to document the FTA's involvement and place an audit in fraud development status. Once an audit is placed in fraud

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<sup>1</sup> Tax fraud consists of both civil and criminal tax fraud.

<sup>2</sup> See Appendix VII for a glossary of terms.



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development status, a plan of action is usually developed jointly with the examiner, first-line manager, and FTA to establish affirmative acts (proof) of fraud and guide the investigation to its appropriate conclusion in a timely manner.

This review was performed at the SB/SE Division Examination function in New Carrollton, Maryland, and the IRS National Headquarters in Washington, D.C., during the period October 2010 through September 2011. 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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## *Results of Review*

Our review of a statistical sample of 116 closed field audits found 26 audits with fraud indicators that were not recognized and investigated in accordance with some key IRS procedures and guidelines. As a result, opportunities may have been missed to further promote voluntary compliance and enhance revenue for the Department of the Treasury. The Treasury Inspector General for Tax Administration's (TIGTA) evaluation indicates that a combination of factors caused the quality problems and that actions can be taken at the examiner and first-line manager levels to better ensure fraud indicators are recognized and properly investigated.

### ***Numerous Management Controls Have Been Developed to Help Ensure Fraud Is Emphasized and Considered During Audits***

The IRS relies on its examiners and their first-line managers to ensure that the civil fraud penalty is adequately considered. To assist examiners and first-line managers in meeting this responsibility, the IRS has developed and implemented a number of policies, procedures, and techniques (management controls). At the agency level, broad policy statements provide guidance nationwide to IRS personnel. Of the 184 IRS Policy Statements, 36 cover examination issues, such as taxpayer rights and examiner responsibilities.

At the divisional level, the quality measurement staff in the SB/SE Division reviews a statistically valid sample of examination audits to assess the degree to which SB/SE Division examiners pursued and developed fraud indicators. In addition to reviews by the SB/SE Division quality measurement staff, SB/SE Division mid-level managers may evaluate ongoing work during operational reviews. Operational reviews are required to be performed at least annually to ensure work is being done effectively. These processes serve as a quality control by identifying managerial, technical, and procedural problems and providing a basis for corrective actions.

At the first-line manager level, the performance management system requires that, at the beginning of each fiscal year, first-line managers coordinate with their respective Territory managers to set forth commitments in their individual performance plans. The commitments are intended to provide the basis for linking first-line manager critical job responsibilities with the IRS's balanced measures and strategic goals and holding them accountable for their individual and team performances. To realize these benefits, the commitments are to be related to at least one critical job responsibility. They should also, according to the IRS,<sup>3</sup> specifically describe the

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<sup>3</sup> See, for example, the IRS Human Capital Office guide entitled, *Writing Performance Commitments "A Reference Guide for Managers and Management Officials"* (October 2005).



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actions to be taken, include a deadline, indicate an expected result, and include some means of verifying whether the commitment was met. Our review of the FYs 2009 through 2011 performance agreements for a judgmental sample<sup>4</sup> of 20 first-line managers found that all 20 managers received clear and specific commitments related to fraud consideration. We found, for example, commitments that stated:

- *I will improve the quality, effectiveness and efficiency of income probes and fraud development. I will deliver tools and training to examiners supporting income examination techniques. I will consult with the National Fraud Program on a quarterly basis to review potential fraud issues identified in case work, identify best practices and collaborate on potential areas of improvement. I will communicate the need to create an environment conducive to recognition of indicators of fraud and development of cases that meet the quality attributes.*
- *I will support the development of quality fraud referrals by coordinating with the FTA, communicating effective audit techniques to my employees, and by conducting timely, productive four-way meetings with Criminal Investigations. I will conduct a fraud awareness group meeting jointly with the National Fraud Program by June 30, 2010. Through managerial engagement in case activities, I will ensure correct and timely actions are taken in cases with indicators of fraud, as required by the Embedded Quality attributes. Success will be measured based on timeliness in conducting a fraud awareness group meeting, timeliness in conducting four-way conferences and documentation of managerial engagement activities.*

As noted in the examples above, managers were required to complete certain actions related to fraud within a specific time period. We believe that Territory managers should be able to use these types of commitments to hold first-line managers responsible for meeting expectations, including fraud consideration.

At the group level, first-line managers are also an important control component because they are responsible for the quality of work performed by the examiners they supervise. A variety of techniques are used to ensure examiners follow applicable standards and procedures when they identify fraud indicators. These techniques include performance observations, discussions with examiners, and reviews of audit file documentation during audits and after they are closed. Through these observations, discussions, and reviews, first-line managers attempt to identify problems so examiners can take prompt corrective actions. Our review of the FYs 2009 through 2011 performance appraisals and the Embedded Quality Review System for a judgmental sample of 20 examiners found that 18 of the 20 examiners received feedback related to fraud consideration.

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<sup>4</sup> A judgmental sample is a nonstatistical sample for which the results cannot be used to project to the population.



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The IRM is another important control component because it contains the official compilation of detailed instructions and explanations of fraud consideration for examiners to follow during audits. Throughout the IRM, examiners are instructed to properly document in audit files all aspects of their work during the planning, initiating, conducting, and closing phases of audits. Audit file documentation is important because it provides the principal evidence that procedures were followed, as well as the foundation for other control processes, such as managerial reviews and the quality measurement reviews. The importance of examiner documentation is further emphasized in management directives, examiner training materials, and the quality measurement standards.

In addition to the above controls, SB/SE Division management has continued to implement various approaches to emphasize the expectation that examiners identify, pursue, and develop fraud indicators. Specifically, since a 2007 TIGTA report,<sup>5</sup> the Examination and Fraud/Bank Secrecy Act (BSA) functions took the following actions during FYs 2008 through 2011:

- Issued a December 2007 memorandum to examiners reinforcing managerial and FTA involvement and the documentation of actions in the development of fraud cases.
- Implemented a case management tool that assists the FTAs in tracking the cases referred by examiners for further fraud development. This tool also facilitates cases to be reconciled to the Fraud/BSA function's internal database and allows management to monitor FTA staffing needs.
- Highlighted the importance of the required discussion with the first-line manager to consider the potential for fraudulent activity when the examiner identifies an understatement of taxable income<sup>6</sup> greater than \$10,000 (a fraud indicator) in the August 2010 issue of Fraud Digest, a quarterly publication by SB/SE Division's Technical Services.
- Developed a checklist that lists the fraud indicators and fraud penalty considerations. The checklist is an optional tool that may be used by examiners during audits.
- Provided examples of case studies illustrating proper development of fraud indicators for consideration of the civil fraud penalty in each quarterly issue of the Fraud Digest since November 2007.

Although there are layers of management controls in place to guide examiners through the consideration of fraud, our results indicate that additional steps are needed to ensure that potential fraud is adequately considered and investigated during field audits.

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<sup>5</sup> TIGTA, Ref. No. 2007-30-179, *Management Has Emphasized the Fraud Program, but Opportunities Exist to Further Improve It* (Sept. 2007).

<sup>6</sup> Taxable income is all income received minus allowable IRS deductions.



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## **Opportunities May Have Been Missed to Enhance the Contribution Fraud Penalties Make to Compliance**

According to the IRS, penalties, such as for civil fraud, promote voluntary compliance by imposing an economic cost on taxpayers who choose not to comply with the tax law. Consequently, when penalties are not properly considered and assessed, opportunities can be missed to provide economic disincentives for noncompliance, promote future compliance, and enhance revenue for the Department of the Treasury.

We evaluated a statistical sample of 116 field audits that were closed between July 2009 and June 2010 and found 26 (20 percent)<sup>7</sup> field audits for which fraud indicators were not recognized and investigated in accordance with some key IRS procedures and guidelines. For example, in five of the 26 field audits, interviews with the taxpayer were not adequately performed to determine the reasons income that ranged from approximately \$30,000 to \$750,000<sup>8</sup> was not reported. In 16 of the 26 field audits, third parties were not contacted to validate taxpayers' assertions about who was responsible for omitting the income and/or overstating the expenses. We found several instances, for example, where the taxpayers stated that return preparers caused the errors. However, the audit file documentation indicated that the tax preparers were never contacted by the examiners to confirm the taxpayers' statements.

Overall, when the sample results are projected to our population of 9,292 closed field audits, we estimate that fraud indicators were not recognized and investigated in 1,872 field audits. The projection is based on a 95 percent confidence level. We expect the number of field audits where fraud was not adequately considered to fall between 998 and 2,747. We estimate that additional assessments totaling approximately \$19.7 million<sup>9</sup> in civil fraud penalties may have been avoided by taxpayers.

We believe it is important to note that each of the field audits reviewed involved unreported income and/or overstated deductions that resulted in the taxpayer agreeing he or she owed additional taxes of at least \$10,000. The \$10,000 understatement threshold is important because

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<sup>7</sup> Amount is rounded to the nearest percent and represents the weighted average exception rate. See Appendix IV for the calculation.

<sup>8</sup> For these five audits, the total underreported income about which the taxpayers were not questioned amounted to approximately \$1.8 million.

<sup>9</sup> Our calculation assumes that the civil fraud penalty could have been assessed on 50 percent of the audits that we determined were exceptions and is based on our analysis of readily available IRS data. We are unable to quantify the degree of uncertainty associated with the estimated \$19.7 million in additional assessments because of the variability in the dollars assessed for the population of exception audits and the uncertainty as to which of the individual exception audits could have resulted in a civil fraud penalty assessment. See Appendix IV for more details.



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it allowed us to review field audits for which examiners were required, according to the IRM,<sup>10</sup> to discuss the audit with their first-line manager so important decisions could be made about whether the audit scope, depth, or techniques should be changed to investigate the potential for fraudulent activity. In 15 of the 26 field audits, we did not find adequate documentation in the audit files to indicate that such discussions were held. It is equally important to note that, while the IRS's FTAs agreed with the conclusion we reached in all 26 field audits, IRS SB/SE Division Examination function officials disagreed with the TIGTA and the FTAs in 13 of the 26 field audits. Appendix V provides a summary of these 13 field audits, including written comments we received from both the FTAs and IRS SB/SE Division Examination function officials.

**IRS quality reviews have also identified problems with fraud consideration**

Recent reports issued by the SB/SE Division's National Quality Review System (NQRS) staff have also noted problems with the quality of fraud consideration performed by examiners. For example, for FY 2010, the NQRS staff reported that examiners did not meet the standard for determining if fraud indicators were pursued and developed in 55 percent of the field audits reviewed for which fraud consideration was applicable.

Although we did not audit the accuracy of results reported by the SB/SE Division's quality measurement staff, one reason, among others, that could account for the difference between our results (20 percent) and those reported by the SB/SE Division's quality measurement staff (55 percent) was the methodology used to evaluate the field audits. For example, the SB/SE Division's methodology considers an audit an exception if there is an understatement of income<sup>11</sup> greater than \$10,000 and the examiner did not discuss the unreported income with the first-line manager. For our review, we considered whether investigative techniques were properly performed given the fraud indicators present in the file. Therefore, our methodology would not take exception with an audit when the investigative techniques were properly performed even when a discussion with the first-line manager had not occurred.

To address the concerns identified by the NQRS staff in FY 2010, the SB/SE Division Examination function reemphasized the importance of fraud consideration to examiners and their managers using the Division's Technical Digest newsletter. The SB/SE Division Examination function also provided training and presentation sessions that emphasized fraud consideration to examiners and managers. For FY 2011, the NQRS staff reported that examiners did not meet the standard for determining if the fraud indicators were pursued and developed in 35 percent of the field audits reviewed for which fraud consideration was applicable. Although the IRS's actions

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<sup>10</sup> During discussions with IRS officials over the issues in this report, we learned, after our sample cases were selected and reviewed, that the requirement that examiners discuss the audit with their manager when there was an understatement of more than \$10,000 of taxable income was corrected to indicate this requirement only applied when there was an understatement of more than \$10,000 of unreported income.

<sup>11</sup> The IRS methodology used income instead of taxable income in determining when first-line manager involvement would be appropriate. Taxable income factors both income and any IRS deductions.



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have resulted in an improvement (20 percent decrease) in the NQRS scores since FY 2010, the fact that NQRS results show that about one out of every three audits where fraud consideration was applicable is not meeting standards for considering fraud suggests there may be room to better ensure fraud indicators are recognized and properly investigated.

**Audit case files indicated that fraud indicators were not always recognized**

Among the initial steps examiners need to take when investigating taxpayers that may be involved in fraudulent activities is to recognize and document audit case files with indicators of such behavior. To assist examiners with recognizing fraudulent behavior, the IRM lists the following six categories of fraud indicators: income, expenses or deductions, books and records, conduct of taxpayer, methods of concealment, and income allocation. Each category, in turn, contains specific examples of supporting behavior that range from omissions of income, substantially overstating expenses, and failing to keep adequate records to attempts to hinder the audit, making false statements, and failing to disclose relevant facts to an accountant.

To help ensure fraudulent behavior is recognized and investigated, the SB/SE Division revised the job aid during our review, which examiners are required to include in their audit case files. The job aid is called the *Fraud Development Lead Sheet*<sup>12</sup> and contains specific directions to follow in considering, developing, and pursuing a civil fraud penalty or, if warranted, a referral to the IRS's Criminal Investigation. It also solicits certain factual information to help support audit findings and provides references to the IRM where information can be found to answer other questions that may surface.

Although the job aid provides consistent directions for guiding examiners through the fraud development process, we found that fraud indicators were not recognized and properly documented on the *Fraud Development Lead Sheet* in 15 of the 26 field audits where fraud was not adequately considered.<sup>13</sup> This finding indicates that the job aid could be enhanced by listing the fraud indicators along with some of the related supporting behaviors and requiring examiners to acknowledge which indicators, if any, were considered during the audit. We believe the enhancements would involve minimal costs as the fraud indicators have already been identified and are listed in the IRM. If well-designed, the enhancements could provide an even more effective tool to reinforce the importance of examiners ensuring that fraud indicators are recognized, investigated, and documented during audits. The enhancements could also help facilitate managerial reviews after examiners submit the audit file for closing actions. Specifically, for the 15 field audits that lacked documentation of fraud indicators, we found evidence in the audit file of first-line manager involvement in each of these audits; however, the

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<sup>12</sup> See Appendix VI for an example of the *Fraud Development Lead Sheet*.

<sup>13</sup> Although the *Fraud Development Lead Sheet* may not have been adequate for the remaining 11 audits, there was evidence of first-line manager involvement in the examination beyond reviewing the audit file for closure, such as the examiner discussing a fraud indicator with the first-line manager. Therefore, we did not include these 11 audits in this analysis.



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outcome of the managerial reviews and decisions to pursue and investigate civil fraud may have been different had the fraud indicators been documented on the *Fraud Development Lead Sheet*.

**The FTAs could have a greater role in the decision process to investigate fraud indicators**

The IRM specifies that when there are fraud indicators to investigate, a discussion should be initiated with an FTA to help evaluate the risk posed and, if warranted, develop an investigative action plan. The FTAs are generally selected from the ranks of experienced IRS examiners, and the IRS considers the FTAs subject matter experts because they are specifically trained to assist other examiners on the complexities of applying laws, regulations, and procedures governing the development of criminal and civil tax fraud cases.

The first-line manager is the primary control to ensure FTA involvement in an audit when fraud indicators are detected. However, the IRM does not provide specific criteria that require first-line managers to involve an FTA in an audit. Instead, the decision to both further investigate suspected fraudulent behavior and seek the assistance of an FTA is left largely to the experience and judgment of each of the many first-line managers. As a result, the technical and procedural expertise the FTAs possess is not always taken advantage of when warranted. In 26 of the 116 field audits reviewed, we identified fraud indicators that warranted FTA involvement due to the number or magnitude of the behaviors noted in the audit case files. Although the behaviors included large amounts of unreported income, substantial overstatement of business expenses, failure to keep adequate books and records, and unexplained differences between the amounts on the tax return and the amounts in books and records, we found evidence of FTA involvement in only three of the 26 field audits. Moreover, of the 116 field audits evaluated during this review, we found that only 11 audits involved an FTA, even though all had at least one fraud indicator and resulted in an additional tax assessment of at least \$10,000.

**Recommendations**

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

**Recommendation 1:** Enhance the *Fraud Development Lead Sheet* or develop and implement a similar job aid to better assist examiners with recognizing, investigating, and documenting fraud indicators in audit case files.

**Management's Response:** IRS officials did not agree with this recommendation. They indicated the job aid (*Fraud Development Lead Sheet*) was significantly enhanced in March 2011 to provide specific IRM references and guidelines, including those related to fraud development and indicators of fraud.

**Office of Audit Comment:** As discussed in the report and displayed in Appendix VI, the TIGTA evaluated the enhanced job aid (*Fraud Development Lead Sheet*) as part of the review and found that it has some weaknesses that could make it difficult to ensure



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examiners are recognizing and documenting fraud indicators. Because recognizing and documenting fraud indicators are critical first steps in the process of developing and pursuing fraud during audits, we continue to believe further enhancements, such as requiring examiners to acknowledge which indicators, if any, were considered during the audit, would be beneficial. We also added language in the body of the report to clarify that IRS officials revised the *Fraud Development Lead Sheet* during our review.

**Recommendation 2:** Reinforce the importance of involving an FTA in audits when there are indicators of fraud by providing specific examples in the IRM for examiners and first-line managers to use in considering whether it would be beneficial to involve an FTA.

**Management's Response:** IRS officials did not agree to this recommendation but do plan to take alternative corrective action. Specifically, IRS officials will issue a memorandum to all Examination compliance employees emphasizing the importance of involving an FTA in audits when there are indicators of fraud along with highlighting fraud awareness expectations and responsibilities and proper involvement of FTAs.

**Office of Audit Comment:** The TIGTA considered the planned alternative corrective action and concluded that it is responsive to our recommendation. However, we encourage IRS officials to go beyond merely reiterating existing IRM procedures in their memorandum and provide additional instructions and guidance to clarify when the assistance of an FTA should be sought in an audit rather than leaving the decision largely to the experience and judgment of the first-line manager. Such clarification is important for two reasons. First, there is potential revenue at stake. As noted in their response, IRS officials agreed that the recommendations have the potential to increase revenue by some \$19.7 million over a year (\$98.5 million over five years) from approximately 1,872 field audits. Second, as discussed in the report, SB/SE Division Examination personnel and the technical advisors did not always agree with each other over the conclusions reached in our case reviews.



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## **Appendix I**

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

The objective of this review was to determine whether fraud is recognized and pursued during field audits<sup>1</sup> of individual tax returns in accordance with IRS procedures and guidelines.

To accomplish this objective, we:

- I. Evaluated the adequacy of controls for ensuring fraud penalties are adequately considered and applied during field audits.
  - A. Documented the applicable Internal Revenue Code sections, Treasury Regulations, the IRM, management directives, examiner training materials, and IRS public announcements and notices that provide the authority and reasons for assessing the penalty.
  - B. Interviewed IRS officials to obtain an understanding of all policies, procedures, and techniques (management controls).
  - C. Obtained quality review results related to fraud consideration in field audits from the NQRS and the Embedded Quality Review System to determine any areas identified for improvement and the actions taken by management to address weaknesses in the areas identified.
- II. Determined if examiners followed procedures and guidelines during consideration of the civil fraud penalty and the potential tax effect of noncompliance.
  - A. Obtained an extract from the Audit Information Management System of field audits closed between July 1, 2009, and June 30, 2010, for sole proprietor Form 1040<sup>2</sup> returns (Activity Codes 274 through 277) and high-income taxpayers (more than \$200,000) (Activity Codes 279 through 281) that had an agreed assessment equal to or greater than \$10,000. From this extract, only those records with a Fraud Condition Indicator Code of 00 or blank were selected. Any records in which the civil fraud penalty was applied were removed from the population. This was performed by matching the remaining records against the Individual Master File, eliminating any records with a dollar amount in Transaction Code 320 (Fraud Penalty) and Transaction Code 240 with Penalty Reference Number 686 (Accuracy-Related Penalty for Fraudulent Failure to File).

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<sup>1</sup> See Appendix VII for a glossary of terms.

<sup>2</sup> Form 1040, *U.S. Individual Income Tax Return*.



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- B. Validated the data by comparing the data to the Integrated Data Retrieval System and the IRS's Statistics of Income Table 37.
  - C. Stratified the population of field audits identified in Step II.A into four strata based on the amount of additional tax assessed. See Figure 1 of Appendix IV for details regarding each of the four strata. We then selected a statistical sample of 116 closed field audits using a 95 percent confidence level,  $\pm 12.17$  percent precision rate, and 50 percent occurrence rate as discussed with the TIGTA's contracted independent statistician. A statistical sample was taken because we wanted to estimate the number of audits and amount of dollars associated with not properly considering the fraud penalty for a population of 9,292 field audits.
  - D. Determined if examiners are complying with the procedures and guidelines required for considering the fraud penalty.
  - E. Assessed whether examiners adequately considered the fraud penalty during field audits and whether there may be opportunities to enhance revenue. For revenue enhancements, we calculated the potential penalty amount by multiplying the 75 percent civil fraud penalty rate by the agreed assessment amount and subtracting any amounts previously assessed for accuracy-related penalties.
- III. Assessed the emphasis placed on recognizing, considering, and developing fraud in the performance feedback provided to examiners and first-line managers.
- A. Summarized the performance feedback given to a judgmental sample of 20 examiners included in our audit reviews during FYs 2009 through FY 2011 by extracting the requisite information recorded in the Embedded Quality Review System attribute (*i.e.*, Attribute 407) dealing with recognizing, considering, and developing fraud. We used judgmental sampling to select the examiners because we did not plan to project our results.
  - B. Reviewed the FYs 2009 through 2011 midyear and annual appraisals and summarized feedback related to recognizing, considering, and developing fraud that was given to the judgmental sample of 20 examiners in Step III.A.
  - C. Identified the first-line manager for each of the 20 examiners identified in Step III.A. and evaluated the performance expectations for the first-line managers to determine if there were any commitments or expectations relating to asserting the fraud penalty. We used judgmental sampling to select the first-line managers because we did not plan to project our results.
- IV. Determined if corrective actions from prior TIGTA reports have been implemented.



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**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 determining during field audits whether examiners are recognizing and pursuing fraud indicators. We evaluated these controls by reviewing source materials, interviewing management, and reviewing a sample of 116 examined closed field audits.



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**Appendix II**

*Major Contributors to This Report*

Margaret E. Begg, Assistant Inspector General for Audit (Compliance and Enforcement Operations)  
Frank Dunleavy, Director  
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Carole Connolly, Lead Auditor  
Alberto Garza, Lead Auditor  
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Donna Saranchak, Senior Auditor  
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Cynthia Dozier, Auditor  
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Joseph L. Katz, Ph.D., Contractor, Statistical Sampling Consultant



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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

### *Outcome Measure*

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. This benefit will be incorporated into our Semiannual Report to Congress.

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

- Increased Revenue – Potential; \$19.7 million from additional penalties assessed for 1,872 field audits;<sup>1</sup> \$98.5 million over five years (see page 6).

Our calculation assumes that the civil fraud penalty would have been recommended, assessed, and sustained upon any taxpayer appeal, on the entire amount of additional taxes owed for 50 percent of the field audits that we determined were exceptions had the examiners adequately considered and investigated the potential fraudulent activity of the taxpayer during the audit.

We limited our penalty calculation to 50 percent of the audits based on analyzing readily available IRS data that suggest roughly half<sup>2</sup> of the field audits placed in fraud development status result in a civil fraud penalty recommendation. Specifically, IRS data showed that in FYs 2008 through 2011 an average of 2,327 Forms 11661, *Fraud Development Recommendation – Examination*, were completed annually during field audits in the SB/SE Division. IRS data also showed that in FYs 2008 through 2011 an average of 1,175 civil fraud penalties were recommended during SB/SE Division field audits.

Additionally, this calculation is net of any accuracy-related penalties that were previously assessed during the field audits. Further, the value of the outcome measure does not include amounts (revenue) that would partially offset this benefit as a result of directing examination resources away from other taxpayer returns in order to pursue the civil fraud penalty cases.

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<sup>1</sup> See Appendix VII for a glossary of terms.

<sup>2</sup> The approximate percentage was calculated by taking the number of civil fraud penalty recommendations and dividing by the number of Forms 11661 completed over the four-year period. We did not analyze the data to determine whether the civil fraud penalty was recommended within the same year that the taxpayer was placed into fraud development status. Therefore, the approximate percentage for the four-year period may differ as it may include completion of a Form 11661 in a different year than when the civil fraud penalty was recommended. A four-year average is provided to account for the potential overlap between fiscal years.



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

To estimate the potential additional revenue associated with the difference between the number of civil fraud penalties assessed and the number that should be assessed in sole proprietor and high-income taxpayer field audits, we reviewed a statistically valid stratified sample, as shown in Figure 1, of 116 field audits from a population of 9,292 field audits of sole proprietors and high-income taxpayers that were closed between July 1, 2009, and June 30, 2010, and had an agreed assessment of more than \$10,000.

**Figure 1: Statistical Sampling Data**

<b>Strata</b>	<b>Universe Size</b>	<b>Sample Size</b>
Strata 1: Tax assessment of \$500,000 or greater	19	16 <sup>3</sup>
Strata 2: Tax assessment between \$100,000 and \$499,999	427	26
Strata 3: Tax assessment between \$40,000 and \$99,999	1,381	29
Strata 4: Tax assessment between \$10,000 and \$39,999	7,465	45
<b>Totals</b>	<b>9,292</b>	<b>116</b>

*Source: TIGTA analysis of an extract from the Audit Information Management System of field audits closed between July 2009 and June 2010 for sole proprietor and high-income taxpayers with an agreed assessment equal to or greater than \$10,000 and for which fraud penalties were not applied and TIGTA's sampling plan.*

- Calculated the weighted average error rate for our sample, which was required due to our stratified sampling methodology.
  - Prior to determining our overall weighted average error rate for our sample, we first had to determine the weight of each strata in our universe. To do so, we divided the number of field audits in each strata by the total field audits in the universe, as shown in Figure 2.

<sup>3</sup> We attempted to review all of the audits in Stratum 1; however, we did not receive files for three of the audits, and therefore, we limited our review to the 16 audits we received.



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**Figure 2: Weight of Strata in Universe**

Strata	Strata Universe Size	Weight of Strata in Universe (Strata Universe Size/ Total Universe Size) <sup>4</sup>
Strata 1: Tax assessment of \$500,000 or greater	19	0.20%
Strata 2: Tax assessment between \$100,000 and \$499,999	427	4.60%
Strata 3: Tax assessment between \$40,000 and \$99,999	1,381	14.86%
Strata 4: Tax assessment between \$10,000 and \$39,999	7,465	80.34%
<b>Totals</b>	<b>9,292</b>	<b>100.00%</b>

Source: TIGTA analysis of an extract from the Audit Information Management System of field audits closed between July 2009 and June 2010 for sole proprietor and high-income taxpayers with an agreed assessment equal to or greater than \$10,000 and for which fraud penalties were not applied.

- Next, we calculated the error rate per strata, as shown in Figure 3, by dividing the number of errors in each strata by the sample size for each strata and multiplying by 100.

**Figure 3: Error Rate per Strata**

Strata	Number of Errors	Sample Size	Error Rate per Strata
Strata 1: Tax assessment of \$500,000 or greater	0	16	0.00%
Strata 2: Tax assessment between \$100,000 and \$499,999	10	26	38.46%
Strata 3: Tax assessment between \$40,000 and \$99,999	8	29	27.59%
Strata 4: Tax assessment between \$10,000 and \$39,999	8	45	17.78%
<b>Totals</b>	<b>26</b>	<b>116</b>	

Source: TIGTA's sampling plan and audit file analysis.

- We then calculated the weighted average error rate for our sample, as shown in Figure 4, by multiplying the error rate for each strata by the percentage of each respective strata represented in our universe (*i.e.*, “Weight of Strata in Universe”) and summing the results.

<sup>4</sup> Percentages are rounded.



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**Figure 4: Weighted Average Error Rate Calculation for Stratified Sample**

Strata	Error Rate per Strata	Weight of Strata in Universe	Weight of Error Rate
Strata 1: Tax assessment of \$500,000 or greater	0.00%	0.20%	0.00%
Strata 2: Tax assessment between \$100,000 and \$499,999	38.46%	4.60%	1.77%
Strata 3: Tax assessment between \$40,000 and \$99,999	27.59%	14.86%	4.10%
Strata 4: Tax assessment between \$10,000 and \$39,999	17.78%	80.34%	14.28%
<b>Weighted average error rate for sample</b>			<b>20.15%</b>

Source: TIGTA analysis of 1) an extract from the Audit Information Management System of field audits closed between July 2009 and June 2010 for sole proprietor and high-income taxpayers with an agreed assessment equal to or greater than \$10,000 and for which fraud penalties were not applied and 2) results of audit file testing.

- Based on our sample error rate of 20.15 percent and a confidence level of 95 percent ( $\pm 9.41$  percent precision), we calculated the number of field audits where fraud was not adequately recognized and pursued to be 1,872 field audits [ $9,292 \times 20.15$  percent], with a range of 998 to 2,747.
- To estimate the potential amount of additional civil fraud penalties that may have been assessed for these 26 field audits, we computed the additional penalty assessment by multiplying the agreed assessment for each audit by the 75 percent civil fraud penalty rate and subtracting any amounts previously assessed for accuracy-related penalties. Based on this analysis, we estimated that had potential fraud been adequately considered and investigated for these 26 field audits, \$1.3 million in additional penalties could have been assessed.<sup>5</sup>
  - However, as discussed previously, our analysis of available data suggests that there is a 50 percent probability that a civil fraud penalty will be recommended when a Form 11661 is completed. Based on this probability, we reduced the above amount by 50 percent, from \$1.3 million to \$650,000.
- To determine the total amount of potential additional penalties owed for the field audits in our universe, we:
  - Calculated the weighted average additional penalties for all 116 field audits in our sample. To calculate the weighted average additional penalties, we calculated the average additional penalties for each strata and then multiplied it by the weight of the

<sup>5</sup> Amounts are rounded to the nearest dollar.



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strata in our universe. We summed the results for each strata to arrive at the weighted average additional penalties for our sample. See Figure 5 for details of our calculation.

**Figure 5: Weighted Average Penalty Dollar Calculation<sup>6</sup>**

Strata	Average Additional Penalties <sup>7</sup>	Weight of Strata in Universe	Weight of Additional Penalties <sup>8</sup>
Strata 1: Tax assessment of \$500,000 or greater	\$0	0.20%	\$0
Strata 2: Tax assessment between \$100,000 and \$499,999	\$37,720	4.60%	\$1,735
Strata 3: Tax assessment between \$40,000 and \$99,999	\$8,455	14.86%	\$1,256
Strata 4: Tax assessment between \$10,000 and \$39,999	\$1,549	80.34%	\$1,244
<b>Weighted average additional penalties for sample</b>			<b>\$4,235</b>

*Source: TIGTA analysis of 1) an extract from the Audit Information Management System of field audits closed between July 2009 and June 2010 for sole proprietor and high-income taxpayers with an agreed assessment equal to or greater than \$10,000 and for which fraud penalties were not applied and 2) results of audit file testing.*

- To calculate the potential amount of additional penalties owed by sole proprietors and high-income taxpayers in our universe who we estimate may have avoided a civil fraud penalty that otherwise should have been assessed, we multiplied the number of field audits in the universe by the weighted average additional penalties for our sample field audits [9,292 x \$4,235 = \$39.4 million]. The \$39.4 million represents the point estimate for the total potential additional penalties for a one-year period. Based on a 95 percent confidence interval, the total potential additional penalties range from \$25.5 million to \$53.2 million.
  - However, as discussed previously, our analysis of available data suggests that there is a 50 percent probability that a civil fraud penalty will be recommended when a Form 11661 is completed. Based on this probability, we reduced the above additional penalty amount by 50 percent. Therefore, we estimate that sole proprietors and high-income taxpayers in our universe may have avoided additional penalties totaling \$19.7 million.<sup>9</sup> Our calculation assumes that for 50 percent of the field audits that we determined were exceptions, the civil fraud penalty would have been recommended, assessed, and sustained upon taxpayer appeal, on the entire amount of additional taxes

<sup>6</sup> Amounts in Figure 5 are calculated using the estimate for \$1.3 million in additional penalty assessments.

<sup>7</sup> Amounts are rounded to the nearest dollar.

<sup>8</sup> Amounts are rounded to the nearest dollar.

<sup>9</sup> We are unable to quantify the degree of uncertainty associated with the estimated \$19.7 million in additional assessments because of the variability in the dollars assessed for the population of exception audits and the uncertainty as to which of the individual exception audits could have resulted in a civil fraud penalty assessment.



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owed had the examiners adequately considered and investigated the potential fraudulent activity of the taxpayer during the audit.

- To calculate the potential amount of additional penalties owed by sole proprietors and high-income taxpayers in our universe who we estimate may have avoided a civil fraud penalty that otherwise should have been assessed over five years if the IRS does not change its procedures, we multiplied the total amount of additional penalties we estimated is owed for the field audits closed between July 2009 and June 2010 by five to obtain the amount of taxes [\$19,700,000 x 5 = \$98,500,000]. Our calculation assumes that all estimated penalties would be owed based upon the development of fraud and that conditions such as economic factors, tax law, compliance rates, and IRS audit coverage remain the same.

We shared our sampling and outcome measure methodologies with an outside statistical expert who confirmed the accuracy of our methodology and projection.



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**Appendix V**

*Summary of Disagreed Exception Field Audits*

This appendix summarizes the responses provided by the FTAs<sup>1</sup> and SB/SE Division Examination function officials for the 13 field audits where the Examination function officials disagreed with both our conclusions and those of the IRS’s FTAs. One common issue in these field audits was the absence of evidence to show third parties were contacted to determine who was responsible for the potential fraudulent acts. According to the IRM, substantiating information obtained from taxpayers with third parties is a critical investigative technique for investigating fraud.

Audit	TIGTA’s Conclusions	SB/SE Division Examination Function Response	FTA (Fraud/BSA) Response
1	*****   *****	*****   *****	*****   *****

<sup>1</sup> See Appendix VII for a glossary of terms.



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Audit	TIGTA's Conclusions	SB/SE Division Examination Function Response	FTA (Fraud/BSA) Response
2	*****1*****	*****1*****	*****1*****
3	*****1*****	*****1*****	*****1*****



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Audit	TIGTA's Conclusions	SB/SE Division Examination Function Response	FTA (Fraud/BSA) Response
4	*****1*****	*****1*****	*****1*****
5	*****1*****	*****1*****	*****1*****

<sup>2</sup> \*\*\*\*\*1\*\*\*\*\*.



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Audit	TIGTA's Conclusions	SB/SE Division Examination Function Response	FTA (Fraud/BSA) Response
6	*****1*****	*****1*****	*****1*****
7	*****1*****	*****1*****	*****1*****



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Audit	TIGTA's Conclusions	SB/SE Division Examination Function Response	FTA (Fraud/BSA) Response
8	*****1*****	*****1*****	*****1*****
9	*****1*****	*****1*****	*****1*****

<sup>3</sup> \*\*\*\*\*1\*\*\*\*\*  
\*\*\*\*\*1\*\*\*\*\*



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Audit	TIGTA's Conclusions	SB/SE Division Examination Function Response	FTA (Fraud/BSA) Response
10	*****1*****	*****1*****	*****1*****
11	*****1*****	*****1*****	*****1*****



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Audit	TIGTA's Conclusions	SB/SE Division Examination Function Response	FTA (Fraud/BSA) Response
12	*****1*****	*****1*****	*****1*****
13	*****1*****	*****1*****	*****1*****

*Source: Summary of SB/SE Division Examination function and Fraud/BSA function officials' written comments as well as TIGTA's conclusions for the 13 exception field audits for which Examination function officials disagreed with the conclusions reached by both the TIGTA and Fraud/BSA function officials.*

4 \*\*\*\*\*1\*\*\*\*\*

5 \*\*\*\*\*1\*\*\*\*\*



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**Appendix VI**

*Fraud Development Lead Sheet*

<b>Taxpayer Name:</b> <b>TIN:</b> <b>Tax Form:</b> <b>Tax Year (s):</b>	<b>Examiner:</b>  <b>Date:</b>		
<b>Fraud Development Lead Sheet</b>			
<b>Tax Period</b>	<b>Code Section</b>	<b>Penalty Amount</b>	<b>Reference</b>
<b>Conclusion:</b> <i>(Reflects action on the issue.)</i>			
<input type="checkbox"/> No Fraud [Comment required if there are adjustment(s) and fraud had been considered] <input type="checkbox"/> Indications of fraud [Explain]; Date of discussion with manager: <input style="width: 100px;" type="text"/>			
<p>The following items are not intended to be all-inclusive nor are they mandatory steps to be followed. Judgment should be used in pursuing the items that apply to each taxpayer. Refer to IRM 25.1, <i>Fraud Handbook</i> and the Fraud Website at <a href="http://sbseservice.wide.web.irs.gov/Fraud/default.aspx">http://sbseservice.wide.web.irs.gov/Fraud/default.aspx</a> and contact your local Fraud Technical Advisor (FTA) when indicators of fraud are present.</p> <p style="text-align: center;"><b>Guidelines</b></p> <p>IRM 25.1.1.1(6) The FTA plays a vital role in the development of a potential fraud case. The FTA will be consulted in all cases involving potential fraud after discussing the case with the group manager.</p> <p>IRM 25.1.1.2(2) defines tax fraud. Tax fraud is often defined as an intentional wrongdoing on the part of a taxpayer, with the specific purpose of evading a tax known or believed to be owing. Tax fraud requires both an underpayment of tax due and fraudulent intent.</p> <p>IRM 25.1.2.3, <i>Indicators of Fraud</i> lists examples of fraud indicators. Fraud cannot be established unless affirmative acts of fraud are present.</p> <p>IRM 25.1.1, <i>Overview/Definitions</i>; IRM 25.1.2, <i>Recognizing and Developing Fraud</i>; and IRM 25.1.7, <i>Failure to File</i> provide specific guidance on fraud indicators and the development of fraud for filed and/or non-filed returns.</p> <p>IRM 20.1.5.3, <i>Examination Penalty Assertion</i> and IRM 20.1.2.7, <i>Fraudulent Failure to File — IRC section 6651(f)</i>, provide specific procedures for assertion of the civil fraud and fraudulent failure to file penalties.</p> <p>In cases where fraud was considered and the civil fraud penalty is not being recommended, the examiner will explain the reasons why the penalty was not asserted. Document the explanation in the "Conclusion" section above or at Lead Sheet 300, <i>Civil Penalty Approval Form</i>.</p> <p style="text-align: center;"><b>Key Items</b></p> <p><b>Fraud Development (IRM 25.1.2.2 &amp; IRM 25.1.7.4) and Indicators of Fraud (IRM 25.1.2.3 &amp; IRM 25.1.7.2):</b></p> <ol style="list-style-type: none"> <li>1. Document discussion with group manager in the Conclusion section above.</li> <li>2. Discuss with FTA and prepare Form 11661 electronically if there is an agreement that potential for fraud exists and forward to group manager. If a disagreement exists on whether a case should or should not be in fraud development status, the ultimate decision rests with the group manager.</li> <li>3. Upon receipt of approved Form 11661 with Plan of Action, update the case to Status Code 17.</li> <li>4. Timely actions and periodic meetings with FTA are required.</li> <li>5. If no fraud potential, Form 11661 will be updated by the FTA and the case returned to status 12.</li> </ol>			
Rev. 03/2011	Workpaper #	-1.1	

Source: SB/SE Division Workpaper 205-1, dated March 2011.

Abbreviations are used for the following terms in this lead sheet: Internal Revenue Code (IRC) and Audit Information Management System (AIMS).



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**Taxpayer Name:** \_\_\_\_\_ **Examiner:** \_\_\_\_\_  
**TIN:** \_\_\_\_\_ **Date:** \_\_\_\_\_  
**Tax Form:** \_\_\_\_\_  
**Tax Year (s):** \_\_\_\_\_

**Fraud Development Lead Sheet**

**Affirmative Acts (firm indicators) of Fraud warranting criminal consideration (IRM 25.1.3):**

1. If affirmative acts of fraud are established, suspend all activity.
2. When affirmative acts (firm indications) of fraud/willfulness exist and criminal criteria are met, refer the case to Criminal Investigation (CI) via Form 2797, *Referral Report of Potential Criminal Fraud Cases*. The FTA is available to assist in determining if firm indications of fraud/willfulness are present, criminal criteria has been met, etc.
3. No actions should be taken until Criminal Investigation accepts or declines referral.
4. If accepted, cases should be updated to Status 18.
5. If not accepted by CI, civil fraud consideration should be pursued.
6. If assigned a case as Cooperating Agent (Form 6544), review and follow guidelines set out in IRM 25.1.4, *Administrative Joint Investigation* and/or IRM 25.1.5, *Grand Jury Investigations*.

**Civil Fraud Developed (IRM 25.1.6)**

1. A civil fraud penalty including the fraudulent failure to file may be developed based on the civil examination and/or result from a criminal investigation (CI) initiated case.
2. Discuss the case with group manager and the FTA. If agreement can not be reached regarding assertion of the civil fraud penalty, the decision will rest with the group manager.
3. Complete a write up including the facts, applicable law, argument, and conclusion (IRM 4.10.8.11.2, *Explanation of Items*).
4. Cases being developed for civil fraud will be updated on AIMS to status code 17 (Fraud Development), via Form 11661, *Fraud Development Recommendation - Examination*.
5. Examiners should be aware of Collateral Estoppel on cases criminally prosecuted. Refer to IRM 25.1.6.4, IRM 25.1.7.8(5) and IRM 20.1.2.7(9). A taxpayer or nonfiler convicted of IRC 7201, *Attempt to Evade or Defeat Tax*, is collaterally estopped from denying liability for the civil fraud or fraudulent failure to file penalty.

**Facts:** (Document the relevant facts.)

**Law:** (Tax Law, Regulations, court cases, and other authorities. If Unagreed, add Argument)

**IRC Section:**

**Specific Citations:**

**Taxpayer Position:** (If applicable) Summarize defenses given by the Taxpayer / Filer, Representative, or Preparer for acts of fraud.

Additional Items:	Workpaper Reference
Form 11661 - Fraud Development Recommendation - Examination	
Form 2797 - Referral Report of Potential Criminal Fraud Cases	
Form 10498A - Joint Investigations Intent to Commence Civil Action	
Form 10498B - Joint Investigations Intent to Solicit Consent to Extend Statute	Attach to back of tax return
Form 6544 - Request for Cooperating Examiner	
Form 13308 - Criminal Investigation Closing Report (Tax and Tax Related Only)	



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## Appendix VII

### *Glossary of Terms*

**Activity Codes** – A code that identifies the type and condition of returns selected for audit.

**Attributes** – Concise statements of SB/SE Division’s expectations for quality audits. Attributes are guidelines to assist examiners in fulfilling their professional responsibilities.

**Audit Information Management System** – A computer system used to control returns, input assessments/adjustments to the Integrated Data Retrieval System, and provide management reports.

**Embedded Quality Review System** – The Embedded Quality Review System allows field managers to provide timely feedback to individual employees through performance reviews of audits.

**Field Audit** – A field audit is an audit of a tax return that is typically conducted by a revenue agent. A revenue agent conducts face-to-face audits of more complex tax returns such as businesses, partnerships, corporations, and specialty taxes (e.g., excise tax returns).

**First-Line Manager** – a group manager in the Examination function responsible for supervision of IRS examiners.

**Fiscal Year** – A 12-consecutive-month period ending on the last day of any month, except December. The Federal Government’s fiscal year begins on October 1 and ends on September 30.

**Fraud Condition Indicator Code** – A code that identifies for audited returns the following conditions: no fraud, civil fraud, criminal fraud, both civil and criminal fraud, or blank.

**Fraud/Bank Secrecy Act Function** – Within the IRS, the SB/SE Division Fraud/BSA function provides oversight and direction for fraud policy and operations Service-wide and examines for compliance with BSA requirements.

**Fraud Technical Advisor** – An FTA is a specialized revenue agent who provides guidance to other examiners who have identified fraud indicators. Among their various responsibilities, the FTAs provide technical and procedural fraud advice to examiners to help identify and develop potential civil fraud penalty cases and criminal fraud referrals. The FTAs are qualified to provide such guidance because they are required to have specialized knowledge of the laws, regulations, and procedures governing criminal and civil tax fraud cases as well as extensive fraud development experience.



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**Group Manager Concurrence Meeting** – The group manager concurrence meeting is an opportunity for a group manager and examiner to have a detailed and meaningful discussion about the audit. Involvement by a group manager in the early stages results in fewer delays, increased efficiency, and higher quality of examinations.

**Individual Master File** – The IRS database that maintains transactions or records of individual tax accounts.

**Integrated Data Retrieval System** – 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.

**National Quality Review System** – The NQRS allows national reviewers to evaluate audit files to determine whether examiners complied with quality attributes established by the IRS.

**Penalty Reference Number** – Penalty reference numbers are used to assess and abate miscellaneous civil penalties.

**Tax Year** – The 12-month period for which tax is calculated. For most individual taxpayers, the tax year is synonymous with the calendar year.

**Territory Manager** – Territory managers are responsible for planning, organizing, coordinating, monitoring, and directing their respective programs through subordinate managers who are geographically dispersed throughout the assigned territory.

**Transaction Code** – A three-digit code used to identify actions being taken on a taxpayer's account.



*Actions Can Be Taken to Reinforce  
the Importance of Recognizing and Investigating  
Fraud Indicators During Field Audits*

**Appendix VIII**

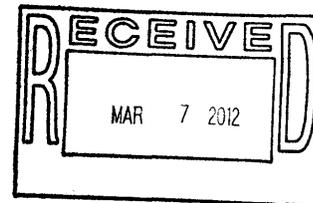
*Management's Response to the Draft Report*



COMMISSIONER  
SMALL BUSINESS/SELF-EMPLOYED DIVISION

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

MAR 7 2012



MEMORANDUM FOR MICHAEL R. PHILLIPS  
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Faris R. Fink *Faris R. Fink*  
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – Actions Can be Taken to Reinforce the  
Importance of Recognizing and Investigating Fraud  
Indicators During Field Audits (Audit # 201130021)

Thank you for the opportunity to review your draft report titled, "Actions Can Be Taken to Reinforce the Importance of Recognizing and Investigating Fraud Indicators During Field Audits." We appreciate your recognition that SB/SE management has continued to implement various approaches to emphasize the expectation that examiners identify, pursue, and develop fraud indicators. You also recognized that our actions have resulted in a 20 percent improvement in our National Quality Review System (NQRS) scores related to fraud consideration since FY2010.

You recommend enhancing the *Fraud Development Lead Sheet* or developing a similar job aid to better assist examiners. The lead sheet was significantly enhanced in March 2011 and now provides specific Internal Revenue Manual (IRM) references and guidelines, including those related to fraud development and indicators of fraud. The cases reviewed as part of this audit were closed between July 2009 and June 2010 and used an older version of the lead sheet. Thus, the enhancements have been incorporated into the lead sheet currently being used.

Your draft report also recommends we provide specific examples in the IRM to reinforce the importance of involving a fraud technical advisor (FTA) when there are indicators of fraud. IRM 25.1.1, *Fraud Handbook, Overview/Definitions*, was updated on December 16, 2011, to include additional information about the FTA program. Further, it emphasizes the compliance employees' responsibility to discuss the cases with their managers at the earliest possible opportunity when they suspect "first indicators of fraud." The group manager's involvement in potential fraud cases and concurrence regarding when it's appropriate to contact an FTA are essential since they are responsible for the quality and consistency of work performed by the examiners they supervise; are aware of the local business environment and community in which the



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taxpayer resides; and have knowledge of other factors which may impact fraud development. While we agree with TIGTA on the important role FTAs play in the development of a potential fraud case, we believe their case involvement should be based on the facts of the case and the experience and judgment of the group manager working in coordination with the examiner.

We agree with the proposed outcome measure. We appreciate your acknowledgement of the many factors affecting the ability to estimate the impact of your recommendations.

If you have any questions, please call me, or members of your staff may contact Shenita Hicks, Director, Examination, Small Business/Self-Employed Division at (859) 669-5526.



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**Attachment**

**RECOMMENDATION 1:**

The Director, Exam Policy, Small Business/Self-Employed Division, should enhance the *Fraud Development Lead Sheet* or develop and implement a similar job aid to better assist examiners with recognizing, investigating, and documenting fraud indicators in audit case files.

**CORRECTIVE ACTION:**

We concur that enhancements were needed to the previous version of the *Fraud Development Lead Sheet* that were used in the cases reviewed as part of this audit. The lead sheet was significantly enhanced in March 2011 and now provides specific IRM references and guidelines, including those related to fraud development and indicators of fraud. We believe the updated lead sheet better assists examiners with recognizing, investigating, and documenting fraud indicators because it appropriately emphasizes IRM 25.1, Fraud Handbook; the Fraud Website; and the FTA's involvement in the development of a potential fraud case.

**IMPLEMENTATION DATE:**

N/A

**RESPONSIBLE OFFICIAL(S):**

N/A

**CORRECTIVE ACTION MONITORING PLAN:**

N/A

**RECOMMENDATION 2:**

The Director, Exam Policy, Small Business/Self-Employed Division, should reinforce the importance of involving an FTA in audits when there are indicators of fraud by providing specific examples in the IRM for examiners and first-line managers to use in considering whether it would be beneficial to involve an FTA.

**CORRECTIVE ACTION:**

We agree to emphasize the importance of involving an FTA in audits when there are indicators of fraud by issuing a joint memorandum from the Directors, Examination Policy and Fraud/BSA to all Examination compliance employees highlighting fraud awareness expectations, responsibilities and proper involvement of FTAs. However, due to the factual nature of tax fraud cases and the important role the group manager plays in the development of potential fraud, we do not agree to include specific examples in the IRM for use in considering whether it would be beneficial to involve a FTA.



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**IMPLEMENTATION DATE:**

April 15, 2013

**RESPONSIBLE OFFICIAL(S):**

The Director, Exam Policy, Small Business/Self-Employed Division (SB/SE)

**CORRECTIVE ACTION MONITORING PLAN:**

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