Audit Report

OIG-06-043

REVENUE PROTECTION: TTB's Revenue Protection Audits Target the Largest Taxpayers

September 26, 2006

Office of Inspector General

Department of the Treasury

This report has been reviewed for public dissemination by the Office of Counsel to the Inspector General. Information requiring protection from public dissemination has been redacted from this report in accordance with the Freedom of Information Act, 5 U.S.C. §552.

Contents

Abbreviations

EFT	Electronic Fund Transfer
FET	Federal Excise Tax
IRC	Internal Revenue Code
NRC	National Revenue Center
RMS	Risk Management Staff
TAD	Tax Audit Division
TTB	Alcohol and Tobacco Tax and Trade Bureau

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OIG

Audit Report

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Administrator
The Alcohol and Tobacco Tax and Trade Bureau

The Alcohol and Tobacco Tax and Trade Bureau (TTB) is responsible for enforcing and administering laws covering the production, use, and distribution of alcohol and tobacco products. TTB also collects excise taxes on alcohol, tobacco, firearms, and ammunition. TTB collects about $15 billion in excise taxes annually. TTB's Tax Audit Division (TAD) conducts taxpayer audits to ensure that taxpayers pay the correct amount of taxes and to promote voluntary compliance with excise tax requirements.

TAD has a staff of about 80 auditors to conduct audits of the approximately 7,300 taxpayers subject to excise taxes on their sales of alcohol, tobacco, firearms, and ammunition. Therefore, to most effectively assess taxpayer compliance with excise tax requirements, TAD must be selective about which taxpayers to audit. The objectives of our audit were to determine how TAD targets industry members for audit and to assess the results that TAD achieved. To accomplish our objectives, we reviewed TAD data on audits conducted and the TTB Risk Management Staff's (RMS) risk assessment model (risk model) – including the data used – for fiscal year 2005, which is designed to assess the risk that an entity will not pay its taxes in full. We also reviewed TTB's strategic plan and annual performance and accountability reports. We conducted our fieldwork from July 2005 through July 2006. Appendix 1 contains a more detailed description of our objectives, scope, and methodology.

Results in Brief

TTB's strategic plan for fiscal years 2003 through 2008 calls for TAD to move from random selection of audit targets to risk-based selection. To achieve this goal, TAD and the Risk Management Staff (RMS) developed a risk model which includes a variety of risk factors [REDACTED - FOIA EXEMPTION 2, 5 U.S.C. §552 (b) (2)]. TAD focused its audits on the largest taxpayers [REDACTED - FOIA EXEMPTION 2, 5 U.S.C. §552 (b) (2)] in a cycle that would complete audits of all large taxpayers in 5 years. These taxpayers accounted for approximately 98 percent of all excise taxes collected. TTB's Assistant Administrator for Field Operations decided on this approach because it supports TTB's strategic objective of collecting "all revenue that is rightfully due" and TAD's strategic objective of validating 90 percent of excise tax revenues paid by TTB-regulated taxpayers. Using this strategy, TAD reported about $17.1 million in additional taxes due or collections from 110 completed audits in fiscal year 2005.

We reviewed the fiscal year 2005 risk model and found that it contained errors which resulted in the assignment of incorrect risk rating scores to some large taxpayers. For example, the risk scores used to select large taxpayers identified incorrect revenue scores for 6 taxpayers who were erroneously assigned a score of zero indicating audits had been completed in fiscal year 2004. However, 5 of these audits were not started in fiscal years 2004 or 2005. One was started and completed in fiscal year 2005.

We could not easily reconcile the National Revenue Center (NRC) source data with the data found in the risk model. To provide the most current tax data and to allow easier reconciliation, NRC has taken steps to ensure that future reports will allow RMS to reconcile the risk model data to the NRC database, yielding consistent results for the same time period, regardless of the date the report is run. This procedure should also leave an audit trail of taxpayer transactions.

While attempting to verify risk model data at NRC, we also found that individual taxpayer account balances may be inaccurate because of a Federal Excise Tax (FET) system control weakness in the processing of electronic fund transfer (EFT) payments to individual taxpayer accounts at NRC. The weakness allows EFT payments to be transferred among taxpayer accounts without adequate explanation, potentially affecting the accuracy of NRC data on taxpayer account balances. NRC is currently working to resolve this problem.

We are making recommendations to TTB that address use of the risk model to select taxpayers for audit, the accuracy of data in the risk model, and controls over EFT payments.

TTB Response and OIG Comments

In a written response, the TTB Administrator stated that he agreed with our five recommendations and had implemented four. Action will be taken on the final recommendation to complete an FET system enhancement at NRC within the next 90 days. See appendix 3 for the entire reply.

The Administrator did express some concerns about the report content and audit approach. First, in response to the third finding, he noted that NRC manually documented and maintained all adjusting records and approval records, but the OIG did not review the pertinent documentation. As noted in the report, we asked for and received assistance in trying to reconcile taxpayer account data, including adjustments, to the RMS risk model. A NRC tax coordinator could not readily reconcile the taxpayer accounts in question (described on report pages 18 and 19), but he did provide us with documents detailing adjustments which we reviewed and cited in the report. He did not provide the approval records.

The Administrator next noted that TAD never intended to use the results of the risk model as the sole criteria for allocating audit resources. The risk model was used as a tool for audit selections rather than sole selection criteria. We agree and detail the other factors TAD considered on page 7 of the report.

The Administrator stated that TAD focused a majority of its limited audit resources on the largest taxpayers because the $14.7 billion in excise tax revenue represented the greatest risk. Plus, many of the alcohol and tobacco taxpayers had not been audited in 5 – 10 years. However, the final decision as to whom to select for audit rested with the TAD Director. The report also concludes that resource allocation was focused on large taxpayers, with the TAD Director having the discretion to include the numerous factors cited on page 7, as part of his basis for audit selection.

The Administrator acknowledged that some errors were made in the risk model calculations and an audit trail needs to be maintained for FET data used in the model. TTB has already taken corrective actions to remedy the items noted in the report.

Background

TTB Legal Authority

TTB administers and enforces federal laws and implements regulations related to the production and taxation of alcohol and tobacco products and to the collection of federal excise taxes on firearms and ammunition. After TTB was established in fiscal year 2003 by the Homeland Security Act of 2002,[1] it created the TAD and RMS operations.

TTB derives it authority to regulate the alcohol, tobacco and firearms industries from the Internal Revenue Code (IRC) of 1986[2] and the Federal Alcohol Administration Act.[3] IRC imposes federal excise taxes on distilled spirits, beer, wine, tobacco, firearms, and ammunition. The Federal Alcohol Administration Act regulates trade practices, labeling, and advertising in the distilled spirits, beer, and wine industries.

[1] One provision of this act divided the Bureau of Alcohol, Tobacco and Firearms, a part of Treasury, into two new agencies: the Bureau of Alcohol, Tobacco, Firearms, and Explosives, which was established in the Department of Justice, and TTB, which remained in Treasury. The split occurred on January 24, 2003.
[2] 26 U.S.C.
[3] 27 U.S.C. ch 8.

TAD Audits

TAD is the TTB organizational component responsible for auditing taxpayers for compliance with the IRC and other applicable laws and regulations. After its establishment in January 2003, TTB created TAD to verify proper payment of alcohol, tobacco, firearms, and ammunition excise taxes and to ensure compliance with laws and regulations by taxpayers in a manner that protects the revenue, protects the consumer, and promotes voluntary compliance. TAD uses information received from NRC and RMS to assist in selecting taxpayers for audit.

TAD plans, coordinates, and conducts audits of taxpayers and assists with other initiatives in accordance with TTB's Strategic Plan. IRC provides TAD the authority to enter manufacturer premises, inspect books and records, and summon those responsible for the records. Taxpayer records may be inspected annually for a period dating back 3 years from the date of the return.

Risk Model

Data compiled by NRC are the basis for the RMS risk model, which was first developed for use during fiscal year 2004. TTB solicited the expertise of senior staff to decide which risk factors should be included within the initial model. For fiscal year 2005, the risk model scoring guidelines for large taxpayers is displayed in appendix 2. In its preparation of the annual risk model, RMS uses taxpayer revenues and other relevant taxpayer information provided by NRC.

NRC receives and processes tax returns, payments, claims and operational documents submitted by the regulated industries.[4] NRC also works to collect delinquent taxes identified by field audits as well as liabilities that have been assessed and remain unpaid. This

[4] Taxpayers who are liable during any given year for $5 million or more in excise taxes imposed on distilled spirits, wines, beer or on tobacco products and cigarette papers and tubes are required to pay such taxes during the following year by EFT.

includes handling case resolutions through offers-in-compromise[5], enforced collections and demands on surety or collateral bonds. In addition, NRC tracks a taxpayer's excise tax liability by a unique registry number which is tied to an individual permit (license to operate) number. A taxpayer with more then a single registry number is referred to as a "multi-site" taxpayer. Registry numbers allow NRC to track a taxpayer's potential liability.

RMS develops risk factors to determine the relative risk that a given taxpayer may not be willing or able to voluntarily comply and pay all taxes due. Once RMS identifies the applicable risk factors, which include excise tax revenues, unpaid liabilities, financial difficulties, and operation of multiple sites, it calculates a risk score and a risk rating for each taxpayer. The overall risk score is comprised of a base score (taxpayer revenue) plus a risk indicator score (see appendix 2). The risk model consists of a listing of taxpayers sorted by their overall risk scores and risk ratings.

Findings

Finding 1 TAD Targeted Large Taxpayers for Audit in Fiscal Year 2005

According to TTB's strategic plan for fiscal years 2003 through 2008, TAD was to move from random selection of audit targets to risk-based selection. In fiscal year 2005, TTB's Assistant Administrator for Field Operations decided to concentrate the majority of TAD's resources on the [REDACTED - FOIA EXEMPTION 2, 5 U.S.C. §552 (b) (2)] largest taxpayers [REDACTED - FOIA EXEMPTION 2, 5 U.S.C. §552 (b) (2)] who pay approximately 98 percent of all taxes collected by TTB. At the time of our audit, TAD intended to continue auditing the largest taxpayers until all of them have been audited over a 5-year period.

[5] Tax Related Offer in Compromise: TTB will compromise a tax liability when there is doubt as to liability (i.e., there is doubt as to whether the taxpayer actually owes the amounts TTB has determined are due) or doubt as to collectibility (i.e., there is doubt that the taxpayer will be able to pay the full amount due immediately or in the future). In some cases, both doubt as to liability and doubt as to collectibilty may apply.

Decision to Base Audit Selection on Taxpayer Size

TAD's Fiscal Year 2005 Audit Plan supports both TTB's strategic objective to "collect all revenue that is rightfully due" and TAD's strategic objective of validating 90 percent of excise tax revenues paid by TTB-regulated taxpayers. Rather than rely solely on risk model rankings, which take into account both taxpayer size and specific risk factors (late or delinquent tax payments; late-filed tax returns; multi-site operations; history of noncompliance; and other risk factors, such as a precipitous decline in tax payments) to select taxpayers for audit, the TTB Assistant Administrator for Field Operations decided to concentrate the majority of TAD's resources on TTB's largest taxpayers.

The TAD Director supported this change in strategy, citing operational considerations such as staffing levels in TAD district offices, staff availability and training needs, and time and travel constraints. Staffing considerations were especially important because most of the individuals who had been hired by TAD, which was created in 2003, were new to TTB and to the industries regulated and taxed by the bureau. However, the TAD Director indicated that the average risk rankings of the completed audits for fiscal year 2005 would substantiate the fact that the RMS risk model was considered during audit planning.

At the time of our audit, TAD intended to continue auditing the largest taxpayers until they had all been audited over a 5-year period. Although TAD identified millions of dollars in additional taxes or collections using this strategy, we believe that this approach could prevent TAD from selecting certain problem taxpayers for audit. In April 2006, TAD published its Strategic Plan – Proposal for Fiscal Years 2007 – 2009. The plan proposes that TAD continue to use a risk based approach to audit a combination of large, medium, and small excise taxpayers. It also states that TAD would like to focus its resources on areas where there is a significant "risk to revenue."

Effect of TAD's Decision Not to Rely Solely on Using the Risk Model to Select Taxpayers for Audit

TAD provided documentation showing that it completed 110 audits in fiscal year 2005 and that these audits identified $17.1 million in additional taxes due or collected ($11.3 million identified as additional taxes due and $5.8 million in actual collections). We found that TAD's use of taxpayer size in conjunction with the risk model and resource considerations, rather than the risk model alone, impacted which taxpayers were audited in fiscal year 2005. According to the TTB "Risk Assessment – Targeting, Fiscal Year 2005" procedures document, four factors should be considered in selecting taxpayers for audit in fiscal year 2005.The four factors are as follows: unpaid liabilities, financial difficulties, multi-site operations, and risk assessment scores. The universe of taxpayers to which these factors were to be applied consisted of taxpayers with annual tax payments of over [REDACTED - FOIA EXEMPTION 2, 5 U.S.C. §552 (b) (2)].

<u>Unpaid liabilities</u> [REDACTED - FOIA EXEMPTION 2, 5 U.S.C. §552 (b) (2)] The risk model identified 8 taxpayers in this category in fiscal year 2005. We found that TAD had audited 3 and was able to reasonably account for the other 5 taxpayers. One was in the process of being audited; 1 was being investigated by TTB's Trade Investigations Division; 1 had its audit postponed pending implementation of a TTB circular containing guidance on the establishment and operation of alternating brewery proprietorships[6] and 2 had filed for bankruptcy (and 1 of these 2 was no longer in business).

<u>Financial difficulties</u> According to TTB's risk assessment targeting procedures for fiscal year 2005, taxpayers with financial difficulties are those that have filed for bankruptcy since the last audit, had a prior-year audit that recommended a follow-up audit, or for which there is other substantial evidence of serious financial difficulties, such as trade reports of an impending bankruptcy filing or a

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[6] An "alternating proprietorship" is an arrangement in which two or more people take turns using the physical premises of a brewery. Generally, the proprietor of an existing brewery agrees to rent space and equipment to a "tenant brewer." The relevant circular, TTB Industry Circular Number 2005-2, "Alternating Proprietors at Brewery Premises," was issued on August 12, 2005, and was to take effect on September 1, 2006.

precipitous decline in tax payments.[7] Points assigned for various types of financial difficulties are calculated separately on the risk model. [REDACTED - FOIA EXEMPTION 2, 5 U.S.C. §552 (b) (2)]

The risk model identifies taxpayers with financial difficulties by [REDACTED - FOIA EXEMPTION 2, 5 U.S.C. §552 (b) (2)] We reviewed the fiscal year 2005 model in terms of dollar increases and/or decreases and identified 15 large taxpayers with a decline in tax payments from the prior fiscal year that exceeded $10 million.[8] We selected $10 million as a reasonable gauge of a significant decline in taxes paid [REDACTED - FOIA EXEMPTION 2, 5 U.S.C. §552 (b) (2)].

Eight of the 15 were audited in either fiscal year 2004 or fiscal year 2005, though 7 were not. We determined that the declines in these 7 taxpayers' tax payments ranged from about $10 million to $103 million, and totaled about $194 million. After taking these declines into account and recalculating the risk scores of these 7 taxpayers, we found that in 6 of the 7 cases[9] [REDACTED - FOIA EXEMPTION 2, 5 U.S.C. §552 (b) (2)]. According to RMS, the lower the rating [REDACTED - FOIA EXEMPTION 2, 5 U.S.C. §552 (b) (2)], the higher the audit priority should be; thus, these taxpayers should have been considered for audit.

<u>Multi-site operations</u> TTB's risk assessment targeting procedures for fiscal year 2005 call for [REDACTED - FOIA EXEMPTION 2, 5 U.S.C. §552 (b) (2)]. National audits are conducted for the sake of efficiency – for both the government and the taxpayer. Large multi-site operations –taxpayers that operate at multiple sites—undergo "national audits," which means that all sites are audited simultaneously. According to the Director of TAD, simultaneous audits are more efficient than sequential audits for multiple sites with the same corporate control structure because certain steps can be consolidated rather than repeated at each site. For example,

[7] The Chief of RMS said that a precipitous decline in tax payments is defined by market trends and is determined year-by-year for each industry.
[8] The decline in tax payments component of the fiscal year 2005 risk model was derived by comparing an entity's fiscal year 2003 and fiscal year 2002 tax payments —the 2 most recent years for which complete tax data were available.
[9] The other firm was purchased. The risk model contained no prior history for this registry number corresponding to the EIN of its current owner. As a result, no comparison could be definitely calculated.

national audits allow TAD to avoid reviewing the same corporate controls at each location and therefore require fewer resources than it would take to conduct separate audits. During fiscal year 2005, TAD reported performing a total of 9 multi-site audits [REDACTED - FOIA EXEMPTION 2, 5 U.S.C. §552 (b) (2)]

Overall risk assessment TTB's risk assessment targeting procedures for fiscal year 2005 suggests that the remaining large taxpayers selected for audit be based on the scores from the overall risk assessment. The overall risk assessment will be comprised [REDACTED - FOIA EXEMPTION 2, 5 U.S.C. §552 (b) (2)] From a review of the risk ratings for audits completed in fiscal years 2004 and 2005, we found that TAD, on average, selected taxpayers with lower risk ratings – and therefore with higher audit priority – in fiscal year 2005 than in fiscal year 2004. Taxpayers audited by TAD in fiscal year 2005 had an average risk rating of [REDACTED - FOIA EXEMPTION 2, 5 U.S.C. §552 (b) (2)] TAD should continue to rely on the risk based approach when scheduling audits.

Results of TAD's Fiscal Year 2005 Audits

With its strategy of focusing on large taxpayers – those with an annual tax liability of [REDACTED - FOIA EXEMPTION 2, 5 U.S.C. §552 (b) (2)] or more – TAD's fiscal year 2005 audits yielded significant financial results. During the year, TAD completed 110 audits and reported identifying about $17.1 million in additional taxes due or collected. By comparison, TAD completed 55 audits and identified about $9.56 million in additional taxes due or collected in fiscal year 2004. However, TAD was more fully staffed in 2005 than in 2004.

The following table summarizes the results of TAD's audit programs in fiscal years 2004 and 2005.

Table 1: Summary of TAD Audit Results, Fiscal Years 2004 and 2005

Program results	Fiscal year 2004	Fiscal year 2005
Audits completed	55	110
Taxes validated as correct[a]	$16.20 billion	$24.30 billion
Additional tax collections	$.86 million	$5.80 million
Additional tax collections due	$8.70 million	$11.30 million
Total tax collections and tax collections due	$9.56 million	$17.10 million
Audits in progress at end of year	51	36

Source: Treasury, Performance and Accountability report for fiscal year 2004 and TAD for fiscal year 2005.
[a]Audits covered up to 3 years of tax payments.

Continued use of the strategy of auditing large taxpayers on a 5-year cycle, however, could prevent smaller taxpayers with unpaid liabilities, financial difficulties, or other problems considered in risk model rankings from being selected for audit. Use of the strategy could also delay audits of large taxpayers with potential problems if they are audited only according to the 5-year cycle, without regard to problems that could be identified by the risk model. As a means to prevent the exclusion of problematic taxpayers, TAD developed its Strategic Plan – Proposal for Fiscal Years 2007 – 2009. The plan proposes that TAD continue to use a risk based approach to audit a combination of large, medium, and small excise taxpayers. It also states that TAD would like to focus its resources on areas where there is a significant "risk to revenue."

Management Response

The Administrator stated in his response that the draft report implied that the Bureau did not implement a risk based approach but instead decided to audit only the taxpayers [REDACTED - FOIA EXEMPTION 2, 5 U.S.C. §552 (b) (2)], and this was clearly not the case. The draft also implied that TAD should have relied solely on the risk model, without regard to factors such as staffing and training.

OIG Comment

The report states the rationale for the audit strategy implemented by TTB and TAD and cites the other factors (such as staffing, travel and training) impacting audit selection. It does not suggest that TAD only use the model. However, the report expressed concern that auditing large taxpayers over a 5-year cycle could prevent the selection of smaller, problematic taxpayers. TAD addressed this issue in its 2007-2009 Strategic Plan by proposing to continue to use a risk based approach to audit a combination of large, medium and small taxpayers, as well as manufacturers of non-beverage alcohol product claimants, who do not have to pay excise tax.

Finding 2 The Risk Model Contained Errors Which Impacted Overall Risk Scores

We reviewed the risk model for fiscal year 2005 and found that revenue data in the model could not be readily reconciled with source data used to develop the model. We also found that the model contained errors, resulting in the calculation of incorrect overall risk scores and assignment of incorrect risk ratings to certain taxpayers. In addition, the risk rating scores were not always calculated in accordance with the guidelines outlined in "Risk Assessment Targeting Fiscal Year 2005”. We further found that individual taxpayer notations – the detailed notes within the model that identify the specific instances when or the reasons why points were assigned to the taxpayer – were often inaccurate or missing.

In addition, although NRC, the source of the RMS risk model revenue data, updates revenue data in its own database to include any subsequent adjustments to prior tax periods, the data it provided to RMS were fixed as of a particular date. This disparity severely limited our ability to confirm critical source data, such as taxpayer revenue data in the risk model.

The Chief of RMS acknowledged that some taxpayer ratings may have been calculated incorrectly, but maintained that the scoring errors had no impact on the taxpayers selected for audit. Since TAD applies numerous factors (such as availability of staff and travel funds) outside of the risk model, we could neither support nor refute that claim. The Director of TAD and the Chief of RMS reiterated that TAD was a newly created group and agreed that the initial risk models needed improvement. They indicated that as the program evolves and insight is gained from completed audits, modifications and improvements will be made.

Revenue Data Could Not Be Easily Reconciled

The tax revenue data in NRC's Federal Excise Tax (FET) database could not be reconciled easily with the data that RMS used to develop the risk model. When NRC forwards taxpayer revenue collection figures to RMS for use in the risk model, RMS uses the data as of the date they are forwarded. NRC does not subsequently forward modified or updated data that reflects any additional monies collected or credits applied.

Using a limited, random sample of taxpayers listed in the risk model, we compared the revenue figures in the model against the figures for the same taxpayers in NRC's FET database. Even using the same cut-off dates, we were unable to reconcile the revenue data in the FET database with the revenue data in the RMS risk model for the taxpayers in our sample. The Deputy Director of Tax Services at NRC explained that within the FET database, when monies are collected from a taxpayer or credits need to be entered, the posting can be made to a prior tax period and the data can change at any point in time. One purpose of postings to prior periods is to match monies owed to monies received.

To allow easier reconciliation, NRC has agreed that future information sent to RMS will include the selection criteria used to generate the report and the NRC query used. This information will allow RMS and NRC to run future reports with consistent results for the same time period, regardless of the date the report is run. This procedure should also leave an audit trail of taxpayer transactions.

Risk Model Rating Factors Were Often Incorrectly Assigned

We tested the risk model on its own merits, as if the source data were acceptable. While reviewing the largest taxpayers in the fiscal year 2005 risk model, we found problems with both the assignment of the points and the methodology used to determine the ratings.

Revenue score Taxpayers' revenue scores are based on their prior level of tax payments and the amount of time since they were last audited.[10] [REDACTED - FOIA EXEMPTION 2, 5 U.S.C. §552 (b) (2)]

Our review of the risk scores used to select large taxpayers for audit in fiscal year 2005 identified incorrect revenue scores for 6 taxpayers for which audits had been planned but not performed in fiscal year 2004. However, 5 of these audits were not started in fiscal years 2004 or 2005, nor were they even scheduled for audit.[11] One was started and completed in fiscal year 2005. RMS assumed that the audits had taken place and therefore used a multiplier of zero with the tax liability amount, resulting in a revenue score of zero for the 6 taxpayers.

RMS agreed that assigning a revenue multiplier of [REDACTED - FOIA EXEMPTION 2, 5 U.S.C. §552 (b) (2)] to taxpayers with planned audits may have distorted the risk scores and resulting ratings of some large taxpayers. The Chief of RMS stated that in the future, multipliers used to calculate revenue scores – including those for any

[10] Except in the case of continuing or repeat tax delinquency or other clear issues of jeopardy to tax revenue, TTB had intended that the audits cycle through all of the large taxpayers over a 5-year period. Therefore, once a large taxpayer is audited, it will generally not be audited again until all of the other large taxpayers have been audited and their actual level of risk determined by completed audits.

[11] According to information from the Director of TAD and Chief of RMS, in fiscal year 2006 1 of the 5 was being audited, 1 was planned for audit, and the remaining 3 were not planned for audit.

taxpayers with planned audits – will vary between [REDACTED - FOIA EXEMPTION 2, 5 U.S.C. §552 (b) (2)].

Late-filed tax returns Points are assigned for late-filed tax returns using a combination of [REDACTED - FOIA EXEMPTION 2, 5 U.S.C. §552 (b) (2)] The fiscal year 2005 risk model contained notations indicating that 43 large taxpayers had at least one late-filed return. We found that 9 of the 43, or 21 percent, had incorrect scores assigned due to the use of incorrect weighting factors. For example, in one case, the change in the taxpayer's overall risk score would have resulted in the taxpayer's risk ranking dropping [REDACTED - FOIA EXEMPTION 2, 5 U.S.C. §552 (b) (2)]

History of noncompliance Points are assigned to a large taxpayer for noncompliance using a combination of [REDACTED - FOIA EXEMPTION 2, 5 U.S.C. §552 (b) (2)] In the fiscal year 2005 risk model, 26 large taxpayers were assigned points for noncompliance. A review of the noncompliance category revealed that the points for noncompliance assigned to 2 of these taxpayers had been calculated incorrectly based on the risk indicators and the amount of taxpayer revenue. One of these 2 taxpayers had points erroneously assigned for noncompliance, while the matching notation showed that the points should actually have been assigned for a [REDACTED - FOIA EXEMPTION 2, 5 U.S.C. §552 (b) (2)] decline in tax payments.

Other risk indicators Points are assigned to a large taxpayer for other risk factors using a combination of both the size of the taxpayer and the presence of other risk indicators, such as a taxpayer's having over [REDACTED - FOIA EXEMPTION 2, 5 U.S.C. §552 (b) (2)] of the business in exports or in-bond transfers, over [REDACTED - FOIA EXEMPTION 2, 5 U.S.C. §552 (b) (2)] in claims during the previous fiscal year, or a precipitous decline in tax payments. Our analysis of the fiscal year 2005 risk model with respect to taxpayers with precipitous declines in tax payments found that 87 of the largest 400 taxpayers had declines in tax payments greater than [REDACTED - FOIA EXEMPTION 2, 5

U.S.C. §552 (b) (2)].[12] RMS did not identify or assign points to 46 (53 percent) of these 87 taxpayers in the risk model.

<u>Small taxpayer observation</u> We also reviewed the listing for small taxpayers —those with an annual tax liability of [REDACTED - FOIA EXEMPTION 2, 5 U.S.C. §552 (b) (2)] – in the fiscal year 2005 risk model. RMS had not scored or rated this group and, in the absence of any risk ratings, the only analysis we could perform was of declines in tax payments between fiscal year 2002 and fiscal year 2003. We found 80 taxpayers with declines in tax payments of 10 percent or more. Of the 80, we found that 27 (34 percent) had experienced a 90 percent or greater decline. One taxpayer's payment was recorded as having dropped from $4.5 million to $200, moving the taxpayer from the large taxpayer category to the small taxpayer category, where it was not apt to be closely scrutinized by RMS. During our visit to NRC, we found that this taxpayer's account tax revenue data had been incorrectly recorded because of a problem in processing an EFT.[13] This problem resulted in errors in both the taxpayer's categorization (as large or small) and the taxpayer's risk rating. Without an analysis of precipitous declines in tax revenue, RMS may not identify such taxpayers as potential risks. RMS should review the small taxpayer listing for taxpayers with precipitous declines in tax payments.

Disproportionate Weight of Revenue in Scoring and Ranking

In RMS's risk assessment of the largest taxpayers, revenue accounts for [REDACTED - FOIA EXEMPTION 2, 5 U.S.C. §552 (b) (2)] of the total points awarded in the model. [REDACTED - FOIA EXEMPTION 2, 5 U.S.C. §552 (b) (2)]

[12] The risk assessment targeting document did not define a precipitous decline in tax payments. For purposes of this report, we considered a decline in tax payments greater than [REDACTED - FOIA EXEMPTION 2, 5 U.S.C. §552 (b) (2)] to represent a precipitous decline. This is in line with the "Other risk indicators", which use [REDACTED - FOIA EXEMPTION 2, 5 U.S.C. §552 (b) (2)] as the defining factor. See appendix 2.

[13] An EFT is a nonpaper, computer-to-computer transfer of funds from the taxpayer's financial institution account to the Treasury's account at the Federal Reserve Bank of New York. The taxpayer's financial institution, either directly or through a correspondent bank, must use the EFT system known as Fedwire. In addition, taxpayers must send a separate Fedwire message for each TTB tax return that is required to be filed.

TAD and RMS have agreed to review the weighting assigned the risk factors. As risk factors are evaluated based on completed audits, TTB should consider adjusting risk factors, other than revenue, which may also represent a substantial threat to tax collections.

Management Response

The Administrator acknowledged that some errors were made in the manual preparation of the risk model. To improve the risk model accuracy, TTB is adding formulas to the spreadsheet used to calculate the risk model scores as well as a second review of the risk model before sending it to TAD.

TTB stated that it [REDACTED - FOIA EXEMPTION 2, 5 U.S.C. §552 (b) (2)] would be reevaluating the future percentages to be used as the most reliable assessment of risk, given the realities of industry practices.

TTB indicated that it had evaluated all taxpayers that moved from the large to small [REDACTED - FOIA EXEMPTION 2, 5 U.S.C. §552 (b) (2)] category, but did not document the effort in the model. Further, the taxpayer identified as having dropped from $4.5 million to $200 in tax payments had been identified as having gone out of business.

The initial risk model initially assigned a majority of risk based upon excise tax revenue. For fiscal year 2007, TTB is not weighing revenue as high and is focusing more heavily on potential liability.

OIG Comment

The steps that TTB indicated it had taken or are considering to improve the validity, accuracy, and usefulness of the data should enhance the risk model's value. [REDACTED - FOIA EXEMPTION 2, 5 U.S.C. §552 (b) (2)]

TTB is taking the correct approach in trying to determine the appropriate percentage to use for precipitous declines.

At the time of the audit, the evidence provided to us concerning the taxpayer whose tax payments dropped from $4.5 million to $200, does not support the statement that the registry had gone out of business. Production reports for that registry showed activity through August 2005.

Finding 3 FET System Controls Need Strengthening at the Taxpayer Level

While attempting to verify risk model source data, we found that FET individual taxpayer account balances may be inaccurate because of a control weakness in EFT processing at NRC. The weakness allows EFT payments to be transferred among taxpayer accounts without adequate explanation. For risk assessment purposes, this may result in taxpayers with incorrect account balances not being identified as high risk.

NRC receives and processes tax returns, payments, claims and operational documents submitted by the regulated industries. Taxpayers who are liable during any given year for $5 million or more in excise taxes imposed on distilled spirits, wines, beer or on tobacco products, cigarette papers and tubes are required to pay such taxes during the following year by EFT.[14] In the fiscal year 2005 risk model, 41 percent of the large taxpayers met the $5 million threshold and were required to file by EFT the following year.

At NRC, we attempted to confirm the account balance belonging to a taxpayer whose tax payments had dropped from $4.5 million in fiscal year 2002 to $200 in fiscal year 2003. Since the fiscal year 2003 $200 balance was used in the 2005 risk model, it resulted in this taxpayer being classified as a small taxpayer. When our initial attempts to reconcile the taxpayer's account balance were unsuccessful, NRC enlisted the help of a tax coordinator to assist with a manual reconciliation.

[14] Treasury Procedure 91-1 entitled *TTB Procedure for Payment of Tax by Electronic Fund Transfer*.

This particular taxpayer was listed on the risk model with 4 different registry numbers because it had operations in 4 locations in 3 states. In mid-February 2002, NRC received a $5.2 million EFT payment for the exact amount due for one registry and correctly posted it to the taxpayer's registry account in the FET system. That same month, NRC made 6 adjusting transactions transferring a total of $4.5 million to a second registry of that taxpayer. NRC was unable to explain the reason for the transfers.

In December 2002, NRC transferred, again without explanation, 5 of those payments ($4.2 million) back to the original registry account. Based upon the information provided during our site visit, 1 payment of $296,000 was not transferred back to the original account. At the time of our inquiry, the balance on the second registry was about $303,000. Because of these transfers, the NRC data for the second taxpayer registry could not be reconciled to the amount ($200) in the 2005 RMS risk model.

When this situation was brought to the attention of the Deputy Director of Tax Services at NRC, she explained that there was a known FET systems problem regarding EFT payments. She described what occurs when a return is reexamined because it was posted to the wrong taxpayer account. If the payment is an EFT payment, the FET system does not post a reversal properly but instead updates the original account.

According to the Deputy Director of Tax Services at NRC, NRC has a current contract to address the problem. The contract for the planning and requirements was awarded on May 1, 2006, with an expected completion date of September 30, 2006. The entire project is expected to be completed within a year and the Deputy Director believes the completed project will correct the EFT problem and result in NRC having an audit trail that is easily followed.

Management Response

The Administrator stated that the EFT process minimizes risk of fraud, waste, and abuse in the excise tax collection process. TTB confirmed that tax receipts were recorded timely, accurately, and completely by conducting a comprehensive review of internal controls over excise tax collections during fiscal year 2006.

The Administrator noted that the FET issues relate to taxpayers with multiple locations. He described the situation relating to the case depicted in the report as one in which the taxpayer made an EFT payment to the wrong registry. When TTB reconciled the account, it made adjusting entries to correctly reflect the payment.

As the draft report disclosed, a need exists to show an audit trail of all adjusting entries, especially for taxpayers with multiple locations. The pending changes to the FET system will create this audit trail and ensure that monies processed from an EFT are easily tracked. In the interim, TTB established mitigating internal controls to serve as an audit trail and as a valid check and balance.

OIG Comment

Since we did not review the internal controls relating to the receipt, processing and posting of payments, we make no judgment as to TTB's assertions about the adequacy of the related internal controls.

As described by TTB in its response, the circumstances involving the payment, reconciliation and adjustment of tax payments do not coincide with the information provided to us and cited in the report. NRC provided us with a copy of the excise tax return for one registry showing an amount due of $5.2 million. After this EFT payment was made, $4.5 of the $5.2 million tax payment was transferred to a second registry. Subsequently, $4.2 million was transferred back to the original account. No explanations were provided for these adjusting entries.

Most importantly, TTB acknowledged the problem with EFT payments being posted in the FET system and had taken action to enhance the FET system. According to the Administrator, the fix will now be completed in the next 90 days.

Conclusions

Utilizing the full risk model provides the best opportunity to target the highest-risk taxpayers (large and small) for audit. The impact of TAD's decision to audit the largest 400 taxpayers in lieu of considering all taxpayers in the RMS risk model has likely been minimal. However, a 5-year audit cycle may not be often enough for certain high-risk large taxpayers, and high-risk small taxpayers may not be audited for more than 5 years. TAD's Strategic Plan – Proposal for Fiscal Years 2007 – 2009 addresses this concern by suggesting that taxpayers be selected in accordance with RMS risk ratings.

The problems with the risk model we identified raise questions about the validity of its rankings. To ensure the validity of the risk model, we believe that RMS must verify that the risk model contains complete and accurate information.

TTB needs to expeditiously fix the FET controls over EFT payments at NRC. In addition to affecting the categorization of taxpayers as either large or small, which directly affects the targeting of taxpayers for audit and for risk assessment purposes, the EFT payment control weakness can affect TTB's ability to adequately ensure that all taxpayers' accounts are accurate. TTB believes the control problems will be corrected by ongoing contract work.

Recommendations

We recommend that the Administrator of TTB do the following:

1. When creating future audit plans, require that TAD consider selecting taxpayers in accordance with the ratings of the RMS risk model.

2. Require NRC to forward to RMS the selection criteria used to generate the taxpayer revenue report and the NRC query used.

3. Ensure that RMS reviews risk model weighting factors and calculations before finalizing the model for use by TAD.

4. Require that RMS review all taxpayers in the risk model to ensure that they are accurately categorized as large or small, and research any anomalies identified.

5. Improve FET controls over EFT payments to ensure accurate and reliable taxpayer account histories. The entire account history needs to include adjustments and correcting entries. In this regard, the FET system corrections currently underway should provide for an adequate audit trail of all changes to taxpayer accounts.

Management Response

The Administrator concurred with the first four recommendations and indicated that TTB has taken actions to implement each one. For the fifth recommendation, the Administrator agreed that the system enhancement that we proposed will further enhance the internal controls over the FET system. The Bureau had recognized the system vulnerability and intends to complete a system enhancement within the next 90 days, but no later than November.

OIG Comment

We believe that the actions TTB states in its response, if implemented as described, address the intent of our recommendations.

* * * * *

We would like to extend our appreciation to TTB for its cooperation and courtesies extended to our audit staff during the audit. If you have any questions, please contact me at (617) 223-8640 or Stephen Syriala, Audit Manager, at (617) 223-8643. Major contributors are listed in appendix 4.

/s/
Donald P. Benson
Director

We conducted this audit to determine how the Tax Audit Division (TAD) targeted industry members for audit and to assess the results achieved. We evaluated the Risk Management Staff's (RMS) risk assessment model by examining the weighting of the risk factors considered by TAD in selecting audit targets and determining if they were reasonable, and by assessing the reliability of the data. During the course of this audit, we also reviewed the National Revenue Center's (NRC) system controls surrounding postings and adjustments to individual taxpayer accounts involving the use of Electronic Fund Transfer (EFT) remittances.

We reviewed (1) applicable laws and regulations related to TTB's duties and responsibilities identified in the Homeland Security Act of 2002, Pub. L. No. 107-296, Section 1111(d); (2) TTB's strategic plan and its annual report and Performance and Accountability Reports; (3) legislation and congressional interest; and (4) TAD's risk assessment targeting documents for fiscal years 2005 and 2004.

We identified (1) TTB's divisions, staff, and systems currently involved in processing tax returns, payments, claims, and operational documents submitted by the regulated industries; (2) the risk factors that are used to determine the relative risk that a given taxpayer may not be willing or able to voluntarily comply and pay all taxes due; and (3) the selection process used to determine which taxpayers will be selected for audit. We conducted interviews with TTB officials at TTB headquarters in Washington, D.C., and with NRC officials in Cincinnati, OH. We performed our fieldwork in Washington, D.C., and Cincinnati, OH.

From the RMS risk assessment model, we selected a random sample of 10 percent of taxpayers for each commodity type represented in the large taxpayer model [REDACTED - FOIA EXEMPTION 2, 5 U.S.C. §552 (b) (2)]. We also reviewed a limited number of small taxpayers with potential anomalies. We reviewed the source revenue data and the risk model data associated with these taxpayers in an effort to assess the status, completeness, and reliability of the data on the model. We reviewed TAD's audit selection process and the extent to which the risk assessment model was used as a tool for audit selections.

We conducted our audit from July 2005 to July 2006 in accordance with generally accepted government auditing standards.

[REDACTED - FOIA EXEMPTION 2, 5 U.S.C. §552 (b) (2)]

[REDACTED – FOIA EXEMPTION 2, 5 U.S.C. §552 (b) (2)]

DEPARTMENT OF THE TREASURY
ALCOHOL AND TOBACCO TAX AND TRADE BUREAU
WASHINGTON, D.C. 20220

ADMINISTRATOR

September 12, 2006

MEMORANDUM TO: **Donald P. Benson, Director**
U.S. Department of the Treasury
Office of Inspector General

FROM: **John J. Manfreda, Administrator**

SUBJECT: **Response to the Office of Inspector General's Draft Report entitled "TTB's Revenue Protection Audits Target the Largest Taxpayers"**

I appreciate the opportunity to comment on the draft report. As the first audit of the Alcohol and Tobacco Tax and Trade Bureau (Bureau), I am encouraged to see that the Office on Inspector General (OIG) has recognized that the Bureau's Tax Audit Division (TAD) and Risk Management staff (RMS) made great strides in not only establishing a viable risk model but also using the risk model as a management tool to identify and select taxpayers for audit. The following paragraphs outline my general comments and address the three audit findings and five recommendations presented in the draft report.

General Comments

I do not dispute the OIG's finding that the FET system did not have a clear electronic audit trail for adjusting entries made to taxpayer accounts with multiple registries; however, the NRC did manually document and approve all adjusting entries made to taxpayer's accounts. Although the NRC maintained these adjusting entries and approval records, the OIG did not review this documentation as a part of their audit. Additionally, I would like to further assure the OIG that there was no jeopardy to the excise tax revenue collected by TTB because the overall taxpayer account balances were reconciled to the individual excise tax returns and reports of operations submitted to TTB. Detailed descriptions of the results of our recent A-123 review as well as of the NRC's reconciliation process are outlined in response to finding 3 below.

I would like to point out that TAD never intended to use the results of the risk model as the sole selection criteria for allocating audit resources. Although this fact was noted to the OIG during the course of the audit, I believe that the draft

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[REDACTED – FOIA EXEMPTION 2, 5 U.S.C. §552 (b) (2)]

report does not clearly present how we intended to use the results of the risk model to select audit entities. As intended, the risk model was used as a tool for audit selections rather than a sole selection criteria. Specifically, the taxpayers were evaluated through the risk model. TAD used the results as a tool to select taxpayers for audit and to allocate audit resources for FY 2004 and 2005, together with other factors such as location, expertise and availability of staff.

Additionally, the draft report concludes that instead of relying solely on the results of risk model, TAD simply audited its largest taxpayers. While it is true that TAD of its limited audit resources on the largest taxpayers, we recognized that the greatest risk was the $14.7 billion in excise tax revenue collected by the Bureau. Furthermore, many of the Bureau's largest taxpayers had not been audited in 5-10 years, if at all. However, it should be noted that the final decision as to who is selected for an excise tax audit has always been at the discretion of the Director TAD.

We acknowledge that some errors were made in calculating the risk ranking scores in the model and that we need to maintain an audit trail for the FET data used in the model. As with the implementation of any new process or program, errors are expected to occur and we have already taken corrective actions to address the items noted in the draft report.

<u>Finding 1</u>: TAD Targeted Large Taxpayers for Audit in Fiscal Year 2005

The draft report correctly identified the Bureau's intention to move from a random-based to a risk-based audit selection methodology. However, the draft report implies that the Bureau did not implement a risk based approach but instead decided to audit only the taxpayers that paid more than in federal excise taxes. As noted above, that was clearly not the case. Further, to the extent the draft report states that "instead of relying solely on the results of the risk model, TAD simply audited it largest taxpayers," the draft implies that TAD should have relied solely on its risk model without regard to any other considerations such as staffing, training requirements, travel costs, etc. – this was never the intent of the Bureau in implementing a risk based approach.

Over the past three years, and in accordance with our strategic objectives, the Bureau has developed, implemented, and refined a risk based approach for identifying potential audit targets. The risk model used over this period includes risk factors that were founded upon past practices of compliance vulnerabilities and believed to be good indicators of risk. Based upon audit findings that TAD produced, RMS continued to evaluate these factors to determine their validity and intends to continue to enhance and update the model based on additional risk indicators identified from the Bureau's audit and investigative activities. However, it takes several audit cycles to evaluate risk factors and analyze the cause and effect relationships between the risk factors and audit findings.

The draft report also identified 15 large taxpayers with a decline in excise tax payments in excess of , 7 of which were not audited in 2004 or 2005. In FY 2006, TAD audited 6 of these 7 taxpayers and the remaining taxpayer had gone out of business. Additionally, the draft report stated that the average risk rating for the taxpayers audited was . As noted in the draft, lower risk rating scores indicate that the taxpayer has more risk. For example, the taxpayer with a risk rating of 1 would be the have the most risk of any taxpayer in the model. Hence, the Bureau's audit activities during 2004 and 2005 indicates that the Bureau focused its limited audit resources on taxpayers with more risk in FY 2005 and supports the fact that the Bureau is moving toward a more risk based approach.

The draft report also recognized the fact that, based on the audit results noted over the past several years, TAD will continue to use a risk based approach to audit a combination of large, medium, and small excise taxpayers as well MNBP claimants. Further, TAD intends to focus its resources on areas where there is significant "risk to the revenue." Revenue Risk areas include, but are not limited to the following areas:

<u>Finding 2</u>: The Risk Model Contained Errors Which Impacted Overall Risk Scores

The draft report identified some errors made in the manual preparation of the risk model. To improve the risk model, we have added formulas to the spreadsheet used to calculate the overall risk model scores, therefore eliminating mathematical errors. In addition, we have added a second independent review of the risk model to ensure that errors are identified and corrected prior to providing the model to TAD.

As noted in the draft, 46 of 87 taxpayers in the risk model (53 percent) did not have scores assigned for a precipitous decline in tax payments. For the FY 2004 and 2005 RMS risk model, the Bureau used a decline in tax payments to assign points rather than the There are a myriad of reasons for declines in tax payments including frequent changes in ownership, the use of bonded wine cellars to delay the payment of taxes, alternating proprietorships, declines in consumption, and increases in imports. Assignment of points for a would have resulted in nearly one quarter of the taxpayers receiving points while a resulted in approximately of the taxpayers receiving points. As it relates to this particular risk factor, we are still evaluating the percentages that should be used to determine what percentage represents the most reliable assessment of risk, given the realities of industry practices.

For the FY 2005 risk model, taxpayers with tax liabilities of were not assigned points for risk ratings. Although these taxpayers did not receive a risk score, we reviewed, analyzed, and evaluated the taxpayers that moved from the large taxpayer category to the under category to determine whether this decline in tax liability represented a revenue risk. However, this analysis was not formally documented in the model. The majority of the taxpayers discussed in the draft audit report who moved from the large taxpayer category to paying under $25,000 did so as a result of a change in ownership, change in business processes such as using a bonded wine cellar or went out of business. The taxpayer identified as having dropped from $4.5 million to $200 was researched during the preparation of the fiscal year 2005 risk model and the decline in tax payments was a result of going out of business. For future risk models, we will formally document the results of these evaluations performed for the taxpayers who move from the large taxpayer category to under and include this documentation as part of the RMS risk model process.

The initial risk models that the Bureau developed assigned a majority of risk points based on As appropriate, was the primary weighting factor because (1) a large majority of the Bureau's alcohol and tobacco taxpayers had not received an in-depth audit or investigation for 5 to 10 years, if at all and (2) the Bureau needed to develop a baseline and use its limited audit resources to concentrate on the known inherent risk, e.g. tax payments. We are using the results of the audits completed that were heavily scored to evaluate our other risk factors. In addition, for fiscal year 2007, we are not weighting as high and are focusing more heavily on such as on those taxpayers who

<u>Finding 3</u>: FET System Controls Need Strengthening at the Taxpayer Level

The vast majority of excise tax collections are deposited directly and timely into the U.S. Treasury via electronic means. Very little monies come directly into the National Revenue Center (NRC). Our statistics show that 98% of the $14.7 billion in Federal excise taxes the Bureau collects are processed through electronic wire transfers. This method of payment does significantly minimize any potential risk of fraud, waste and abuse. The transaction originates with the taxpayer, and the wire transfer goes directly to the financial institution and is recorded directly into Treasury's cash collection system, CA$HLINK. The Bureau can only access CA$HLINK to obtain data necessary to post the collections in the accounting system, and to the Federal Excise Tax (FET) system, and other tax systems.

Additionally, highly effective controls exist over non-electronic payments. The vast majority, 1.9% of the remaining 2% of receipts, are checks receipts remitted to the Bureau through a lockbox system administered by Mellon Bank. Treasury's Financial Management Service oversees the Federal government's lockbox program which requires regular audits of each bank's internal control.

Specifically, during FY 2006, the Bureau conducted a comprehensive review of internal controls over the reporting of excise tax collections. The scope of the internal control review covered all four collection mechanisms.

1)	FedWire/Remittance Express ACH	92.0%
2)	Pay.Gov	6.0%
3)	Lockbox	1.9%
4)	NRC Mailroom	0.1%

Collectively, this evaluation provided us sound assurance that receipts were recorded timely, accurately, and completely. This review disclosed no exceptions, material weaknesses, or reportable conditions over the collection or financial reporting of the deposit transactions, including wire transfers.

All tax receipts remitted to the Bureau were recorded in FET tax system, as well as Treasury's collection system, CA$HLINK, and the Bureau's accounting system. Further, the receipts were recorded in the accounting system in the correct fund and reporting category, which distinguish the tax type.

Additionally, the collections were supported by tax returns, deposit reports, and other support documentation on file at the Revenue Accounting Section of the CFO's Office. The documentation on file at the Revenue Accounting Section disclosed that timely and accurate reconciliations on all collection activity was well documented, and that the business transactions recorded in the tax systems and the accounting system (Oracle Federal Financials) were both accurate and reliable for financial reporting purposes.

Further, it should be noted that the issues identified in the FET system are related to taxpayers who have multiple locations. As the example cited in the report, the taxpayer in question had 4 locations, each with a separate registry number. Due to an error made by the taxpayer, the taxpayer submitted an EFT payment for registry number 1 when the payment should have been designated for registry number 2. When the individual tax returns were submitted to the Bureau, we performed a reconciliation between the EFT submission and the tax return information and determined that the tax returns did not match the EFT submissions. At that point, we made adjusting entries to the FET system to accurately reflect the payment to the correct registry number. Because the adjustments were made to the same taxpayer, the FET system only showed the final adjusted amount for these taxpayers. Had an erroneous allocation been made between two unrelated entities, the FET system would have captured the errors and the reconciliation would have taken place.

The draft report disclosed that a need exists, within the FET system, to show an audit trail of all adjusting entries, especially for those taxpayers that have tax accounts for multiple locations. Such an audit trail would have shown the original posting entry, as well as the corrective change to the various accounts under the same taxpayer. The pending changes to the FET system, which were proposed prior to the audit, will create this audit trail and will ensure that monies processed from an electronic fund transfer are easily tracked. However, having recognized this vulnerability in the system, the Bureau established mitigating internal controls in the current environment that ensured accurate and reliable taxpayer accounts, even those taxpayers who have multiple accounts. Those existing controls serve as an audit trail and as a valid check and balance.

Recommendations

1. **When creating future audit plans, require that TAD consider taxpayers in accordance with the ratings of the RMS risk model.**

   Concur: For FY 2004 and 2005, TAD considered the results of the RMS risk model rankings in selecting audit targets and TAD will continue to consider the results of the risk model for future audit periods.

2. **Require NRC to forward to RMS the selection criteria used to generate the taxpayer revenue report and the NRC query used.**

   ***Concur*.** This recommendation has been implemented. For the FY 2006 RMS risk model, the NRC provided the selection criteria used to generate the taxpayer revenue report. Additionally, the NRC provided the language used to query the FET database and RMS has maintained the query language so that any subsequent reviewer can "recreate" the report used for the risk model rankings.

3. **Ensure that RMS reviews the risk model weighting factors and calculations before finalizing the model for use by TAD**

    Concur: This recommendation has been implemented. For the FY 2006 risk model, an independent review of the risk model was performed before finalizing the risk model for use by TAD.

4. **Require that RMS review all taxpayer in the risk model to ensure that they are accurately categorized as large or small, and research any anomalies identified.**

    Concur: This recommendation has been implemented. For the FY 2006 risk model, RMS reviewed all taxpayers in the risk model to ensure that they were accurately categorized as large or small, and researched any anomalies identified. Additionally, RMS documented this review as part of the overall risk model process.

5. **Improve FET controls over EFT payments to ensure accurate and reliable taxpayer account balances. The entire account history needs to include adjustments and correcting entries. In this regard, the FET system corrections currently underway should provide for an accurate audit trail of all changes to taxpayer accounts.**

    Concur: Although the internal controls over FET are currently sound and there is a low risk of fraud, waste and abuse surrounding the systems and processes on tax collections, a system enhancement as recommended by the OIG will further reinforce those controls. The Bureau had already recognized this vulnerability in the system and intends to complete a system enhancement within the next ninety days, but no later than end of November.

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Department of the Treasury

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