

# TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION



## **Improvements to the Correspondence Examination Process May Increase Taxpayer Compliance and Collection Potential**

September 30, 2021

Report Number: 2021-30-061

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document..

# HIGHLIGHTS: Improvements to the Correspondence Examination Process May Increase Taxpayer Compliance and Collection Potential

Final Audit Report issued on September 30, 2021

Report Number 2021-30-061

## Why TIGTA Did This Audit

This audit was initiated to assess the IRS's effectiveness in selecting and examining income tax returns for correspondence examinations, including the selection of the subsequent year returns when similar tax issues are present.

### Impact on Taxpayers

Correspondence examinations are generally narrower in focus than a traditional in-person audit of a taxpayer's return and enable the IRS to reach more taxpayers at a lower cost.

The IRS relies heavily on correspondence examinations as a more economical means to address taxpayers with suspected underreporting of tax liabilities.

From Fiscal Year 2017 to Fiscal Year 2019, the IRS conducted almost 2 million correspondence examinations and recommended approximately \$12.2 billion in additional taxes.

## What TIGTA Found

In Fiscal Years 2017 through 2019, correspondence examinations accounted for nearly 80 percent of all IRS examinations completed but accounted for less than one-half of the recommended additional tax after examination. TIGTA's review of the Small Business/Self-Employed Division's correspondence examination case selection process found that the issues the IRS examined most frequently were not the most productive issues. This was due in part to the IRS not prioritizing the annual workplan based on prior year results.

In addition, TIGTA's analysis of 743,648 examinations closed from Fiscal Year 2017 to Fiscal Year 2019 found that the IRS conducted 139,492 (19 percent) subsequent examinations identified by the subsequent return process, and 23,741 (17 percent) of these examinations were closed with the taxpayers agreeing to the additional tax assessed. However, the IRS did not open the correspondence examination on the subsequent year return until after it closed the examination on the current year. This increases the burden to the taxpayers, subjecting them to two separate correspondence examinations instead of one examination for multiple tax years.

According to the Internal Revenue Manual, IRS correspondence examiners are to consider subsequent year returns containing the same issues as in the year examined. However, TIGTA interviewed 15 tax examiners who stated that they are instructed only to review the specific issue and year that was selected for the examination and not to expand their work into the following year. TIGTA identified 53,969 correspondence examinations that had an issue on an individual tax form or the taxpayer was identified as a nonfiler. Further review showed these examinations had a subsequent year tax return with the same potential issue that had not been examined and met the IRS's criteria for potential audit selection.

## What TIGTA Recommended

TIGTA recommended that the IRS: 1) evaluate closed correspondence examination cases to identify the issues that result in the most significant noncompliance and develop a workplan to include most of these cases; 2) change the subsequent return process to only address returns about which the taxpayer did not respond; and 3) provide a reminder to ensure that employees are following processes for subsequent year returns during the correspondence examination process.

The IRS agreed with two of the three recommendations, including ensuring that tax examiners and managers are following processes for subsequent year returns during the correspondence examination process. However, the IRS disagreed with TIGTA's recommendation to evaluate closed correspondence examination cases to identify the issues that result in the most significant noncompliance, stating that historical business results are already utilized in the case selection process.



TREASURY INSPECTOR GENERAL  
FOR TAX ADMINISTRATION

**U.S. DEPARTMENT OF THE TREASURY**

**WASHINGTON, D.C. 20220**

September 30, 2021

**MEMORANDUM FOR:** COMMISSIONER OF INTERNAL REVENUE

**FROM:** Michael E. McKenney  
Deputy Inspector General for Audit

**SUBJECT:** Final Audit Report – Improvements to the Correspondence Examination Process May Increase Taxpayer Compliance and Collection Potential (Audit # 201930013)

This report presents the results of our review to determine the Internal Revenue Service's effectiveness in the selection and examination of correspondence examinations. This review is part of our Fiscal Year 2021 Annual Audit Plan and addresses the major management and performance challenge of *Improving Tax Reporting and Payment Compliance*.

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

Copies of this report are also being sent to the Internal Revenue Service managers affected by the report recommendations. If you have any questions, please contact me or Matthew A. Weir, Assistant Inspector General for Audit (Compliance and Enforcement Operations).

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## Background

Internal Revenue Code § 7602(a) provides the Internal Revenue Service (IRS) with the authority to conduct examinations for the purpose of determining whether a tax return is correct, creating a return if the taxpayer has not filed one, and determining a taxpayer's tax liability. Audits of individual income tax returns range from reviewing tax returns and resolving questionable items by corresponding with taxpayers through the mail to having a face-to-face (in-person interview) examination of the taxpayer's financial records at their place of business.

Correspondence examinations are generally narrower in focus than a traditional in-person audit of a taxpayer's return and are conducted by mail or other written communications. They thereby enable the IRS to reach more taxpayers at a lower cost. In contrast to the more detailed and lengthy face-to-face audits in the field, the correspondence examination process is less intrusive, more automated, and conducted by examiners who are trained to deal with less complex tax issues. As a result, the IRS relies heavily on correspondence examinations as a more efficient means to address taxpayers with suspected underreporting of tax liabilities that can be readily identified through the IRS's systemic processes.

The IRS conducts examinations through multiple business divisions and their corresponding functions. However, correspondence examinations are mainly conducted by the Wage and Investment and Small Business/Self-Employed (SB/SE) Divisions. The majority of the Wage and Investment Division's correspondence examinations are related to the Earned Income Tax Credit (EITC), whereas SB/SE Division correspondence examinations cover other types of tax issues, such as issues on the Child Tax Credit, nonfilers, and Form 1040 Schedule C, *Profit or Loss From Business (Sole Proprietorship)*.<sup>1</sup> Our review specifically consisted of reviewing the IRS's effectiveness in the selection and examination of non-EITC correspondence examinations conducted by the SB/SE Division.

### **SB/SE Division correspondence examination case selection process**

The SB/SE Division's Exam Planning, Performance, and Analysis function has the primary responsibility for the SB/SE Division's workplan development. The Campus Exam and Document Matching Workload Planning and Analysis team in the Planning, Performance, and Analysis function has the primary responsibility for SB/SE Division Campus workplans, which include correspondence examination.

The SB/SE Division Campus Case Selection (CCS) selects the population of correspondence examinations for the SB/SE Division. The CCS consists of two teams: Campus Workload Delivery and Campus Workload Identification. The CCS identifies potential non-EITC cases primarily from three main sources:<sup>2</sup>

- Dependent Database (DDB). [REDACTED]

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<sup>1</sup> Form 1040, *U.S. Individual Income Tax Return*.

<sup>2</sup> In addition to the three main sources from which potential cases are selected for examination, the IRS has potential cases that are selected from unidentified other sources as well.

[REDACTED] The Discretionary Exam Business Rules (DEBR) is a subset of the workload selection rules built into DDB programming. [REDACTED]

- Compliance Data Environment (CDE). The CDE is a workload identification, planning, and delivery system that operates in a web-based environment. It is used to filter, order, classify, and deliver returns for examination. SB/SE Division CCS analysts gather CDE output and perform further classification and filtering to make the final case selection.
- Referrals. Referrals are cases identified by functions other than Examination that have audit potential. Cases are referred from the Lead Development Center, Criminal Investigation, Treasury Inspector General for Tax Administration (TIGTA), Collection, Integrity and Verification Operation, Submission Processing, and other areas. For final case selection, referral cases must go through a filtering and classification process that is similar to the process used in the CDE.

Inventory is delivered by the CCS based on workplan volumes determined by the Planning, Performance, and Analysis function. Cases available in inventory are [REDACTED]

[REDACTED] The workplan takes into account a multitude of considerations, such as staffing changes, resources available, policy changes, system issues, new inventory, training, collectability (including abatements), and historical data of prior audits.

### **SB/SE Division correspondence examination process**

Once the selected case is identified for examination, an Initial Contact Letter (ICL) is systemically prepared and mailed to the taxpayer explaining what is being examined on the tax return.<sup>3</sup> If the taxpayer responds to the ICL, the case is assigned to an examiner to verify if information received is sufficient to make a determination. If the examiner needs the taxpayer to submit additional documentation, the tax examiner issues Letter 692, *Request for Consideration of Additional Findings*.<sup>4</sup>

If the taxpayer does not respond to the ICL or if the response is not sufficient to close the case, Letter 525, *General 30-Day Letter*, or Letter 1862, *Initial Contact Letter – SFR Program, (Computed Tax and Penalties Based on Information Available SFR)*,<sup>5</sup> is issued with a report (Form 4549, *Report of Income Tax Examination Changes*) showing the proposed changes. If the taxpayer is still not able to substantiate the issue(s) under examination or does not respond to Letter 525, a Letter 3219, *Statutory Notice of Deficiency*, is issued.<sup>6</sup> If the taxpayer responds and the information provided does not change the determination or partially changes the proposed

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<sup>3</sup> Based on the project code, certain ICLs are issued: Letter 566-S, *Initial Contact Notifying Taxpayer of Examination and Requesting Additional Supporting Documentation*; Letter 525, *Proposed Letter of Change to Return and Appeal Rights General 30-Day Letter*; Letter 2269, *Delinquent Individual Return, Insufficient Response/No Record*; or Computer Paragraph 59, *1<sup>st</sup> Notice-Return Delinquency*.

<sup>4</sup> This cycle can be repeated until the case moves to the next status, such as the issuance of the *Statutory Notice of Deficiency*.

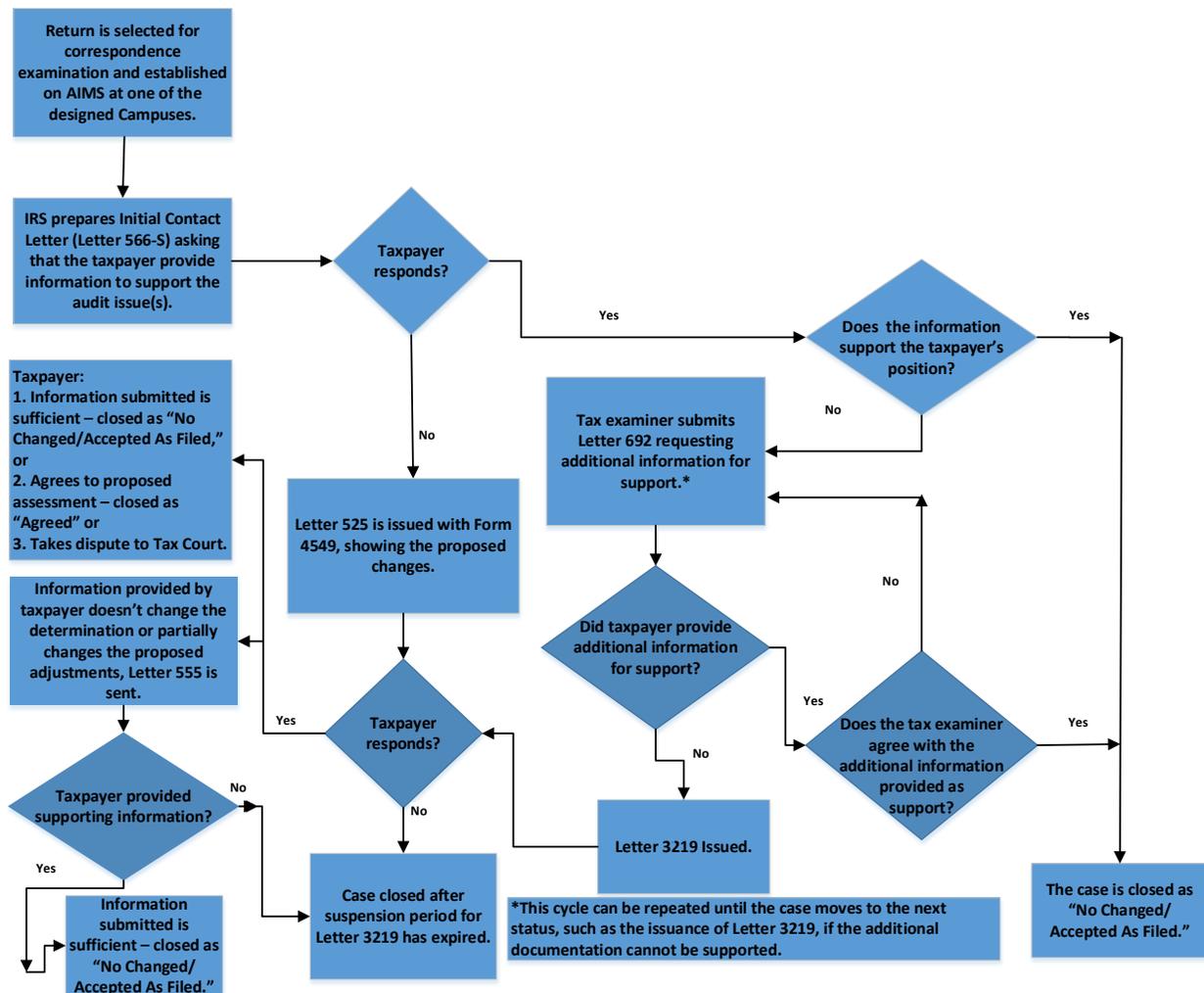
<sup>5</sup> SFR = Substitute for Return.

<sup>6</sup> Letter 3219 is a legal notification sent to taxpayers by certified mail. It explains the taxpayer's right to file a petition with Tax Court and the IRS's right to change the tax without consent if no timely petition is filed.

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adjustments, Letter 555, *Notification of Findings Data Re Tax Liability*, is issued to the taxpayer. Figure 1 shows a simplified overview of the correspondence examination process.

**Figure 1: Flowchart of a Regular Correspondence Examination Process**



Source: TIGTA's analysis of the correspondence examination process from information provided by the IRS and the Internal Revenue Manual (IRM) 4.19.10. AIMS = Audit Information Management System.

As indicated in the IRS's IRM, examiners must consider prior and subsequent year returns containing the same or shared issues as the year in examination, when appropriate.<sup>7</sup>

## Results of Review

### Correspondence Examination Case Selections Could Be Improved to Identify More Noncompliance

The IRS's latest estimate of the gross Tax Gap, the amount of tax liability not paid voluntarily and timely, was \$441 billion annually for Tax Years 2011 through 2013. The gross Tax Gap is caused

<sup>7</sup> IRM 4.19.13.3.1, *Auditing Standard 1 – Adequate Consideration of Significant Issues* (Feb. 9, 2018).

## Improvement to the Correspondence Examination Process May Increase Taxpayer Compliance and Collection Potential

by taxpayers who did not timely pay tax and timely file required returns (nonfiling), taxpayers misreporting amounts used to calculate tax liabilities on timely filed returns (underreporting), and taxpayers not paying tax liabilities reported on timely filed tax returns (underpayment). The IRS estimates that these components contribute, on average, \$39 billion, \$352 billion, and \$50 billion, respectively, to the gross Tax Gap annually.

Examinations are generally believed to deter noncompliance, thus narrowing the Tax Gap. However, IRS resources have been significantly reduced in recent years, and IRS examinations have plummeted as a result. The IRS lost 15,000 enforcement employees between Fiscal Years (FY) 2010 and 2018, which led to a significant reduction in the number of examinations and the number of follow-ups on discrepancies between returns and third-party data.<sup>8</sup> Over that period, the overall number of IRS examinations dropped by about 40 percent even as the number of returns filed grew by 5 percent. SB/SE Division's Campus Exam function had a 26.8 percent decrease in enforcement employees during that period. Given the decline in enforcement employees and the increase in the number of returns filed, the SB/SE Division's examination strategy should focus on the highest areas of tax noncompliance that are appropriate for correspondence examination employees to work.<sup>9</sup>

Between Fiscal Years 2010 and 2018  
IRS experienced:



**15,000** reduction in  
enforcement employees



**40%** reduction in  
examinations



**5%** increase in  
returns filed

### Correspondence examinations case selection could identify higher levels of noncompliance

The IRS relies on correspondence examinations as an efficient way to address taxpayers' tax returns which have potential noncompliance issues that the IRS can identify systemically.

Correspondence examinations accounted for nearly 80 percent of all IRS examinations completed between FY 2017 and FY 2019.<sup>10</sup> However, correspondence examinations account for less than one-half of the recommended additional tax after examination.

**80%**  
of all examinations  
completed between  
FY 2017-2019 were  
correspondence  
examinations.



**49%**  
of total recommended  
additional tax after  
examination between  
FY 2017-2019 were  
from correspondence  
examinations.



<sup>8</sup> TIGTA, Report No. 2021-30-011, *Trends in Compliance Activities Through Fiscal Year 2019* (Mar. 2021).

<sup>9</sup> Correspondence examinations are conducted by tax examiners who examine individual returns that are generally less complex and for which the scope of the examination is defined. In contrast, field examinations are conducted by revenue agents who examine individual, corporate, partnership, and specialty returns. In addition, revenue agents generally work complex issues, and the scope of the examination is broad.

<sup>10</sup> According to the IRS's Data Books for FYs 2017 through 2019, the IRS conducted a total of 2,506,515 examinations. Of those total examinations, 1,989,086 were correspondence examinations.

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Of all correspondence examinations, 743,648 (37 percent) are non-EITC examinations closed by the SB/SE Division. Our analysis of the 743,648 non-EITC correspondence examinations found that 202,112 (27.2 percent) of the cases closed did not have a net impact on dollars recommended. Specifically, 74,588 (10 percent) cases were not assessed additional tax after the correspondence examination, *i.e.*, were a “no-change” case. Additionally, for the 127,524 (17.1 percent) cases that had a proposed assessment, the taxpayer had not yet made payments towards the tax assessment. While the Internal Revenue Code allows the IRS to collect up to 10 years after the assessment of the tax, the probability of collecting a delinquent account drops dramatically with the length of the delinquency.<sup>11</sup>

**Non-EITC Correspondence Audits closed by SB/SE Division in FY17-FY19**

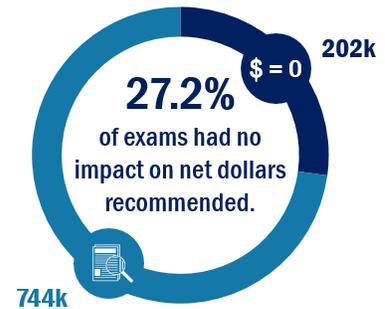


Figure 2 shows the percentage of non-EITC correspondence examinations compared to the total number of returns filed for the following Total Positive Income (TPI) categories: under \$200,000; \$200,000 to under \$1 million; and \$1 million and over.<sup>12</sup> The examinations of taxpayers with \$200,000 TPI or over have decreased at a higher rate than those of taxpayers with TPI under \$200,000,

**Figure 2: Non-EITC Correspondence Examinations for FYs 2017 Through 2019 as a Percentage of Returns Filed**

FY	Returns Filed in CY Prior to FY Exam (TPI Under \$200K)	Exams (TPI Under \$200K)	Percentage of Returns Examined (TPI Under \$200K)	Returns Filed in CY Prior to FY Exam (TPI \$200K to Under \$1M)	Exams (TPI \$200K to Under \$1M)	Percentage of Returns Examined (TPI \$200K to Under \$1M)	Returns Filed in CY Prior to FY Exam (TPI \$1M and Over)	Exams (TPI \$1M and Over)	Percentage of Returns Examined (TPI \$1M and Over)
2017	114,483,096	317,639	0.28%	6,875,092	38,613	0.56%	519,406	11,617	2.24%
2018	115,125,495	325,628	0.28%	7,068,147	32,799	0.46%	504,278	5,619	1.11%
2019	117,374,873	238,610	0.20%	7,833,021	20,773	0.27%	582,008	3,913	0.067%

Source: IRS Data Books for FYs 2017, 2018, and 2019. CY = Calendar Year.

Figure 3 shows the percentage of non-EITC correspondence examinations completed by taxpayer income found in the IRS’s Data Books for FYs 2017 through 2019. Despite a lower level of collectability for lower income taxpayers, the relative percentage of non-EITC correspondence examinations conducted for taxpayers with less than \$200,000 in TPI continues to increase. However, the percentage of correspondence examinations conducted for higher income taxpayers has decreased.

<sup>11</sup> Internal Revenue Code § 6502 states that, “where the assessment of any tax imposed by this title has been made within the period of limitation properly applicable thereto, such tax may be collected by levy or by a proceeding in court, but only if the levy is made or the proceeding begun within 10 years after the assessment of the tax.” According to a survey by the Commercial Collection Agency Association of the Commercial Law League of America, the likelihood of recovering a current balance was over 94 percent; however, if that delinquent balance is outstanding for just 90 days, the likelihood of payment is under 74 percent. Caine and Weiner, *Recovery Percentage Based on Age of Debt*, <https://www.caine-weiner.com/client-access/reference-information/recovery-percentage-based-on-age-of-debt>.

<sup>12</sup> TPI includes only the total positive values from income fields and treats losses as a zero.

**Figure 3: Non-EITC Correspondence Examinations for FYs 2017 Through 2019**

FY	Under \$200,000 TPI	Percentage of Exams Under \$200,000 TPI	TPI \$200,000 to Under \$1,000,000	Percentage of Exams TPI \$200,000 to Under \$1,000,000	TPI \$1,000,000 or More	Percentage of Exams TPI \$1,000,000 or More	Total Exams
2017	317,639	86%	38,613	10%	11,617	3%	367,869
2018	325,628	89%	32,799	9%	5,619	2%	364,046
2019	238,610	91%	20,773	8%	3,913	1%	263,296

Source: IRS Data Books for FYs 2017, 2018, and 2019.

Lastly, 39,180 (5.3 percent) cases were subjected to additional examination activity after the correspondence examination was initiated. Specifically, these cases were appealed, petitioned, or had an audit reconsideration case initiated.<sup>13</sup>

### SB/SE Division Correspondence Examination case selection process could be improved

We reported in our *Trends in Compliance Activities Through FY 2019* audit report that the proposed assessments in correspondence examinations show a general declining trend from \$8.4 billion in FY 2010 to \$3.5 billion in FY 2019, representing a 58 percent drop.<sup>14</sup> The IRS stated that this was attributable to training needs and a decline in staff as well as changes in the business plan and priorities. Proposed assessments declined 52 percent from \$7.3 billion in FY 2015 to \$3.5 billion in FY 2019.

There has been a **52% decrease** in proposed assessments in correspondence examinations between Fiscal Years 2015 and 2019.



Our review of the SB/SE Division correspondence examination case selection process found that the IRS does not always select the cases from the source with the highest assessment potential. SB/SE Division Examination closed 743,648 non-EITC correspondence examination cases between FYs 2017 through 2019 totaling more than \$6.1 billion in proposed tax assessed (see Figure 4). These cases accounted for approximately 37 percent of all correspondence examinations and 50 percent of the tax assessed by all correspondence examinations.

<sup>13</sup> Audit reconsiderations refer to requests to reevaluate the results of a prior audit for which additional tax was assessed and remains unpaid or a tax credit was reversed.

<sup>14</sup> TIGTA, Report No. 2021-30-011, *Trends in Compliance Activities Through Fiscal Year 2019* (Mar. 2021).

**Figure 4: Non-EITC Correspondence Examinations  
Closed by the SB/SE Division for FY 2017 Through FY 2019**

FY	Number of Closed Examinations	Total Proposed Assessments	Average Proposed Assessment per Examination
2017	253,720	\$1,972,538,301	\$7,774
2018	265,690	\$2,336,272,049	\$8,793
2019	224,238	\$1,808,691,145	\$8,066
Total	743,648	\$6,117,501,495	\$8,226

*Source: Data Center Warehouse Closed Audit Information Management System files for FYs 2017, 2018, and 2019.*

During our review, we identified the most productive issues, *i.e.*, highest proposed average assessments, and compared these issues to the average assessment amounts of the most examined cases in a subsequent year to determine whether the IRS was allocating its resources to the most productive issues. Our analysis found that the most examined issues do not correspond with the most productive issues from the prior year, *i.e.*, average assessment or time per case.

Additionally, the issues that the IRS examined most frequently were not the most productive issues. Figure 5 shows the 10 issues examined most frequently on average for FYs 2017 through 2019, including the average assessment amounts and exam time. As illustrated, the issues that the IRS most frequently audited, Form 1040 Schedule A, *Itemized Deductions*, and Form 1040 Schedule C issues were less productive than other issues, such as nonfiler issues.<sup>15</sup>

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<sup>15</sup> See Appendix III for the most frequently examined issues for FYs 2017 through 2019.

**Figure 5: Most Frequently Examined Issues in Non-EITC  
Correspondence Examinations for FY 2017 Through FY 2019 (on Average)**

Project Code Definition	Average Number Examined	Average Assessment	Average Exam Days	Average Exam Time (in hours)
0381 – Form 1040 Schedule A: Employee Business Expense	55,856	\$3,688	228.63	1.58
0377 – Form 1040 Schedule C Issues	46,052	\$4,576	239.82	1.92
0277 – Nonfilers	44,702	\$28,102	186.29	0.41
0453 – Combined Annual Wage Reporting Audits - Employment Tax Nonfiler	15,921	\$5,188	139.23	0.37
0288 – Questionable Form 1040 Schedule C With Earned Income Tax Credit	10,868	\$3,669	234.74	0.90
0406 – American Opportunity Tax Credit – Max Years Exceeded	10,830	\$2,647	179.45	2.90
0133 – Criminal Investigation – Non-Earned Income Tax Credit Referral	9,383	\$3,508	170.96	1.25
0639 – Medical/Contribution/Miscellaneous Expense on Form 1040 Schedule A	5,167	\$5,535	269.30	2.23
0231 – Alimony Compliance Project (Payer)	4,368	\$4,984	194.20	3.32
0000 – Valid Correction – Alternative Minimum Tax	4,251	\$3,190	136.64	1.52

*Source: TIGTA analysis of Closed Audit Information Management System files for FYs 2017, 2018, and 2019.*

Specifically, the average assessment for nonfiler cases (\$28,102) was more than three times higher than the average assessment for the two most frequently examined issues combined (\$3,688 and \$4,576). According to IRS management, CCS workplan volumes are identified by the SB/SE Division’s Examination Planning, Performance, and Analysis function annually using the Enterprise Planning Scenario Tool (EPST).<sup>16</sup> The Planning, Performance, and Analysis function provides the projected available inventory by project code for the EPST to consider such factors as projected available high-dollar inventory, collectability (including abatements), project code constraints, historical data of prior years, and resources available to determine the optimal inventory mix by project code for the Correspondence Exam Starts Plan. Although historical data are considered in the EPST, some factors can influence how many years of historical data are used, for example, tax law changes, any updates since the prior year, and removing or adding workplan starts. The CCS then uses the filter criteria from the three sources, the CDE, the DEBR, and referrals, to select cases for the inventory to be worked in accordance with the optimal inventory mix generated by the EPST. After the inventory is selected, cases are prioritized within each issue category. For example, if a case involves a tax credit, the inventory

<sup>16</sup> The EPST is used in the production for Campus Correspondence Exam to determine the optimal inventory mix for improved performance measure outcomes.

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is prioritized by the amount of the credit in question. However, the results of our review show that the IRS does not prioritize the annual workplan based on the most recent years' results.

In addition, the IRS does not prioritize its workload by source. As previously noted, the population of correspondence examination cases comes from three main sources.<sup>17</sup> DEBR and CDE sources each use systemically filtered criteria in determining the most productive returns. During our review, we found that the largest number of cases selected are from the CDE. However, of the three main sources, referrals have a significantly better assessment value than the other sources. In addition, the amount of time to close a case and number of examination days is also lower for referrals than the other sources. Figure 6 shows the average assessments and time spent on cases by source.

**Figure 6: Average Assessment and Examination Time by Source**

	Average Assessment	Time Spent on Case (in Hours)	Total Exam Days
DDB/DEBR	\$3,132	2.09	206
CDE	\$4,195	1.79	230
Referral	\$16,941	0.74	173
Other	\$6,064	3.33	237

*Source: Data Center Warehouse Closed Audit Information Management System files for FYs 2017, 2018, and 2019.*

As noted in Figure 6, referrals yield higher average assessments with less time spent on case in comparison to the other sources. However, referrals accounted for 33 percent of the total Correspondence Examinations between FYs 2017 and 2019. Figure 7 shows the number of cases selected by source.

**Figure 7: SB/SE Division Correspondence Case Selection by Source for FY 2017 Through FY 2019**

Source	Cases Selected	Percentage
DDB/DEBR	132,681	18 percent
CDE	353,064	47 percent
Referrals	244,269	33 percent
Other	13,634	2 percent
<b>Total</b>	<b>743,648</b>	<b>100 percent</b>

*Source: Data Center Warehouse Closed Audit Information Management System files for FYs 2017, 2018, and 2019.*

Furthermore, the IRS does not have a central source tracking mechanism for all referrals received, and SB/SE Division CCS does not have a consistent selection process for referrals. The IRS indicated that it tracks and documents all referral selection decisions by project code. According to SB/SE Division CCS management, once referrals are received, they are listed on different spreadsheets according to selection criteria. Referrals are then assigned and worked

<sup>17</sup> Correspondence Examination works a small number of cases that are not identified by those three sources, such as the Return Integrity and Compliance Services Preparer Program.

by a number of analysts based on project codes. In addition, a referral case can have different characteristics and issues that each analyst evaluates to determine which case is selected for examination. For each case, the analyst documents the reason as to whether the case would or would not meet selection criteria. Although the IRS has a process in place to track and document all selection decisions, individual analysts are responsible for evaluating and selecting referrals for examination. As a result, there is no way to distinguish whether one referral is better than another without having them placed in a centralized location for management to make a decision. Without a consistent process to evaluate and select potential referral cases for examination, the IRS may not be selecting the most productive cases for correspondence examination to work.

**Recommendation 1:** The Commissioner, SB/SE Division, should evaluate closed correspondence examination cases to identify the issues that result in the most significant noncompliance by proposed assessment and develop a workplan to prioritize the case selection process to include most of these cases.

**Management's Response:** The IRS disagreed with this recommendation. IRS management stated that the use of historical business results is already utilized in the case selection process and incorporated within the EPST. Correspondence examination work is planned using the EPST, which uses scenarios to optimize business results based on collectability and cost. The EPST considers historical performance results such as dollars collected, dollars recommended, no change rates, and total cost per case to determine the best mix of inventory by project code. The EPST also considers all available resources including mail projections. The IRS stated it will continue to use the EPST to determine the priority of correspondence examination work.

**Office of Audit Comment:** Although the EPST uses historical business results during the case selection process to identify an optimal mix of inventory, our analysis found that the most examined issues do not correspond with the most productive issues examined from the prior year, *i.e.*, average assessment or time per case. Because other factors can influence the cases selected for inventory to be worked, *i.e.*, filter criteria from the three sources, the CDE, the DEBR, and referrals, TIGTA continues to believe that the IRS should evaluate and prioritize the selection process to include the most productive cases.

## **The Small Business/Self-Employed Division's Campus Case Selection Subsequent Return Process Still Does Not Address Taxpayers' Continued Noncompliance**

In FY 2013, TIGTA reported that the IRS was not auditing prior and/or subsequent year tax returns when similar tax issues are present and recommended that the IRS should develop and implement procedures to provide additional guidance on when to audit a prior and/or subsequent year tax return.<sup>18</sup> The IRS agreed with the recommendation and implemented a new process [REDACTED]

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<sup>18</sup> TIGTA, Report No. 2013-30-077, *The Correspondence Audit Selection Process Could be Strengthened* (Aug. 2013).

████████████████████ This process is designed to complete a quarterly analysis of a select population of correspondence examinations when the taxpayer agreed with the additional assessment or the examination was closed by default and resulted in an audit assessment of ██████████ to determine whether the subsequent year tax return has audit potential for the same issue examined, *i.e.*, same project code.<sup>19</sup> These returns are identified by a special tracking code, and viable cases are entered into the workstream during the next scheduled delivery. However, our review found that the IRS is still not reviewing the majority of subsequent year returns. As such, the IRS is missing the opportunity to bring the taxpayer into full compliance and increase potential revenue by examining subsequent year returns.

Our review of non-EITC correspondence examinations closed between FYs 2017 and 2019 identified 743,648 examinations. Further analysis of these examinations found that 139,492 (19 percent) were subsequent examinations identified by the subsequent return process, and 23,741 (17 percent) of these examinations, representing 21,767 unique taxpayers, were closed agreed, meaning that the taxpayer responded to the ICL and agreed with the additional tax assessed that resulted from the correspondence examination. However, the IRS did not open the correspondence examination on the subsequent year returns until after it closed the correspondence examination on the current year. The IRS's current process on considering the viability of the subsequent year after the closure of the current examination increases the burden to the taxpayers by subjecting them to two separate correspondence examinations instead of one examination for multiple tax years.

### **Additional returns could be reviewed during the examination process**

The IRS could be addressing additional tax noncompliance if tax examiners reviewed subsequent year tax returns as part of the correspondence examination process. Our analysis of all 743,648 examinations closed between FY 2017 and FY 2019 identified 542,588 (73 percent) correspondence examinations that had a subsequent year that was not examined. Of those 542,588 correspondence examinations, 379,404 were closed with taxpayer agreement with the IRS's proposed assessment of tax or by default, meaning the taxpayer did not respond to the IRS's inquiry so the IRS proceeded with the assessment of tax. We reviewed two of the project codes with the highest number of examinations from our population and identified 120,313 examinations that had an issue on the Form 1040 Schedule C or that were on taxpayers that appeared not to file tax returns that were due. Further review of the subsequent year tax returns for these taxpayers found that 56,464 (47 percent) of the 120,313 examinations had the same potential issue in the subsequent year and were not examined. Of the 56,464 examinations, 53,969 (96 percent) met the IRS's criteria for potential audit selection (an assessment for the current exam of ██████████). Specifically for these 56,464 examinations, we found:

- 47,022 closed agreed and default examinations for which the issues related to Schedule C and the subsequent return also had a Form 1040 Schedule C, yet the return had not been considered for examination. Of these, 45,052 (96 percent) examinations resulted in an audit assessment of ██████████.
- 9,442 nonfiler examinations closed as either agreed or default and the taxpayer did not file the following year return, yet the IRS did not select that subsequent year for

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<sup>19</sup> IRM 4.1.26.3.7.3 (Dec. 27, 2016).

examination. Of these, 8,917 (94 percent) examinations resulted in an audit assessment of [REDACTED]

We provided the IRS our analysis of the 53,969 cases, and the IRS identified 19,969 (37 percent) cases that were deemed unworkable due to certain filtering conditions, *e.g.*, [REDACTED]. The remaining 34,000 (63 percent) cases had a subsequent year return with the same issue as the year prior and were considered for inclusion in the examination plan, but not selected due to a variety of reasons as determined by the CCS. In addition, the IRS states that 13,326 of these cases have a short or expired statute, making them no longer available for examination. Due to the expired statute, the IRS is no longer able to assess taxes on these taxpayers. Had the subsequent year been examined as part of the correspondence examination process, the statute more than likely would not have been a factor in reviewing the subsequent year return.

According to IRS procedures, tax examiners are required to consider significant tax issues during examination, including prior and subsequent year returns. In addition, the procedures state that prior and subsequent returns need to be evaluated for audit potential, and if the examination of a prior or subsequent year return is warranted, the return should be audited concurrently with the assigned return.<sup>20</sup> However, current IRS practices do not align with the written procedures. We interviewed 15 tax examiners during our review, and all 15 tax examiners indicated that they are instructed not to consider prior and subsequent tax years during an examination. Specifically, the tax examiners indicated they are instructed only to review the specific issue and year that was selected for the examination and not to expand their work into the following year.

According to IRS management, the decision to have examiners work single year examinations is based on the systemic inventory of cases that SB/SE Division Correspondence Examination assigns to each examiner, which is based on a single tax year. Although the examiner's inventory is based on the next case systemically, which selects only one year, the examiners are still required to consider the prior and subsequent year returns. Examiners and management are not following the guidance to consider the prior and subsequent year tax returns for audit potential. This practice could diminish the deterrent effect because the same behavior on a subsequent year tax return was not also examined. The current IRS practices could potentially encourage future noncompliance because taxpayers had their mistakes corrected for only one year when the same issues existed in subsequent or prior tax years.

The Commissioner, SB/SE Division, should:

**Recommendation 2:** Change the subsequent return process to address only subsequent year returns in which the taxpayer did not respond to the ICLs for the current examination.

**Management's Response:** The IRS agreed with this recommendation. IRS management will review and assess current processes and procedures to determine if there are opportunities for improvement.

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<sup>20</sup> IRM 4.19.13.3.1 (Feb. 19, 2018).

**Improvement to the Correspondence Examination Process  
May Increase Taxpayer Compliance and Collection Potential**

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**Recommendation 3:** Provide a reminder to ensure that tax examiners and managers are following processes for subsequent year returns during the correspondence examination process.

**Management's Response:** The IRS agreed with this recommendation. IRS management will revise IRM 4.19.13 to clarify the Correspondence Examination subsequent year process to ensure that tax examiners and managers are following processes for subsequent year returns during the correspondence examination process.

## Appendix I

### Detailed Objective, Scope, and Methodology

Our overall objective was to determine the IRS's effectiveness in the selection and examination of correspondence examinations. To accomplish our objective, we:

- Determined the applicable policies, procedures, and controls that are in place for Correspondence Examinations in the SB/SE Division.
- Evaluated how the number of correspondence examinations are determined each year as part of the SB/SE Division annual workplan.
- Evaluated the workload selection process to determine how cases are being selected for correspondence examinations, including classification criteria and distribution of correspondence examination work nationwide.
- Evaluated the IRS's current processes on considering the viability of the subsequent year return after the closure of the current examination.

#### **Performance of This Review**

This review was performed by obtaining and reviewing information from the SB/SE Examination Division headquartered in Lanham, Maryland, during the period October 2019 through June 2021. 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.

Major contributors to the report were Matthew Weir, Assistant Inspector General for Audit (Compliance and Enforcement Operations); Linna Hung, Director; Robert Jenness, Director; Tim Greiner, Acting Director; Michele Jahn, Audit Manager; Ken Henderson, Lead Auditor; Malissa Livingston, Senior Auditor; Kim McMenamin, Senior Auditor; and Lance Welling, Information Technology Specialist (Data Analytics).

#### **Validity and Reliability of Data From Computer-Based Systems**

We performed tests to assess the reliability of data from the closed Audit Information Management System files for FY 2017 through FY 2019 and the Individual Return Transaction File files for Processing Years 2015 through 2019. We evaluated the data by 1) performing electronic testing of required data elements, 2) reviewing existing information about the data and the system that produced them, and 3) interviewing agency officials knowledgeable about the data. We determined that the data were sufficiently reliable for purposes of this report.

## **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 that the following internal controls were relevant to our audit objective: applicable policies and procedures in the IRM for the workload case selection process and correspondence tax examiners. We evaluated these controls by reviewing annual workplans and project code filters, and interviewing management and employees.

## Outcome Measure

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

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

- Taxpayer Burden – Potential; 21,767 taxpayers (see Recommendation 2).

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

Our analysis identified a population of 743,648 examinations closed between FY 2017 and FY 2019. We found that the IRS conducted 139,492 (19 percent) subsequent examinations identified by the subsequent return process, and 23,741 (17 percent) of these examinations, representing 21,767 unique taxpayers, were closed agreed, meaning that the taxpayer responded to the ICL and agreed with the additional tax assessed that resulted from the correspondence examination. However, the IRS did not open the correspondence examination on the subsequent year return until after it closed the correspondence examination on the current year. The IRS's current process on considering the viability of the subsequent year after the closure of the current examination increases the burden to the taxpayers subjecting them to the two separate correspondence examinations instead of one examination for multiple tax years.

## Appendix III

### Top 10 Examined Issues in Non-Earned Income Tax Credit Correspondence Examinations (Fiscal Years 2017 Through 2019)

Project Code Definition	FY 2017			
	Number Examined	Average Assessment	Average Exam Days	Average Exam Time (in hours)
0277 - Nonfilers	51,270	\$23,913	174.19	0.38
0381 - Form 1040 Schedule A: Employee Business Expense	50,897	\$3,424	196.34	1.63
0377 - Form 1040 Schedule C Issues	38,983	\$4,615	213.66	2.05
0453 - Combined Annual Wage Reporting Audits - Employment Tax Nonfiler	16,579	\$3,589	102.64	0.31
0639 - Medical/Contribution/Miscellaneous Expense on Form 1040 Schedule A	11,674	\$4,513	229.79	2.78
0288 - Questionable Form 1040 Schedule C With Earned Income Tax Credit	9,263	\$3,429	232.69	0.88
0133 - Criminal Investigations - Non-Earned Income Tax Credit Referral	8,025	\$3,252	156.31	1.22
0097 - NON Earned Income Credit - DEP/DEP (Dependent/Dependent Match TIN)	7,949	\$2,843	226.45	2.04
0405 - Education Credit, Student Filing/ Age-Related	6,580	\$2,024	205.70	1.84
0000 - Valid Correction - Alternative Minimum Tax	4,952	\$3,485	118.35	1.64

**Improvement to the Correspondence Examination Process  
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FY 2018				
Project Code Definition	Number Examined	Average Assessment	Average Exam Days	Average Exam Time (in hours)
0381 – Form 1040 Schedule A: Employee Business Expense	71,413	\$3,399	227.35	1.37
0377 – Form 1040 Schedule C Issues	57,639	\$4,319	231.03	1.75
0277 – Nonfilers	37,765	\$38,544	177.26	0.41
0406 – American Opportunity Tax Credit – Max Years Exceeded	15,337	\$2,756	201.07	3.06
0453 – Combined Annual Wage Reporting Audits, Employment Tax Nonfiler	13,334	\$4,614	131.38	0.33
0133 – Criminal Investigations – Non-Earned Income Tax Credit Referral	10,139	\$3,567	172.34	1.14
0288 – Questionable Form 1040 Schedule C With Earned Income Tax Credit	8,867	\$3,875	237.41	0.82
0459 – Itemized Deductions	6,821	\$3,283	193.30	2.04
0231 – Alimony Compliance Project (Payer)	5,644	\$4,726	186.14	3.06
0000 – Valid Correction – Alternative Minimum Tax	5,195	\$3,133	133.29	1.46

FY 2019				
Project Code Definition	Number Examined	Average Assessment	Average Exam Days	Average Exam Time (in hours)
0381 – Form 1040 Schedule A: Employee Business Expense	45,257	\$4,241	262.19	1.73
0277 – Nonfilers	45,070	\$21,850	207.42	0.44
0377 – Form 1040 Schedule C Issues	41,535	\$4,794	274.78	1.97
0453 – Combined Annual Wage Reporting Audits, Employment Tax Nonfiler	17,851	\$7,360	183.67	0.46
0288 – Questionable Form 1040 Schedule C With EITC	14,473	\$3,704	234.11	0.99
0406 – American Opportunity Tax Credit – Max Years Exceeded	14,045	\$2,756	223.35	2.84
0133 – Criminal Investigations – Non-Earned Income Tax Credit Referral	9,984	\$3,704	184.22	1.39
0419 – Moving Expenses	3,637	\$3,172	234.50	1.77
0231 – Alimony Compliance Project (Payer)	3,087	\$5,544	221.08	3.78
0459 – Itemized Deductions	2,792	\$4,471	262.60	2.46

Source: TIGTA analysis of Closed Audit Information Management System Files for FYs 2017, 2018, and 2019.

Management's Response to the Draft Report



COMMISSIONER  
SMALL BUSINESS/SELF-EMPLOYED DIVISION

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

September 9, 2021

MEMORANDUM FOR MICHAEL E. MCKENNEY  
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: De Lon Harris  Digitally signed by Gearl D. Harris  
Date: 2021.09.09 16:05:29 -0400  
Commissioner, Small Business/Self-Employed, Examination

SUBJECT: Draft Audit Report – Improvements to the Correspondence Examination Process May Increase Taxpayer Compliance and Collection Potential (Audit # 201930013)

Thank you for the opportunity to review and comment on the subject draft audit report. Unlike traditional in-person audits, correspondence examinations are conducted by mail and are generally used for single issues of deductions and credits that are easily verified. In contrast to Field Examination, Correspondence Examination does not conduct full scope compliance examinations. The IRS has limited resources to address a large and growing number of non-compliant taxpayers. The Correspondence Examination Program allows the IRS to cover a broader range of less complex issues with less burden to taxpayers and the IRS, which helps to ensure our highly trained and experienced Tax Compliance Officers (TCOs) and Revenue Agents (RAs) can be devoted to the more complex returns and financial transactions contained within the population of individual income tax return filings.

Correspondence Exam cases are opened with notices generated systemically based on results of the case selection process to maximize resources and achieve balanced coverage of compliance activities. The cases advance through an automated process and examiners only intervene after a taxpayer responds. The case selection filters and Enterprise Planning Scenario Tool (EPST) are working effectively to identify non-compliance, as demonstrated by the low no change rate of 10%. The correspondence case selection process is very effective at detecting noncompliance based on the data TIGTA supplied; however, whether we will be able to collect is not a measure of examination noncompliance.

## Improvement to the Correspondence Examination Process May Increase Taxpayer Compliance and Collection Potential

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We utilize our tools such as the EPST to consider multiple variables to optimize inventory across workstreams. Annually, we review selection rules and make any necessary updates to account for tax return changes, legislative updates and changes in taxpayer behavior. Our review also helps ensure the selection rules are functioning as intended and properly identifying populations of noncompliance. Case selection delivers the highest risk cases, which typically result in the largest assessments. As such, these business results and assessment dollars cannot be expected from the remaining available inventory, which may be lower risk. When excluding non-filer examination results from Figure 5, the remaining project code performance is relatively consistent and within a similar range. Additionally, the IRS cannot focus only on a single issue, we must maintain a compliance presence across the taxpayer population including both filers and non-filers and across different issue types.

When assessing our workload mix choices, TIGTA analyzed and compared non-filer audit examination results to filed return examination results. Non-filer examinations may initially appear more productive because a non-filer does not receive the benefit of expenses, deductions, or credits that they may otherwise be entitled to claim. However, these taxpayers frequently file a tax return after the examination claiming expenses, thus resulting in a significant reduction to the original assessment. TIGTA is also projecting these dollars per return to the entire population without considering the cost of computing and abating tax, penalties, and interest, upon processing of the delinquent returns filed.

Throughout the report, TIGTA advocates for the concurrent expansion of correspondence examinations to subsequent years. Notices for correspondence examination are generated systemically, without requiring a human review. We strive to make compliance contacts with taxpayers as quickly as possible after they have filed. At the time returns are systemically identified for examination, the subsequent year returns generally have not yet been filed. Waiting for a subsequent year to be filed and available would not be in the best interest of the taxpayer, and would negatively impact the automation and efficiency of the correspondence exam program by increasing cycle time and potentially not delivering the next best case for selection. The IRS has created criteria to ensure selection decisions are made fairly and without bias per [IRM 4.1.26.2, Cases Selected for Examination](#). We maintain that our current procedures allow the selection of subsequent years of correspondence examinations when appropriate while retaining the efficiency of automation and fairness in case selection. However, we will review and assess current processes and procedures to determine if there are opportunities for improvement.

Attached are our comments and proposed actions to your recommendations. If you have any questions, please contact me, or Scott Irick, Director, Examination, Small Business/Self-Employed Division.

**Improvement to the Correspondence Examination Process  
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Attachment

**RECOMMENDATION 1:**

The Commissioner, SB/SE Division, should evaluate closed correspondence examination cases to identify the issues that result in the most significant noncompliance by proposed assessment and develop a workplan to prioritize the case selection process to include most of these cases.

**CORRECTIVE ACTION:**

The use of historical business results is already utilized in the case selection process and it is incorporated within EPST. The correspondence exam work is planned using the EPST. The EPST scenarios are used to optimize business results based on collectability and cost. The EPST considers historical performance results such as dollars collected, dollars recommended, no change rates, and total cost per case to determine the best mix of inventory by project code. The EPST also considers all available resources including mail projections. We will continue to use the EPST to determine the priority of correspondence exam work.

**IMPLEMENTATION DATE:** N/A

**RESPONSIBLE OFFICIAL:** N/A

**CORRECTIVE ACTION MONITORING PLAN:** N/A

**RECOMMENDATION 2:**

The Commissioner, SB/SE Division, should change the subsequent return process to address only subsequent year returns in which the taxpayer did not respond to ICLs for the current examination.

**CORRECTIVE ACTION:**

The current subsequent year return identification process is conducted in a systemic environment where taxpayers are treated consistently and fairly. However, we will review and assess current processes and procedures to determine if there are opportunities for improvement.

**IMPLEMENTATION DATE:**

October 15, 2022

**RESPONSIBLE OFFICIAL:**

Director, Examination Field and Compliance Policy, Small Business/Self-Employed Division and Director, Examination Case Selection, Small Business/Self-Employed Division

**Improvement to the Correspondence Examination Process  
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**CORRECTIVE ACTION MONITORING PLAN:**

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

**RECOMMENDATION 3:**

The Commissioner, SB/SE Division, should provide a reminder to ensure that tax examiners and managers are following processes for subsequent year returns during the correspondence examination process.

**CORRECTIVE ACTION:**

We will revise IRM 4.19.13 to clarify the Correspondence Examination subsequent year process.

**IMPLEMENTATION DATE:**

October 15, 2022

**RESPONSIBLE OFFICIAL:**

Director, Examination Field and Campus Policy, Small Business/Self-Employed Division

**CORRECTIVE ACTION MONITORING PLAN:**

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

## Glossary of Terms

<b>Term</b>	<b>Definition</b>
Audit Information Management System	The Audit Information Management System is a computer data system used by Appeals, Examination (Large Business and International, Small Business/Self-Employed, and Wage and Investment Divisions), and the Tax Exempt and Government Entities Division to control returns, input assessment/adjustments to Master File, and provide management reports.
Calendar Year	Twelve (12) consecutive months ending December 31.
Classification	An IRS process that is performed to determine which cases are selected for examination.
Classify	This is a task performed in the classification process which involves elimination filtering (deceased taxpayer, already under audit, disaster area, <i>etc.</i> ) and filter checks, which include checking against Information Returns, comparative ranking of the issue, identifying the overall potential deficiency amount, and determining the most egregious issue to be examined.
Correspondence Exam Starts Plan	These are correspondence examinations case starts from the exam plan. Campus Exam and Document Matching Workload Planning and Analysis team will populate the campuses' new start reports with the weekly start plan.
Data Center Warehouse	A TIGTA Office of Information Technology function that obtains and stores numerous IRS data files and makes them available to auditors and investigators via the TIGTA intranet.
Fiscal Year	Any fiscal accounting period, regardless of its relationship to a calendar year. The Federal Government fiscal year begins on October 1 <sup>st</sup> and ends on September 30 <sup>th</sup> .
Individual Return Transaction File	Contains data transcribed from initial input of the original individual tax returns during return processing.
Processing Year	The calendar year in which the tax return or document is processed by the IRS.
Project Code	A four-digit code used on the Audit Information Management System to identify a special program to which an examination belongs.
Statute of Limitations	A specified period of time for correction of taxes by the IRS, usually three years from the due date or received date of the return, whichever is later.
Tax Year	The 12-month accounting period for keeping records on income and expenses used as the basis for calculating the annual taxes due. For most individual taxpayers, the tax year is synonymous with the calendar year.

**Abbreviations**

CCS	Campus Case Selection
CDE	Compliance Data Environment
DDB	Dependent Database
DEBR	Discretionary Exam Business Rules
EITC	Earned Income Tax Credit
EPST	Enterprise Planning Scenario Tool
FY	Fiscal Year
ICL	Initial Contact Letter
IRM	Internal Revenue Manual
IRS	Internal Revenue Service
SB/SE	Small Business/Self-Employed
TIGTA	Treasury Inspector General for Tax Administration
TPI	Total Positive Income



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