

GAO

Report to the Chairman, Subcommittee
on Oversight, Committee on Ways and
Means, House of Representatives

March 1999

IRS AUDITS

Weaknesses in Selecting and Conducting Correspondence Audits



General Government Division

B-276687

March 31, 1999

The Honorable Amo Houghton
Chairman, Subcommittee on Oversight
Committee on Ways and Means
House of Representatives

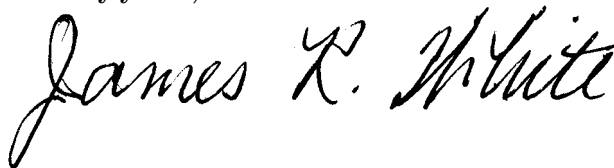
Dear Mr. Chairman:

This report responds to your request that we review the Internal Revenue Service's (IRS) program to audit income tax returns through correspondence. We provide information on the number, results, and duration of correspondence audits as well as the characteristics of the audited returns and examine the processes and requirements that IRS has put in place to govern correspondence audits. This report also includes our recommendations on improving the correspondence audit program.

We are sending copies of this report to Representative William J. Coyne, Ranking Minority Member, Subcommittee on Oversight, House Committee on Ways and Means; Senator William V. Roth, Jr., Chairman, and Senator Daniel Patrick Moynihan, Ranking Minority Member, Senate Committee on Finance; various other congressional committees; The Honorable Robert E. Rubin, Secretary of the Treasury; The Honorable Charles O. Rossotti, Commissioner of Internal Revenue; The Honorable Jacob Lew, Director, Office of Management and Budget; and other interested parties. Copies will also be made available to others upon request.

This report was prepared under the direction of Thomas D. Short, Assistant Director. Other major contributors are listed in appendix VI. If you have any questions about this report, please call me or Mr. Short on (202) 512-9110.

Sincerely yours,



James R. White
Director, Tax Policy
and Administration Issues

Executive Summary

Purpose

Between 1992 and 1997, the Internal Revenue Service (IRS) audited between 1 and 2 million individual income tax returns per year. Audits are one of the enforcement tools used by IRS in its efforts to close the tax gap—the amount of taxes owed but not voluntarily paid. IRS' most recent estimate put the tax gap for individuals at over \$125 billion for 1992. IRS also estimates that it eventually collects about one-quarter of the gross tax gap through its enforcement efforts.

Since 1996, the most common type of IRS audit of individual taxpayers has been the correspondence audit conducted through IRS' 10 service centers. As the name implies, these audits are conducted through the mail, with IRS typically asking taxpayers for more support regarding one or two simple issues on a tax return. Audits of more complex tax issues are done at IRS' 33 district offices.

In recent years, Congress has been concerned about IRS' use of its enforcement tools, particularly about whether the tools are used fairly and in a manner that does not impose excessive burdens on taxpayers. Concerns such as these led, in part, to the passage of the IRS Restructuring and Reform Act of 1998. The act included provisions affecting audits.

In keeping with the Committee's oversight responsibilities for IRS enforcement activities, the Chairman of the House Committee on Ways and Means, Subcommittee on Oversight, asked GAO to review correspondence audits and IRS' processes for conducting these audits. Accordingly, this report (1) provides information on the number, results, and duration of correspondence audits as well as the characteristics of the audited returns and (2) examines the processes and requirements that IRS has had for years to govern correspondence audits. GAO's analysis is based on computerized IRS data on audits closed during fiscal years 1992-97, a study population of traditional correspondence audits closed in 1996 from which we drew a sample, and surveys from compliance officials at IRS' 10 service centers.

Results in Brief

GAO found several weaknesses in IRS' correspondence audit processes. These weaknesses, individually or in combination, can erode the integrity of the correspondence audit processes, which are designed to help ensure that taxpayers pay the correct tax amounts and are treated properly.

During fiscal years 1992-97, the annual number and results of correspondence audits conducted by IRS varied considerably. The number ranged annually from just over 200,000 to about 1.1 million audits. The rate at which IRS auditors closed audits without recommending additional

taxes (the no-change rate) ranged from 13 percent to 46 percent. When they did recommend additional taxes, the average amounts ranged from \$1,300 to \$2,800. The rate at which taxpayers did not respond to these recommended additional taxes after being requested to do so by IRS (the default rate) ranged from 29 percent to 63 percent. These variations resulted, in part, from an increase in the number of correspondence audits of returns claiming an earned income credit (EIC).

For the traditional correspondence audits closed in fiscal year 1996, the time between the filing of a return and the start of the correspondence audit averaged 10 months. It then took 11 more months before IRS assessed any taxes that were recommended during the audits. As for the characteristics of these 1996 returns, an estimated 75 percent had reported adjusted gross incomes of less than \$15,000. In part, this percentage reflects the correspondence audit's focus on simple tax issues and EIC.

IRS had weaknesses in implementing the correspondence audit requirements for four processes. First, not all of the traditional correspondence audits closed in 1996 were manually reviewed (or classified) to identify all issues for audit, as required by IRS. Further, the classification of returns that included complex business and investment schedules was not always done by qualified personnel in district offices, as required. Second, support for recommended audit findings was not adequately documented in the audit workpaper files, as required, for about one-third of the audits. Third, the taxpayer documentation that was required to justify EIC claims varied from service center to service center. Fourth, GAO found weaknesses in the reviews that IRS did on a sample of closed audits to measure their quality. For example, some service centers excluded certain types of correspondence audits that are required to be included in the sample.

In addition to the weaknesses in implementing the requirements, IRS allowed service centers to exclude certain types of audits that did not have all required documentation from being measured against the audit standard on workpaper documentation. Further, more than 50 percent of the taxpayers who were audited by correspondence did not respond to IRS' letters, and IRS has not analyzed why. GAO is making a number of recommendations to deal with these and other weaknesses in the correspondence audit process.

Background

Each year, IRS checks all individual income tax returns filed for compliance with the tax laws using a variety of tools. These compliance checks include reviews of some required information, such as signatures

and Social Security numbers, at the time a return is filed; computerized corrections of what IRS labels “math errors;” computerized matching of information, such as income, with the corresponding information reported to IRS by third parties; and audits.

Auditors seek additional support from taxpayers for questionable items on tax returns—which IRS calls tax issues. IRS may raise tax issues regarding any of the items on a return, such as exemptions, income, deductions, and credits.

IRS does two types of audits of returns filed by individual taxpayers: correspondence and district office audits. Correspondence audits deal with simpler issues through correspondence sent from one of IRS’ service centers. District office audits deal with more complex issues, such as those on business or investment schedules that are attached to tax returns, usually through face-to-face meetings in an IRS office or a taxpayer’s place of business. Correspondence audits are conducted by tax examiners trained in simple tax issues, while district office audits are conducted by revenue agents and tax auditors trained in more complex tax issues.

IRS has established audit quality standards and requirements for selecting, conducting, and reviewing the quality of correspondence audits. The standards require actions such as considering all significant issues for audit and adequately documenting audit recommendations. During audit selection, tax returns should be reviewed (classified) by IRS personnel qualified to identify all questionable issues for audit, particularly complex issues on business and investment schedules. Further, classification should determine whether the issues can be addressed through correspondence audits or through district office audits. In conducting audits, IRS also requires tax examiners to adequately support their audit recommendations and to document that support and audit steps in the workpaper files. When auditing claims for tax credits, such as EIC, tax examiners are required to substantiate these claims using third-party verification, such as school records. In reviewing audits, IRS has established two levels of review. The first is to be carried out by the tax examiners’ supervisors, who are to review some examiners’ work while the audit is in progress. The second review is to be performed on a sample of closed audits by quality assurance staff within each service center to measure adherence to the audit standards.

To start the correspondence audit process, IRS is to send a notice to the taxpayer that the return has been selected for audit. This notice is to request certain information or documents needed to support the issues

identified for audit through classification. If the taxpayer responds with such support, the tax examiner is to recommend closing the audit with no changes to the reported tax liability (no-change audit) and notify the taxpayer through a letter. If the taxpayer does not provide support, the tax examiner is to recommend changes to the tax liability and similarly notify the taxpayer. If the taxpayer does not respond to the recommended tax changes within 30 days, the tax examiner is to notify the taxpayer that the recommended tax will be assessed. If the taxpayer does not respond to this tax assessment notice within 90 days, the tax examiner is to close the audit as a default by the taxpayer, meaning the tax assessment becomes final and the taxpayer is liable for the additional taxes.

Principal Findings

IRS' Use of Correspondence Audit

During fiscal years 1992-97, the annual number of correspondence audits conducted by IRS varied considerably from year to year. The fewest number of audits—232,000—were closed in 1993. Between 1994 and 1995, the number of correspondence audits tripled from about 353,000 to about 1.1 million but then decreased to 758,000 between 1996 and 1997. The increase between 1994 and 1995 was due, in large part, to increased emphasis on auditing returns claiming EIC in response to congressional concerns about EIC noncompliance. The decrease in 1997 was due to moving many of the EIC returns from the correspondence audit program to the math-error program.

During fiscal years 1992-97, correspondence audit results—such as the no-change rates, amount of taxes recommended per audited return, and default rates—also varied considerably from year to year. For example, the no-change rate increased through 1995 to a high of 46 percent and then decreased by 1997 to a low of 13 percent. In contrast, the amount of taxes recommended per audited return declined between 1992 and 1995 to a low of \$1,282 and then increased in 1997 to a high of \$2,835. Similarly, the default rate decreased by 1995 to a low of 29 percent and then increased in 1997 to a high of 63 percent.

For the correspondence audits closed in fiscal year 1996, GAO found an overall average of 21 months elapsed from the time the returns were filed until IRS assessed any taxes recommended during the audit. The time between the filing of a return and the start of the correspondence audit averaged 10 months. It then took an average of 11 more months before IRS assessed any taxes recommended during the audits. Audits of returns for

which the taxpayers never responded to IRS' letters usually took longer to do than other returns.

GAO's review of characteristics of the audited returns during fiscal year 1996 showed that an estimated 75 percent of the returns had reported adjusted gross incomes of less than \$25,000. In part, this percentage reflects the correspondence audit's focus on simple tax issues and EIC. Specifically, these correspondence audits dealt primarily with a few types of issues reported on individual tax returns, such as EIC and self-employment taxes, as well as taxpayers who did not appear to have filed the required tax returns. Further, an estimated 20 percent of the audited returns included complex schedules, such as business and investment schedules. Such schedules included those filed by individuals to report business net profits or losses generated through self-employment and to report capital gains or losses.

Weaknesses in IRS' Correspondence Audit Processes

IRS had weaknesses in its processes for implementing correspondence audit requirements as well as for seeking taxpayers' responses. Specifically, IRS did not consistently implement all requirements in its processes for (1) classifying returns to identify issues for audit, (2) documenting the audit steps and support for audit recommendations, (3) justifying EIC claims, and (4) reviewing the quality of audits. Also, IRS did not know why over half the taxpayers audited by correspondence did not respond during the audit. Although GAO did not measure the effects of these weaknesses, each weakness can, individually or in combination, erode the integrity of the correspondence audit processes, which are designed to help ensure that taxpayers pay the correct tax amounts and are treated properly.

First, service centers did not follow IRS' requirements for classifying returns for audits and referring returns with complex business or investment schedules to districts. IRS' manual requires tax returns identified for audit to be classified so that all questionable issues are audited. However, excluding nonfilers, an estimated 69 percent of the workpapers in the audits closed in 1996 had no evidence of classification. When classification did occur, tax examiners classified most returns, some involving complex schedules for which they were not trained. IRS officials at both the National Office and the service centers said that classification was not needed for all correspondence audits but could be needed for returns having complex schedules.

GAO found evidence that less than an estimated 1 percent of the returns with complex schedules were referred, as required, to revenue agents and

tax auditors in the district offices. Such referrals are important because IRS generally has one chance to audit a return. If these complex schedules are not classified for potential audit issues, tax noncompliance is more likely to go undetected.

Second, the workpapers for the 1996 correspondence audits showed that up to about one-third of the audits had little or no evidence of how the tax examiner did the audit or supported any recommended taxes. IRS' manual requires that tax examiners adequately support their audit recommendations and document that support in the audit workpaper files. Analyses showed that the less time spent on the audit, the less documentation appeared in the workpapers. When supporting documentation is lacking, it can create uncertainty about the additional taxes recommended in those audits.

Third, the type of taxpayer documentation that was accepted to justify EIC claims varied from service center to service center. Tax examiners in at least three service centers did not follow IRS' requirement to substantiate EIC claims through third-party verification. On the basis of interviews at one of these service centers, GAO found that this weakness occurred when service center management eased requirements because of an inexperienced tax examiner work force. Examiners at the other seven centers generally required third-party verification when auditing EIC claims. GAO could not tell from analyzing IRS' audit workpapers from any service center whether taxpayers received an earned income credit to which they were not entitled or were denied a claim to which they were entitled.

And fourth, IRS' two audit quality reviews were unlikely to identify weaknesses in the audits. The workpapers for the 1996 traditional correspondence audits had evidence of supervisory review in an estimated 6 percent of the audits. IRS officials said that one reason for this low percentage is that IRS does not require supervisors to document their reviews.

Further, although IRS had weaknesses in classifying and documenting support for correspondence audits, IRS' quality measurement reviews gave high ratings in these areas. IRS' higher ratings can be explained, in part, by two types of exclusions from IRS' reviews, which usually occurred when taxpayers did not respond to IRS' request for information. First, some service centers excluded such audits (as well as those not recommending tax changes) from the quality measurement review samples, even though the audits are required to be included. Second, IRS allowed service centers

to exclude certain audits from being measured against the quality standard on workpaper documentation. These audits closed with no responses from the taxpayer and no documentation of the audit steps or support for the audit recommendations. According to IRS requirements, the workpapers still are to document the rationale for recommending additional taxes, even if taxpayers did not respond.

In addition, over half the taxpayers in the traditional correspondence audits did not respond to IRS' audit letters. Without taxpayers' responses, IRS cannot be as certain about actual tax liabilities. IRS had not collected data on why taxpayers did not respond. IRS officials believed that taxpayers were less likely to respond to standardized letters that are not audit-specific and contain legal language that some taxpayers may not understand. Tax examiners use standardized letters and do not spend time crafting audit-specific letters, given the number and simple nature of the audits. Taxpayers who did not respond to these letters were less likely to pay their additional tax assessments. Further, we estimated that 75 percent of the taxpayers who asked IRS to reconsider these assessments—or redo these audits—months after the audit closed had not responded to IRS' letters during the audit.

Recommendations

GAO recommends that the IRS Commissioner improve controls to better ensure that IRS' correspondence audit processes adhere to existing audit requirements and standards on

- classifying filed returns, and in particular, referring returns with complex schedules that may have potential tax changes to staff with sufficient knowledge to classify them;
- documenting the support for audit findings and recommendations in the audit workpaper files;
- ensuring consistency in the treatment of audited EIC claims by collecting and using the information required, including verification from third parties, to justify the claims; and
- including all types of closed audits across the 10 service centers in the samples for measuring audit quality.

GAO also recommends that the IRS Commissioner

- require supervisors in the service centers to document their reviews of audit workpapers;
- eliminate the discretion that service centers have to exclude audits that lack documentation on the audit steps and support for audit

recommendations from the calculations IRS does to measure adherence to the audit quality standard on workpaper documentation; and

- determine the reasons, through statistically valid and cost-effective means, for taxpayers' not responding to IRS' audit letters, so that IRS can identify ways to encourage more taxpayers to respond.

Agency Comments

We requested comments on a draft of this report from the Commissioner of Internal Revenue. Officials representing the Assistant Commissioner for Customer Service and the IRS Commissioner's Office of Legislative Affairs provided IRS' comments in a February 23, 1999, meeting. IRS also documented these comments in a letter dated March 12, 1999, which is reprinted in appendix V.

Overall, IRS concurred with all of our recommendations and agreed to take efforts to implement them. IRS officials provided elaboration on our recommendation involving IRS' requirement to classify returns, particularly returns with complex schedules. Given that the number of returns audited through correspondence that include complex schedules is relatively low, Customer Service officials said that they would work with the Assistant Commissioner (Research and Statistics of Income) on ways to isolate returns with complex schedules so that they are not automatically selected for correspondence audits. This would provide district offices with the opportunity to first look at these returns before they are audited through correspondence.

Contents

Executive Summary		2
Chapter 1		12
Introduction	Screening and Classification of Tax Returns	12
	The Correspondence Audit Process	14
	Audit Quality Reviews	16
	Objectives, Scope, and Methodology	16
Chapter 2		19
Correspondence	Number of Returns Audited and the Results of the Correspondence Audits	19
Audits From 1992 to 1997	Time Taken to Conduct Correspondence Audits	21
	Profile of Tax Issues Audited Through Correspondence	22
	Profile of Tax Returns Audited Through Correspondence	23
Chapter 3		25
Weaknesses in	Most Tax Returns Audited Through Correspondence Were Not Classified	25
Processes and	Audits Did Not Always Have Adequate Documentation	26
Requirements for	Some Service Centers Accepted Differing Levels of Justification for EIC Claims	28
Selecting and	Limited Supervisory Reviews and Audit Quality Reviews	29
Conducting	Minimal Contact With Nonresponsive Taxpayers	31
Correspondence	Conclusions	33
Audits	Recommendations	35
	Agency Comments and Our Evaluation	36
Appendixes	Appendix I: Overview of Audit Processes at Service Centers and District Offices	38
	Appendix II: IRS' Auditing Standards and Key Elements for Correspondence Audits	41
	Appendix III: Sampling and Data Analysis Methodology	42
	Appendix IV: Additional Comparisons of IRS Service Center Workloads	45
	Appendix V: Comments From the Internal Revenue Service	48
	Appendix VI: Major Contributors to This Report	52
Tables	Table 2.1: Number of Returns Audited and Additional Taxes Recommended for Correspondence Audits	19

Table 2.2: Frequency of Audit Closures for Correspondence Audits in Total, Fiscal Years 1992-97	21
Table 2.3: Comparison of Annual Incomes of Taxpayers Audited Through Correspondence to All Taxpayers Filing Tax Returns	24
Table 3.1: Extent to Which Workpaper Files Had an Audit Trail and Supporting Documentation on Audited Issues for Returns in Our 1996 Study Population	27
Table II.1: IRS' Audit Standards and Key Elements for Correspondence Audits	41
Table IV.1: Correspondence Examination Workload by Service Center for Fiscal Year 1992	45
Table IV.2: Correspondence Examination Workload by Service Center for Fiscal Year 1993	45
Table IV.3: Correspondence Examination Workload by Service Center for Fiscal Year 1994	46
Table IV.4: Correspondence Examination Workload by Service Center for Fiscal Year 1995	46
Table IV.5: Correspondence Examination Workload by Service Center for Fiscal Year 1996	47
Table IV.6: Correspondence Examination Workload by Service Center for Fiscal Year 1997	47

Figures

Figure 1.1: Simplified Overview of the Correspondence Audit Process	15
Figure 2.1: Percentage of Time That Each Issue Occurred in Traditional Correspondence Audits, Fiscal Year 1996	23
Figure I.1: Process for Selecting Individual Tax Returns for Audit	40

Abbreviations

AIMS	Audit Information Management System
CEQMS	Correspondence Examination Quality Management System
DIF	Discriminant function
EIC	Earned Income Credit
IRS	Internal Revenue Service
TEFRA	Tax Equity and Fiscal Responsibility Act of 1982

Introduction

Using a variety of tools, IRS checks all individual income tax returns filed each year for compliance with the tax laws. These compliance checks include reviews of some required information, such as signatures and social security numbers, at the time a return is filed; computerized corrections of what IRS labels “math errors;”¹ computerized matching of information, such as income, with the corresponding information reported to IRS by third parties; and audits.

IRS audits individual income tax returns to help ensure that taxpayers pay their proper tax liability. Audits are one of the enforcement tools used by IRS in its efforts to close the tax gap—the amount of taxes owed but not voluntarily paid. IRS’ most recent estimate put the individual tax gap at over \$125 billion for 1992. IRS also estimates that it eventually collects about one-quarter of the gross tax gap through its enforcement efforts.

The audits account for a small share of the returns filed annually—about 1 or 2 percent. Between 1992 and 1997, IRS audited between 1 million and 2 million individual income tax returns per year. In 1996, when about 119 million individual income tax returns were filed, IRS audited 1.9 million returns—1.1 million at its 10 service centers and about 760,000 at its 33 district offices. In selecting returns to audit, IRS attempts to identify those that are most likely to have errors—or audit potential—owing to questionable tax issues such as income, deductions, exemptions, and credits. IRS’ process for selecting returns with the highest audit potential is important because audits can be costly for both taxpayers and IRS.

In recent years, Congress has been concerned about IRS’ use of its enforcement tools, particularly about whether the tools are used fairly and in a manner that does not impose excessive burdens on taxpayers. Concerns such as these led, in part, to the passage of the IRS Restructuring and Reform Act of 1998. The act included provisions affecting audits.

Screening and Classification of Tax Returns

IRS uses both computer technology and manual review to select returns for audit. This selection process results in a determination of whether a return has audit potential. If the return does, the process helps identify specific tax issues to be audited (audit issues) and the audit technique to be used—correspondence sent to taxpayers from IRS’ service centers or meetings with taxpayers or their representatives through IRS’ district offices.

¹For returns with math errors, IRS notifies taxpayers about the errors and the adjusted tax liabilities through computer-generated letters. The letters are similar to those used for correspondence audits.

IRS uses computer programs to screen tax returns filed each year by individual taxpayers for audit potential. One program utilizes a computerized series of discriminant function (DIF) formulas to compute a score for each return. The higher the score, generally speaking, the greater the likelihood that the return's reported tax would be changed if audited. Districts have used DIF scores as a primary source to select most of the returns they audited. Service centers rarely use DIF scores because centers usually focus on one audit issue, whereas DIF focuses on returns with multiple, more complex issues.

Service centers have their own computer programs to identify returns with issues to be audited through correspondence. The types of issues to be audited vary from year to year as Congress, IRS, and the local district offices and service centers focus on particular aspects of the tax law. For example, in recent years, earned income credit (EIC) claims and individual retirement account penalties have been highlighted by the service centers.

Once the screening programs have identified tax returns with audit potential, the returns are to be reviewed (or "classified") by qualified staff for each district office and service center. IRS requires the returns to be classified to determine which can be accepted as filed and, if not accepted, to identify all potential audit issues.² IRS allows tax returns to be classified by different types of auditors, depending on the complexity of the returns and the issues. Returns with more complex audit issues that require personal contacts with the taxpayers are to be reviewed by revenue agents or tax auditors. Returns with less complex issues that can be audited through correspondence are to be sent to service centers to be reviewed by tax examiners. (See app. I for detailed explanations of screening and classification.) Once returns are classified and selected for audit, any identified audit issue is to be documented in the audit workpaper file.

The IRS staff who do the classification have varying degrees of training and audit experience. Revenue agents are the highest graded auditors and are required to have at least 24 hours of college-level accounting courses to audit the most complex tax returns from corporations, other businesses, and higher income individuals. Tax auditors, who usually have some accounting education, audit less complex issues by meeting with taxpayers at the district offices. Service centers use tax examiners to audit the simpler individual issues. Tax examiners, who are not required to have any

²Identifying all potential audit issues is important because the Internal Revenue Code, section 7605(b), provides for only one inspection of a taxpayer's books or records per tax year unless the taxpayer requests another inspection or unless the Secretary of the Treasury notifies the taxpayer in writing that an additional audit is necessary.

accounting education, audit simple issues through correspondence and are not trained to audit complex issues on business and investment schedules attached to tax returns.

The Correspondence Audit Process

According to IRS, tax returns assigned to the service centers are to involve only one or two simple tax issues, such as EIC claims, that can be audited through correspondence. Correspondence audits are to exclude complicated tax issues, such as those on business and investment schedules, and are designed to quickly review a taxpayer's support for the tax issues.

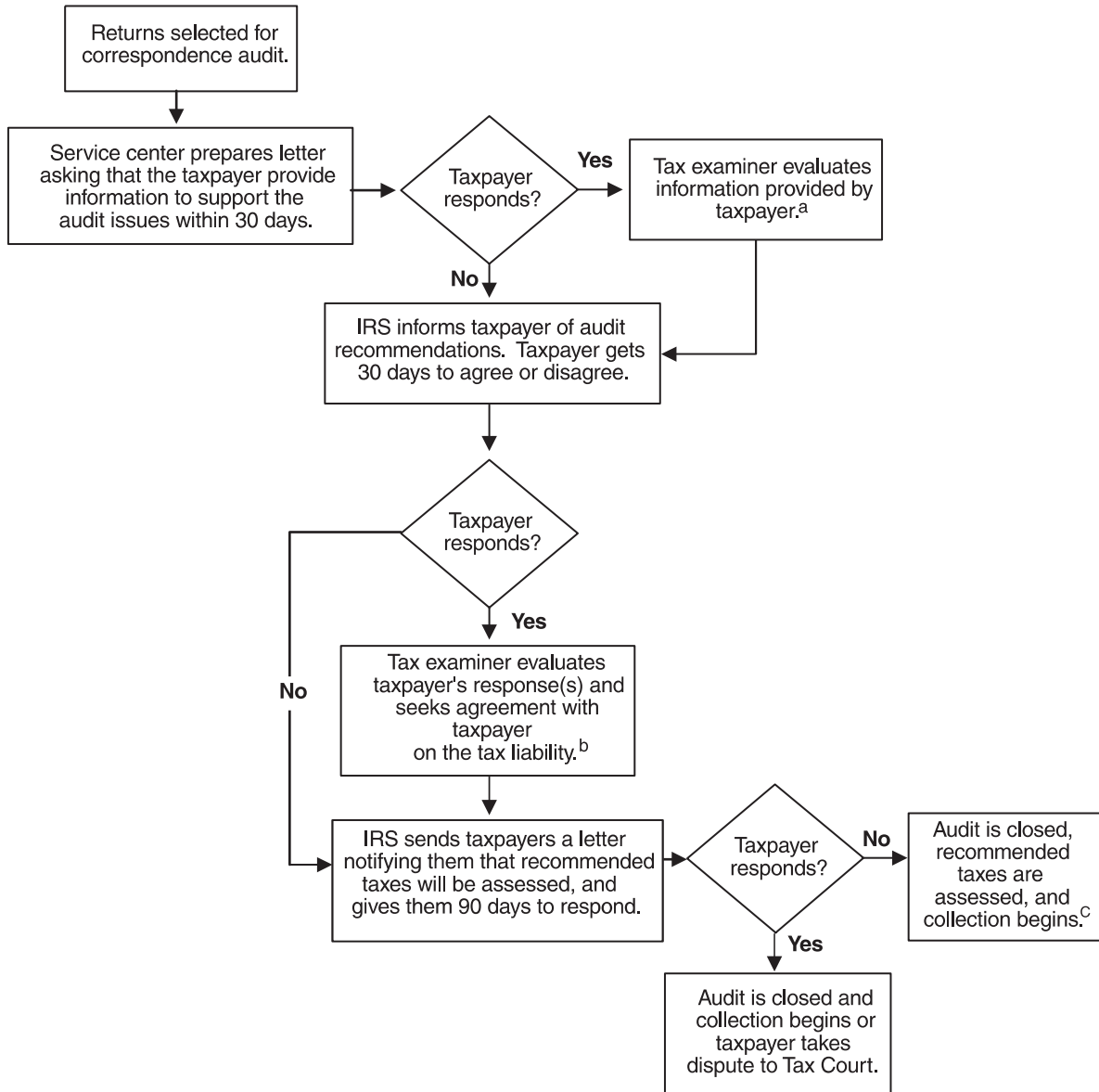
The time needed to audit returns and establish the appropriate tax liability depends, in large part, on the number of letters IRS sends to taxpayers and the sufficiency of the taxpayers' responses. IRS typically sends two letters—one asking for information or documentation and at least one reporting any changes to the tax liability reported on the tax return as a result of the audit. (See fig. 1.1.)

IRS service centers send an initial letter to notify taxpayers of the issues on the return to be audited and to request information on those issues within 30 days. If the taxpayer provides the information requested, a tax examiner is to determine whether it supports the audit issues. If it does provide the support, the tax return can be accepted as filed and the audit closed with no change in the reported tax liability. If the information does not support the issues, the tax examiner can request further clarification or documentation. After reviewing all the submitted information, the tax examiner determines whether additional taxes are warranted. Should the taxpayer not provide information to support the audit issues, the tax examiner is to treat the issues as unsubstantiated and recommend additional taxes.

Whether or not the taxpayer responds to IRS' initial letter, IRS is to notify the taxpayer in writing of the results of the audit, such as whether the tax examiner is recommending any changes to the reported tax liability and, if so, the amount of change. This IRS letter also gives taxpayers a 30-day period to agree or disagree with the recommended results. If the taxpayer agrees, any recommended tax changes are to be assessed as taxes owed. If the taxpayer disagrees, IRS is required to inform the taxpayer of the right to file a protest with IRS' Appeals Office to determine whether the recommended taxes should be assessed.³

³IRS' Appeals Office is charged with trying to settle tax disputes without litigation on the basis of what is fair to the government and the taxpayer.

Figure 1.1: Simplified Overview of the Correspondence Audit Process



^aBased on the information provided, the examiner can close the audit with no changes to the tax liability.

^bTaxpayers can agree or disagree with any proposed changes to their tax liability. If taxpayers disagree, they can ask IRS' Appeals Office to determine whether the recommended tax amounts should be addressed as an additional tax liability.

^cFor various reasons, not all recommended tax amounts are assessed and not all assessed tax amounts are collected, regardless of the type of IRS audit.

Source: GAO summary of IRS data.

Taxpayers who do not respond to these 30-day letters are to be sent another notice giving them an additional 90 days to respond before the recommended taxes are formally assessed. If the taxpayer does not respond to this 90-day letter, the recommended taxes are to be assessed, and the matter is to be referred to IRS' Collection Division.⁴

In addition to the formal appeals process, IRS allows taxpayers who disagreed with the audit results or who did not respond to IRS' audit letters to ask for a reconsideration of any additional taxes that were assessed as a result of an audit. IRS extends this option to taxpayers who provide new information about these assessed taxes, including those who bypassed opportunities to resolve their disputes in IRS' Appeals Office or the Tax Court.

Audit Quality Reviews

IRS has two quality review functions to see whether correspondence audits comply with its requirements and standards.⁵ The audit standards include such requirements as adequate consideration of all significant audit issues and workpaper support for all audit findings. (See app. II, which describes each standard.)

The first review is to be carried out by supervisors who are to periodically review the tax examiners' work during the audits. The results of these reviews are to be used in the tax examiners' performance evaluations, but IRS does not require supervisors to document the results in the audit workpaper files.

The second review is to be performed by quality assurance staff within the service centers. The staff are to review a sample of all closed audits for adherence to IRS' requirements and audit standards. The results of these reviews are to be entered into the Correspondence Examination Quality Management System (CEQMS) database and used to identify procedural and systemic weaknesses and to develop improvements where needed.

Objectives, Scope, and Methodology

In response to a request from the Chairman, Subcommittee on Oversight, House Committee on Ways and Means, this report (1) provides information on the number, results, and duration of correspondence audits as well as the characteristics of the audited returns and (2) examines the processes

⁴Upon receipt of the 90-day letter, the taxpayer may petition the Tax Court to resolve the disputed tax liability.

⁵IRS also does "Action 61" reviews to determine whether tax examiners are responsive with taxpayer inquiries. These reviews consider such items as professionalism, timeliness, and language used.

and requirements that IRS has had for years to govern correspondence audits.

To provide information on the number, results, and duration of correspondence audits, we gathered data from various IRS sources. We gathered detailed data on audits closed in fiscal years 1992-97 from IRS' Audit Information Management System (AIMS), including the number of audits, amount of additional taxes recommended, and type of audit closures (e.g., no tax changes). For the duration and other characteristics, we gathered data from a statistically valid sample of traditional correspondence audits closed in fiscal year 1996 by reviewing audit workpaper files and IRS' individual masterfile data.⁶ We did not check the reliability of IRS' data in AIMS and the masterfile.

In selecting the 1996 sample, we sought traditional correspondence audits, which required us to exclude certain types of workload. According to Customer Service officials, most returns audited in fiscal year 1996 were not the traditional correspondence workload. Rather, they included work on EIC returns that misreported Social Security numbers—which IRS transferred out of the audit program to the math-error adjustment program in 1997.⁷ Therefore, with the concurrence of the Customer Service officials, we excluded these and other types of tax returns from our sample to allow us to analyze more traditional correspondence audit work.⁸

This adjusted the fiscal year 1996 total of 1.1 million tax returns audited to 335,050 returns, from which we randomly selected 502 returns. We stratified our sample by whether (1) the taxpayer responded to IRS' letters and (2) a tax change was recommended. IRS located 446 of the 502 tax returns and related audit workpapers for us to analyze. (See app. III for a detailed description of our sampling methodology.)

To examine IRS' processes and requirements for correspondence audits, we collected documentation and did interviews at IRS on those processes and requirements. We then used three methodologies. First, we reviewed

⁶Because our review pertains to traditional correspondence audits closed in 1996, all results are subject to sampling errors. Unless otherwise noted, all estimates of percentages in this report have a 95-percent confidence interval of less than plus or minus 10 percentage points.

⁷Congress created EIC in 1975 to help workers offset payroll taxes and stay off welfare. In 1994, Congress expanded EIC eligibility.

⁸For example, we also excluded audits of certain types of partnership returns as defined under the Tax Equity and Fiscal Responsibility Act (TEFRA). In these audits, tax adjustments flowed through service centers to allow necessary adjustments to be made to individual partners' accounts on the basis of audits by district office auditors of the partnership.

the 446 tax returns in our sample and related audit workpaper files. For these returns, IRS' Fresno Service Center also provided masterfile account data on what happened to the additional taxes assessed as of April 1998. Second, we received written comments to a survey from all 10 service center Compliance chiefs on the processes and requirements. And third, we interviewed Examination officials at the National Office, as well as the Directors, Compliance chiefs, Examination chiefs, and selected Examination officials in 4 of IRS' 10 service centers: Andover, MA; Fresno, CA; Kansas City, MO; and Memphis, TN. (See app. IV for a comparison of workloads at the service centers.)

We requested comments on a draft of our report. IRS provided comments in a meeting on February 23, 1999, and a letter dated March 12, 1999.

We have incorporated these comments as appropriate. We have also summarized the comments at the end of chapter 3 and have reprinted the letter in appendix V.

We performed our audit work between September 1997 and August 1998 in accordance with generally accepted government auditing standards.

Correspondence Audits From 1992 to 1997

During fiscal years 1992-97, the correspondence audit program experienced distinct shifts. IRS tripled the number of returns audited from 1992 to 1994-95 before reducing its correspondence audit inventory in 1997. A higher percent of the audits closed with no tax changes during fiscal years 1994-96, and the percent of audits that closed with no response from taxpayers more than doubled from 1995 to 1997.

In terms of the characteristics for the traditional correspondence audits closed in 1996, an average of about 11 months elapsed between the start of the audit and the assessment of any taxes recommended during the audit. Many of the audited returns included complicated business and investment schedules that were not audited. Because so many of the correspondence audits in our study population year dealt with EIC claims, the reported income of most of the audited taxpayers was below \$15,000.

Number of Returns Audited and the Results of the Correspondence Audits

The number of correspondence audits and their results varied considerably between 1992 and 1997, with three distinct periods.¹ As discussed with Customer Service officials and shown in table 2.1, these periods were 1992-94, 1995-96, and 1997.

Table 2.1: Number of Returns Audited and Additional Taxes Recommended for Correspondence Audits

Fiscal year	Number of audited returns ^a	Direct audit hours	Direct audit hours per return audited	Staff years	Additional taxes recommended (dollars in millions) ^b	Recommended taxes per return audited
1992	339,120	273,744	0.8	3,224	\$740.1	\$2,182
1993	232,237	245,692	1.1	3,107	576.7	2,483
1994	352,596	336,992	1.0	3,223	621.4	1,762
1995	1,054,573	703,848	0.7	3,969	1,368.6	1,298
1996	1,113,646	749,058	0.7	3,536	1,765.9	1,586
1997	757,670	572,957	0.8	3,048	2,170.5	2,865

^aThese figures do not include TEFRA returns.

^bIRS does not assess or collect all of these additional recommended taxes. Our earlier work shows, as of September 1997, that IRS assessed 76 percent and collected 43 percent of the additional taxes recommended in service center correspondence audits that closed in fiscal year 1997. See [Tax Administration: IRS Measures Could Provide a More Balanced Picture of Audit Results and Costs](#) (GAO/GGD-98-128, June 23, 1998).

Source: GAO analysis of IRS data.

In the first period (fiscal years 1992-94), the number of tax returns IRS audited through correspondence totaled a few hundred thousand annually. Comparing 1992 to 1994, the amount of taxes recommended overall and

¹The number of returns audited and the results of correspondence audits also varied by service center. Appendix IV provides these numbers and results across the 10 service centers for fiscal years 1992-97.

per audited return declined. According to Customer Service officials, these 3 fiscal years represented IRS' traditional practices for doing correspondence audits.

In the second period (fiscal years 1995-96), IRS' correspondence audit inventory increased to over 1 million returns annually because of an increase in audits of returns that claimed EIC. Almost 800,000 of the audits that closed in 1996 involved EIC returns with missing or invalid Social Security numbers.² This increased audit focus on EIC arose from congressional concerns about EIC noncompliance. With the threefold increase in audits, the amount of recommended taxes more than doubled. As a result, the tax amounts recommended per audited return declined by as much as about half (from \$2,483 in 1993 to \$1,298 in 1995).³

In the third period (fiscal year 1997), IRS decreased the correspondence audit inventory to about 758,000. Customer Service officials told us that IRS moved over 700,000 EIC returns with misreported Social Security numbers to its math-error adjustment program. To partially substitute for these transferred audits, the officials said IRS began auditing more individual retirement accounts and potential nonfilers.⁴ With this shift in the audit inventory in 1997, the number of audited returns and staff years decreased and the amounts of taxes recommended overall and per audited return increased compared to 1996. With the new types of tax issues being audited, the audits were more likely to recommend tax changes in higher amounts compared to audits of other types of issues such as EIC.

The large number of audited EIC returns also affected audit closures. From 1992 to 1994, less than 25 percent of the audits closed with no changes to tax liability. Further, the default rate—that is, the rate at which audits closed when taxpayers did not respond to tax assessment notices—remained relatively constant at around 40 percent. With the inclusion of EIC returns in 1995, the no-change rate doubled to 46 percent, and the default rate initially dropped to 29 percent. After the EIC returns were transferred to the math-error adjustment program in 1997, the no-change rate decreased to the 1992 level, but the default rate more than doubled

²Although our study population for fiscal year 1996 excluded this type of EIC return from the audit inventory, IRS still audited many other types of EIC claims.

³A contributing factor was that many of these EIC audits recommended either no change to the tax liability or lower amounts of tax changes compared to audits of other tax issues.

⁴Potential nonfilers, as the name implies, are those who may not have filed returns. When IRS is unable to find a return that matches financial information reported by employers or financial institutions, it prepares a tax return for the nonfiler (an SFR or Substitute for Return) and computes the tax liability based on the reported information.

compared to 1995, reaching 63 percent. Table 2.2 shows these shifts in audit closures over the three time periods.

Table 2.2: Frequency of Audit Closures for Correspondence Audits in Total, Fiscal Years 1992-97

Fiscal year	Audited returns closed as					Total ^c
	Agreed	Unagreed	No change	Default ^a	Undeliverable ^b	
1992	28%	3%	13%	41%	14%	100%
1993	27	4	16	43	9	100
1994	31	4	23	36	6	100
1995	17	1	46	29	6	100
1996	15	2	36	43	4	100
1997	15	4	13	63	6	100

^aIRS closed the audit with a recommended tax assessment, and the taxpayer did not respond to IRS' letter on the assessment.

^bIRS closed the audit with a recommended tax assessment when the letter on the audit recommendations was returned to IRS.

^cPercentages may not sum to 100 due to rounding.

Source: GAO analysis of IRS data.

Time Taken to Conduct Correspondence Audits

In the correspondence audit process, many audits are started soon after the returns are filed, while others are started a year or more later. For returns involving EIC claims, beginning the audit soon after the return is filed increases the likelihood that the issues can be examined before any tax refunds are released. For other returns filed in the spring, the audits often do not begin until the following winter.⁵ Audits of taxpayers who do not file tax returns may take a year or more to begin.

For traditional correspondence audits closed in 1996, we found that the time between the filing of the return and the start of the audit averaged 10 months, and the time between the start of the audit and the assessment of any additional taxes took, on average, over 11 more months. The length of the audit varied, depending on whether taxpayers responded and how it was closed. On the one hand, audits took about 7 months⁶ when taxpayers responded to IRS' notice of audit and the audits closed without recommending additional taxes. On the other hand, when taxpayers did not respond to IRS' 90-day letters notifying them of any additional tax assessments and the audits closed with the taxpayer defaulting, audits took much longer. For example, an average of about 13 months elapsed between the start of the audit and the assessment of any additional taxes.

⁵This delay is often necessary to allow IRS to enter return data into its computers, associate tax returns with information returns (e.g., Forms W-2 and 1099), process returns filed after April 15, and classify returns for audit potential.

⁶The 95-percent confidence interval for this estimate ranges from a low of 185 days to a high of 248 days.

Seven months of this time were spent simply waiting for the taxpayers to respond to one or more of IRS' letters.

For these audits, the average time that elapsed from the filing of the return to the additional tax assessment was 21 months. This elapsed time is significant in two respects. First, IRS collects 27 percent of taxes assessed through correspondence audits before the assessment becomes final and another 49 percent within 15 weeks of the final assessment.⁷ Second, Congress' 1998 legislation to restructure IRS contains provisions that suspend the accrual of interest and some penalties if IRS fails to notify the taxpayer of additional tax liabilities within 18 months after a return is filed.⁸ After 2003, suspension will begin 12 months after the tax return is filed. Delays in completing the audit, therefore, could reduce revenue from penalty and interest assessments.⁹

Aside from these considerations, the time to assess any recommended taxes in these audits may be extended if taxpayers choose to exercise their right to appeal these audit recommendations. For audits being appealed or otherwise disputed by the taxpayer, a long amount of time can elapse before a determination on the tax assessment can be reached.

Profile of Tax Issues Audited Through Correspondence

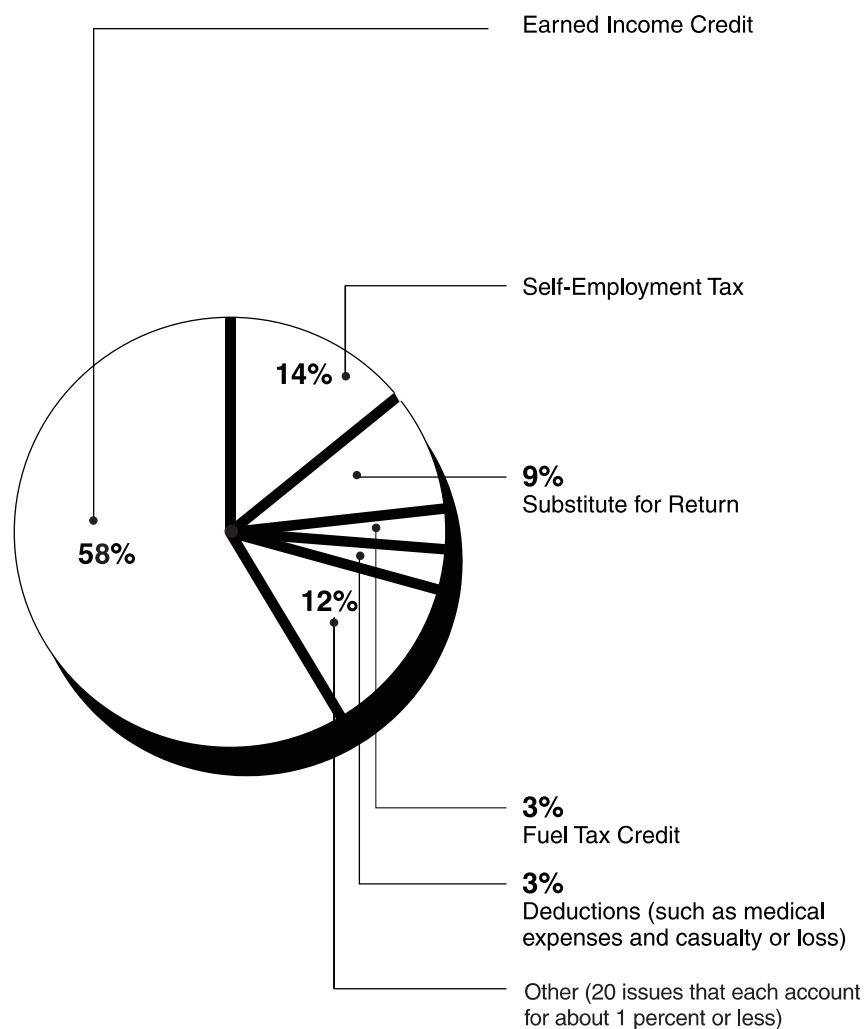
The traditional correspondence audits closed in 1996 dealt with a few types of simpler tax issues rather than the more complex business and investment tax issues on individual returns. The types of tax issues audited through correspondence primarily included EIC claims and self-employment tax. On average, each traditional correspondence audit dealt with two tax issues. As figure 2.1 shows, EIC and related issues, such as the taxpayer's filing status and dependent exemptions, accounted for over half of these audited tax issues.

⁷Percentages are taken from an earlier analysis of correspondence audits closed in fiscal year 1992. See GAO/GGD-98-128, June 23, 1998.

⁸The legislation is not explicit, however, on which IRS letter—the one recommending additional tax assessments or the one notifying taxpayers of the tax assessment—will serve to notify the taxpayer.

⁹According to Customer Service officials, to reduce the time to identify any additional assessments through audits as well as to give taxpayers more options, four service centers will be testing during fiscal year 1999, the impact of a new letter that combines the initial letter and the 30-day letter. This new letter will give taxpayers the choice of agreeing to pay a specific amount of tax and interest (as well as any penalty amount) at the start of the audit. If taxpayers do not agree to pay, they can respond by providing information in support of the original tax amount that they reported.

Figure 2.1: Percentage of Time That Each Issue Occurred in Traditional Correspondence Audits, Fiscal Year 1996



Source: GAO summary of IRS data.

Profile of Tax Returns Audited Through Correspondence

Although IRS' traditional correspondence audits closed in 1996 usually addressed simpler tax issues, an estimated 65 percent of the audited returns had at least one schedule attached. Many of these schedules (such as C, D, E, and F) reported more complex business and investment tax

issues that were not audited. For the audited returns with schedules, an estimated

- 61 percent had schedules supporting their EIC claims;
- 26 percent had a schedule A or B to report itemized deductions or interest and dividend income;
- 22 percent had a schedule C to report business income from self-employment;
- 10 percent had a schedule D to report capital gains or losses;
- 8 percent had a schedule E to report gains or losses from rental property, partnerships, and other entities; and
- 3 percent had a schedule F to report income from farming.

In addition, the individual taxpayers subjected to traditional correspondence audits that closed in 1996 usually reported annual incomes of less than \$15,000 on their audited returns. In fact, as table 2.3 shows, an estimated 76 percent of the audited returns reported taxable incomes of less than \$15,000. However, 44 percent of all income tax returns filed by individuals in 1996 reported taxable incomes of less than \$15,000. The returns audited through correspondence tend to report income below \$15,000 because they also report simpler tax issues and EIC claims, both of which can be associated with lower amounts of income.

Table 2.3: Comparison of Annual Incomes of Taxpayers Audited Through Correspondence to All Taxpayers Filing Tax Returns

Range of reported income	Percent of individual tax returns			
	1996 traditional audit population by		1996 data on filed tax returns by ^a	
	Adjusted gross income	Taxable income	Adjusted gross income	Taxable income
\$0 < \$15,000	55%	76%	34%	44%
\$15,000 < \$25,000	20	6	18	17
\$25,000 < \$50,000	13	12	25	24
\$50,000 < \$100,000	9	4	17	11
\$100,000 and over	3	2	5	4
Total	100%	100%	99%^b	100%

^a1996 represents the filing year and not the year the audits were closed.

^bPercentages may not sum to 100 due to rounding.

Source: GAO analysis of results from our study population and IRS data.

It is important to recognize that table 2.3 does not compare all taxpayers with audited returns to all taxpayers who filed returns. Taxpayers with higher annual incomes and more complex tax issues are typically audited through IRS district offices using other types of audit methods than correspondence audits.

Weaknesses in Processes and Requirements for Selecting and Conducting Correspondence Audits

The correspondence audit process is one of the tools IRS uses to help ensure that taxpayers pay their proper tax liability. It is designed to audit, through the mail, all questionable issues identified on less complicated tax returns. However, our work pointed to a number of weaknesses in the processes for implementing requirements for selecting returns to audit and for auditing those returns.

Most Tax Returns Audited Through Correspondence Were Not Classified

We found that service centers did not follow IRS' requirements for classifying returns and referring returns with complex business or investment schedules to district offices. IRS manuals state that after being identified for audit, tax returns should be classified to ensure that all issues worth auditing are identified. Returns with complex issues and schedules are to be classified by revenue agents or tax auditors who have the training and experience with complex tax issues. Returns with less complicated issues can be classified by tax examiners. However, service centers used tax examiners to classify most returns, some of which involved complex schedules, and rarely referred returns with complex schedules to an IRS district office.

In examining the administrative files and audit workpapers for the traditional correspondence audits closed in 1996, we found that, excluding nonfilers, an estimated 69 percent did not have any evidence of classification as required. When returns are not classified by trained staff, potential noncompliance may go undetected. Moreover, the lack of classification can lead to IRS' unnecessarily auditing returns or issues and thus burdening taxpayers.

For the returns that had been classified, we found indications that tax examiners did most of the classification. Having tax examiners classify one or two issues on simpler tax returns is to be expected. However, in 1996, an estimated 20 percent of the tax returns traditionally audited through correspondence included complex business and investment schedules.¹ Specifically, IRS requires returns with more than one business schedule or schedules C or F to be referred to district offices for classification and possible audit. We found referrals of such returns to IRS district offices in less than an estimated 1 percent of the traditional correspondence audits.

We reviewed a judgmental sample of about 30 files with these complex returns and found that one-third could have merited referral to a district.

¹We estimate that 50 percent of the workpapers for these returns with complex schedules (schedules C, D, E, or F) had no evidence of classification. The 95-percent confidence interval for this estimate ranges from 38 to 62 percent.

For example, we found complex business returns that deducted sizable expense amounts compared to the reported business income but no evidence that anyone at IRS looked at the audit potential of these deductions. Without a control such as classification of returns with complex schedules by IRS tax auditors or revenue agents with commensurate training and experience, IRS could not verify whether returns slated for correspondence audits should have been referred to district offices.

We surveyed compliance chiefs at all 10 service centers, who confirmed that not all returns are classified and that tax examiners do most classifications. For example, five chiefs noted that their service centers usually classify less than one-third of the returns they audit. When classification occurs, tax examiners classify 85 percent or more of the returns according to six compliance chiefs; the other four centers use tax examiners but also use tax auditors or revenue agents. Two compliance chiefs added that tax examiners are trained to audit simple issues and are not ideal for classifying returns with complex issues. Also, many chiefs noted that service centers might not have referred returns with complex issues because they believed the returns would not meet district office criteria. They said service centers tend to receive returns because computerized criteria targeted a simpler issue to audit, usually before districts began their classification of returns.

In our follow-up on the classification practices, Customer Service officials told us that not all tax returns needed to be classified to identify all potential audit issues. They said that correspondence audits were designed for quickly auditing one or two issues through the mail and then moving on to other audits with similar types of issues. As a result, these officials said that a fuller classification beyond the one or two issues is unnecessary for simple returns, which most of the audit workload comprises. However, these officials also said that such a fuller classification might be useful for returns with complex issues and schedules.

Audits Did Not Always Have Adequate Documentation

IRS' manuals and audit quality standards require that tax examiners adequately support their audit recommendations in the audit workpaper files. Officials at the four service centers we visited told us that documents with information on the case history, audit issue development, and support for recommended taxes are key documents in developing an audit trail on the examiners' actions as well as in documenting support. Without an audit trail or documented support, neither IRS nor the taxpayer can be assured of the basis for any additional taxes recommended.

Our analysis of these and other documents in the workpaper files for traditional correspondence audits closed in 1996 showed that about one-third of the audits had little or no evidence of documents to explain the audit trail. Furthermore, about one-fourth of the issues audited had little or very little support in the workpaper files for the recommended additional taxes. In making our determination, we looked for these key documents or any evidence to show what the tax examiners did or how they arrived at certain tax recommendations. When any evidence was in the files, we assessed the extent to which it documented the tax examiners' actions, ranging from none or a very little extent to a very great extent. Kansas City Service Center staff confirmed our determinations for files with none or a very little extent. (See table 3.1.)

Table 3.1: Extent to Which Workpaper Files Had an Audit Trail and Supporting Documentation on Audited Issues for Returns in Our 1996 Study Population

Extent	Audit trail ^a	Supporting documentation ^b
Very great	7%	9%
Great	28	27
Some	31	38
Little	25	17
Very little	^c	8
None	9	^c
Total	100	99

Note: Percentages may not sum to 100 due to rounding.

^aThis analysis is based on an estimated 335,050 tax returns in the traditional correspondence audits closed in 1996.

^bThis analysis is based on an estimated 776,200 audited issues on tax returns in the traditional correspondence audits for which an indication of supporting documentation was given.

^cNot applicable.

Source: GAO analysis of results from our study population.

In attempting to determine the reasons for this lack of documentation, our analyses showed a direct relationship between the amount of time charged and degree of documented support. That is, the less time charged to an audit, the less the workpapers documented the audit findings. (See app. III for a detailed description of our analyses.) It is possible that some audits may be so brief that documentation to a little extent may be enough. For example, Customer Service officials said that audits of nonfilers or in which taxpayers did not respond might have less documentation. However, these officials could not describe an audit for which no or very little documentation would be acceptable.

At two of the four service centers we visited, we found that management affected how much time tax examiners spent documenting their work. For example, the Andover Service Center management told us they encouraged tax examiners to document their work in the files. We found

that Andover examiners spent 1.2 hours per audited return in 1996 and were generally consistent in documenting their work in the files. However, the Fresno Service Center management eased documentation requirements in 1996 because of the increase in EIC work. As such, Fresno tax examiners spent 0.6 hours per audited return and had a larger proportion of audit files with little or no audit trail or documented support for the additional taxes recommended.

Compliance chiefs in the four service centers we visited told us that the significant increase in the number of audits during 1995 and 1996 added pressure on tax examiners to respond to taxpayers within prescribed time frames and to close the audits as quickly as possible. They said service centers with the greatest increase in workload had even more pressure to quickly audit the returns. As a result, they said the tax examiners had difficulty documenting their audit work when they were expected to quickly audit so many returns.

In addition to the increased workload, the four chiefs also indicated that service center management diverts tax examiners from their audit work to assist in nonaudit duties, such as answering telephone calls during the filing season. According to various service center officials, the filing season is a critical time for tax examiners because most of the EIC workload is done then. Thus, they said these diversions placed additional pressure on the tax examiners to work quickly.

Some Service Centers Accepted Differing Levels of Justification for EIC Claims

Because the traditional correspondence audits that closed in 1996 contained a large number of returns claiming EIC, we determined whether the service centers adhered to IRS' seven-point eligibility test, including third-party verification to support the EIC claims. For example, taxpayers claiming EIC are required to provide information on the children being served by EIC, such as their birth dates, Social Security numbers, and school records. IRS sends taxpayers a questionnaire with the initial letter to solicit documentation, including information from third parties, that justifies their EIC claims.

We found that the 10 service centers accepted differing levels of documentation to justify EIC claims. For the traditional correspondence audits that closed in 1996, at least three service centers allowed EIC claims based on assurances from the taxpayers but without documentation or third-party verification. Officials at one of the three service centers stated that the documentation requirements were eased because the center's tax examiner work force was inexperienced and unable to otherwise audit the large volume of returns within the prescribed time frames. As taxpayers

responded to IRS' letters, service center management pushed the tax examiners to provide timely responses. To do this as quickly as possible, the service center eased the documentation requirements. We did not ask IRS to check these EIC claims to determine whether any of these taxpayers received an EIC to which they were not entitled or were denied a claim to which they were entitled.

The other seven service centers required varying degrees of taxpayer and third-party justification. Of these seven service centers, at least three required taxpayers to submit documentation, such as birth certificates and Social Security cards or third-party residency verification from schools or day care providers.

Limited Supervisory Reviews and Audit Quality Reviews

IRS has two levels of review to check whether correspondence audits adhered to established requirements and audit standards. The first review is to be performed by the tax examiners' supervisors while the audits are being conducted. A second review is to be conducted on a sample of closed audits by each service center's audit quality staff to measure adherence to the audit quality standards.

We found evidence of supervisory review in an estimated 6 percent of the workpaper files for the traditional correspondence audits. In searching these files, we counted any supervisory comment that pertained to the quality of the audits and the support for the auditor's recommendation. We also found that the requirement for supervisory review varied by service center. For example, one center required supervisors to review all the "no-change" audits plus the audit workload of each tax examiner monthly. Another center required supervisors to review eight audits per tax examiner per quarter. A third center required reviews of six audits per examiner for an entire year.

Customer Service and service center officials told us that supervisors could not have reviewed all of the 1.1 million audits that were closed in 1996. They explained that the number of audits that can be reviewed depends on the supervisor's workload, which typically includes overseeing between 10 and 15 tax examiners, with each examiner having roughly 50 audits ongoing at any given time. The officials said they believed that the supervisors reviewed more than 6 percent of the closed audits. It may be possible that some supervisors did reviews but just did not document them. IRS does not require supervisors to document their reviews against the audit quality standards in the audit workpapers. Even so, after we shared the results of our analyses of the 1996 audits, Andover Service

Center officials said they would implement a control to ensure that supervisory reviews were documented in the workpapers.

As for the reviews to measure audit quality, IRS requires each service center to review a sample of all its correspondence audits closed annually, regardless of how they closed, for adherence to IRS' audit standards. For this sample, service centers are required to rate adherence to audit standards, such as the existence of documentation in the workpapers on the audit steps, and support for audit recommendations, such as additional taxes. The results of these reviews are to be entered into the Correspondence Examination Quality Management System (CEQMS) and analyzed to measure the extent of adherence to each quality standard and to identify problem areas.²

Further, we found some disparities between the CEQMS data and our results. For example, the CEQMS data for the correspondence audits closed in 1996 showed that almost 100 percent of the audits had been appropriately classified and that 96 percent of the audits met IRS' standards for workpaper documentation. However, as stated earlier, our review of the workpapers for traditional correspondence audits closed in 1996 found that, excluding nonfilers, an estimated 69 percent had no evidence of classification, and an estimated 34 percent had little or no evidence of documents to explain the audit trail. We asked IRS officials about these disparities. Customer Service officials had no opinions about the reasons for the disparities. Officials at 6 of IRS' 10 service centers attributed the disparities to unreliable CEQMS data because service centers are excluding certain types of audits from the review sample and from being measured against the audit standard on workpaper documentation.

In following up with service center officials about CEQMS data reliability, we found that not all service centers were following IRS' requirements for drawing the review samples. For example, according to these officials, some centers' samples excluded closed audits in which the taxpayers did not respond to IRS' letters because there were few workpapers to review. Even when taxpayers do not respond, the audit recommendations still need to be supported. Similarly, some service centers also excluded audits that recommended no tax changes. Even when recommending no tax changes, examiners are still required to follow IRS' audit quality standards and document adherence to those standards.

²We found evidence of such a quality review for less than 1 percent of the traditional correspondence audits closed in 1996.

We also found a similar exclusion when taxpayers did not respond with information about the tax issue being audited. IRS allowed service centers to exclude such audits from being measured against the audit standard on workpaper documentation. Customer Service officials told us that service centers might instruct their quality reviewers to record “not applicable” for the documentation standard when required documentation is missing if taxpayers do not respond. Regardless of the issue being audited, less documentation of the audit trail or audit support would be expected when taxpayers do not respond. Even so, the service centers had some reason for contacting the taxpayers about the potential for additional tax liabilities, and they are required to document that reason along with the support for the additional taxes that are to be recommended when taxpayers do not respond.

Minimal Contact With Nonresponsive Taxpayers

For the traditional correspondence audits closed in 1996, an estimated 57 percent of taxpayers did not respond to IRS’ audit letters. IRS has not identified the reasons why these taxpayers did not respond. We found that tax examiners sometimes tried to contact these nonresponsive taxpayers beyond the minimal requirements for correspondence audits—an initial letter and a final letter to close the audit. Examination officials at the four service centers we visited stated that additional contacts would increase the time spent on such audits, with no guaranteed results, and would prevent tax examiners from auditing more returns.

We asked Customer Service and service center officials why so many taxpayers did not respond. They said they have not studied the reasons but offered three possible explanations. First, some taxpayers might be overwhelmed or intimidated by IRS’ letters and be uncomfortable with responding. Second, some taxpayers might not understand IRS’ letters and not know how to respond. Third, other taxpayers might know that they owe the additional tax but hope that their nonresponsiveness would discourage IRS from trying to collect that tax.

For the traditional correspondence audits closed in 1996, some IRS letters might have been overwhelming or confusing to taxpayers. For example, some letters made blanket, standardized requests for information without specifying the reason for IRS’ concerns; one letter requested up to 14 pieces of information on an alimony issue without stating the specific information needed. Further, we determined that almost half the letters might have been hard to understand because they were written in generic language. An estimated 11 percent of the letters were tailored to a specific audit; in the other audits, either the letters had both generic and tailored

language or the workpaper files did not have the letters for us to make a determination.

Customer Service and service center officials acknowledged that their letters were generic and contained legal language that many taxpayers might not be able to understand. The officials also stated that tax examiners tend to rely on this generic language because it is readily accessible in IRS' computers and expedites the audit. They said that preparing letters tailored to each taxpayer takes more time and thus limits the number of audits that can be processed.

We talked to various Customer Service officials about any plans to gather information from taxpayers on why they do not respond. Although these officials identified some efforts, as of January 1999, these efforts either were not implemented or had not provided any data on why taxpayers did not respond to IRS' audit letters.³ Customer Service officials told us that gathering information from these taxpayers could be difficult, but the benefits of the information collected from them would more than likely be cost-effective. Without knowing the reasons for nonresponsiveness, IRS cannot know the extent to which the clarity of its correspondence, or other factors, contributed to taxpayers' not responding to IRS' audit letters.

Without taxpayer responses, IRS' determinations of the correct tax liability are less certain. When taxpayers do not respond, service centers are to assess any additional taxes that they think are owed. Our analyses of correspondence audits closed in 1996 also identified other negative effects when taxpayers did not respond. The audits usually took longer to complete, and additional taxes owed took longer to collect compared to audits where taxpayers responded. Those not responding paid less of their recommended tax assessment than taxpayers who responded. As of April 1998, taxpayers who responded paid an estimated 79 percent⁴ of the additional taxes, while those not responding paid an estimated 31 percent.

Further, an estimated 72 percent of those asking IRS to reconsider the recommended taxes had not responded to IRS' final letter.⁵ Occurring

³The Memphis Service Center proposed a study in 1996 to gather information on why taxpayers were not responding to IRS' audit letters. According to Customer Service officials, they have not approved this proposal because it was not specific enough. In January 1999, Customer Service officials also said that a customer satisfaction survey might have some information on why taxpayers do not respond.

⁴The 95-percent confidence interval for this estimate ranges from 66 to 92 percent.

⁵An estimated 29 percent of all taxpayers with traditional correspondence audits closed in 1996 asked IRS to reconsider their recommended taxes.

months after the audits closed—usually when IRS took action to collect these assessments—audit reconsiderations cause IRS to redo all or part of the audit, adding to the time for IRS and taxpayers to determine the correct tax liability. With the added time, taxpayers also incur additional interest charges on the unpaid assessments that remain after the reconsideration. We found that IRS closed an estimated 72 percent of the reconsiderations without reducing the assessments. These effects might have been minimized if the taxpayers had responded during the audit or had acted on their appeal rights at the close of the audit.

Customer Service officials described their efforts to improve responsiveness. Customer Service officials told us they initiated an effort to revise the correspondence audit letters in August 1998. They also indicated that IRS is contracting with a private firm to improve the clarity of various IRS letters, starting with collection notices. These officials said the correspondence audit letters eventually would be covered under this contract. Finally, they said that IRS plans to test a toll-free phone system in 1999 to encourage taxpayers who receive audit letters to call for clarification if needed. Customer Service officials also shared their plans to measure the effects of each effort on taxpayer responsiveness. However, Customer Service officials did not know whether these efforts would improve taxpayer responsiveness because the efforts were in the initial stages.

Conclusions

IRS uses audits to help ensure that taxpayers pay their proper tax liability. In reviewing IRS' correspondence audit processes and requirements, we found weaknesses that undermine its ability to (1) identify and audit all questionable tax issues on tax returns, (2) support its audit recommendations for additional taxes, (3) consistently accept justification for EIC claims, (4) review adherence to audit requirements and quality standards, and (5) solicit taxpayers' responses about the tax issues being audited.

Tax returns that are slated for correspondence audits are to be reviewed by knowledgeable staff to identify all questionable issues and to ensure that returns with more complex audit issues have been forwarded to the appropriate auditors. Such a classification is important because IRS generally has one chance to audit a tax return. In reviewing the correspondence audits closed in 1996, we found that an estimated 69 percent had not been classified. When returns were classified, tax examiners usually served as the classifiers. Tax examiners are not trained to identify or audit complex issues, such as investments and business deductions. However, some of the returns we analyzed included complex

schedules, and less than 1 percent of these returns had been referred to district offices, where revenue agents and tax auditors are trained to classify and audit the more complex issues. As a result, these complex returns may have had questionable issues that were neither classified nor audited.

We found that the workpaper files for about one-third of the traditional correspondence audits closed in 1996 provided little or no audit trail for the tax examiners' actions, and about one-fourth of the issues audited had little or very little support in the workpaper files for the recommended additional taxes. Without proper documentation of the workpapers, neither IRS nor taxpayers can be assured that the recommended additional taxes are accurate and supported.

Our analyses indicated that as the time spent by tax examiners on each audit decreased, so did the amount of support in the audit workpaper files. IRS officials said that the large volume of returns that had to be audited pressured the tax examiners to work quickly. Adding to this pressure has been the diversion of tax examiners to nonaudit work during each filing season.

As an outgrowth of this emphasis on working quickly, some service centers eased the documentation requirements for claiming EIC. At least three service centers allowed EIC claims without the third-party verification of the taxpayer's eligibility. The other service centers required more extensive verification than these three centers. We could not determine from the workpapers whether these audits allowed any taxpayers to claim an EIC to which they were not entitled.

IRS' two types of quality reviews were unlikely to identify such weaknesses in the correspondence audit process. We found little evidence of supervisory review for the traditional correspondence audits closed in 1996. IRS does not require supervisory reviews to be documented. Although we found weaknesses in classifying and documenting support, IRS' quality measurement reviews of closed correspondence audits gave these areas high ratings. The discrepancies between our findings and IRS' measurements can be explained, in part, by some service centers' not following IRS' requirement to include all types of audit closures in the review samples. Further, service centers were allowed to exclude audits in which taxpayers did not respond and that lacked required documentation on the audit steps and support for recommended taxes from being measured against the audit standard on workpaper documentation.

Finally, in over half of the traditional correspondence audits closed in 1996, the taxpayers did not respond to IRS' queries during the audit. IRS officials had not determined the reasons but believed that the language in their letters might be a factor. Audit letters often had generic and legal language that was difficult to understand. Because of pressures to process large audit workloads, tax examiners were not likely to take the time to tailor letters to a specific audit. And when taxpayers did not respond, IRS had to assess the additional taxes under audit without knowing for sure if all these taxes were owed. Further, taxpayers who did not respond paid less of their recommended taxes owed. Without knowing the reasons for taxpayers' not responding, IRS cannot know the extent to which its letters, or other factors, contributed to their nonresponsiveness.

We did not attempt to measure the specific effects of the weaknesses we found. Nevertheless, each weakness can, individually or in combination, erode the integrity of IRS' correspondence audit processes, which are designed to help ensure that taxpayers pay the correct tax. Improving controls over the audit processes as well as collecting more information about the weaknesses would help to accomplish these ends.

Recommendations

GAO recommends that the IRS Commissioner improve controls to better ensure that IRS' correspondence audit processes adhere to existing audit requirements and standards on

- classifying filed returns, and in particular, referring returns with complex schedules that may have potential tax changes to staff with sufficient knowledge to classify them;
- documenting the support for audit findings and recommendations in the audit workpaper files,
- ensuring consistency in the treatment of audited EIC claims by collecting and using the information required, including verification from third parties, to justify the claims; and
- including all types of closed audits across the 10 service centers in the samples for measuring audit quality.

GAO also recommends that the IRS Commissioner

- require supervisors in the service centers to document their reviews of audit workpapers;
- eliminate the discretion that service centers have to exclude audits that lack documentation on the audit steps and support for audit recommendations from the calculations IRS does to measure adherence to the audit quality standard on workpaper documentation; and

-
- determine the reasons, through statistically valid and cost-effective means, for taxpayers' not responding to IRS' audit letters, so that IRS can identify ways to encourage more taxpayers to respond.

Agency Comments and Our Evaluation

We requested comments on a draft of this report from the Commissioner of Internal Revenue. Officials representing the Assistant Commissioner for Customer Service and the IRS Commissioner's Office of Legislative Affairs provided IRS' comments in a meeting on February 23, 1999. IRS also documented these comments in a letter dated March 12, 1999, which is reprinted in appendix V.

Overall, IRS concurred with all of our recommendations and agreed to take efforts to implement them. IRS officials provided elaboration on our recommendation involving IRS' requirement to classify returns, particularly returns with complex schedules. Given that the number of returns audited through correspondence that include complex schedules is relatively low, Customer Service officials said that they will work with the Assistant Commissioner (Research and Statistics of Income) on ways to isolate returns with complex schedules so that they are not automatically selected for correspondence audits. This would provide district offices with the opportunity to first look at these returns before they are audited through correspondence.

IRS also provided us with a technical comment on figure 1.1 to clarify at what point recommended taxes become assessed. We have incorporated this comment into the report.

Overview of Audit Processes at Service Centers and District Offices

This appendix illustrates the differences between the audits conducted at IRS' service centers and district offices.

Processes to Screen and Select Tax Returns for Audit

Approximately 119 million individual taxpayers filed returns in 1996. Some returns are likely to have errors or misinterpretations of the tax laws. IRS' process for identifying returns with the most significant errors or misinterpretations is important because only 1.9 million, or less than 2 percent, of the returns are audited. IRS uses computer programs to select many of the returns for audit and manual reviews of the returns (known as classification) to identify tax issues for audit. The selection and classification processes help IRS to choose an auditing technique—correspondence sent from service centers or face-to-face meetings at the district offices.

Differences Between Service Center and District Office Audits

For fiscal year 1996, service centers did two-thirds of the 1.9 million audits under the Compliance Branch of Customer Service.¹ The remaining audits were done through district offices under IRS' Examination Division. Audits at the service centers differ from those at the district offices in terms of the (1) audit techniques being used and complexity of tax issues being audited (i.e., audit issues) and (2) selection of the audited returns.

First, service center audits generally involve one or two audit issues that are simple enough to be audited through correspondence, such as the self-employment tax. District office audits generally involve multiple audit issues that are complex enough to require face-to-face meetings with taxpayers. Complex issues include gains and losses from various kinds of investments as well as business income and deductions.

Second, the methods to screen and select returns with audit potential because of apparent noncompliance differ somewhat at the districts compared to the service centers. These methods include using various sources to identify returns with audit potential and classifying those returns to check not only whether they should be audited but also what issues should be audited. For example, although centers and district offices use computer programs to identify tax returns for audit, these programs differ in scope. The programs usually identify returns with one audit issue for service centers and with multiple, more complex issues for district offices.

¹Correspondence audits were conducted under the Examination Division until about 1995. At that time, IRS transferred this audit program to the Collection Division until 1996, when it was moved to Customer Service.

In addition to computer screening, IRS uses about 30 other sources to select returns with audit potential.² District offices tend to use these sources more than service centers. Sources include referrals from inside and outside IRS; a program on tax preparers who are associated with noncompliant returns; projects on groups of taxpayers that are known or suspected to be noncompliant; returns that are related in the same or different tax year to a noncompliant return; and information filed by third parties, such as banks or employers.

Service centers also do audit work that is discretionary, allowing each center to identify returns with audit issues for its local area. Each service center may apply audit resources to discretionary programs, which can vary from year to year, as a center finishes its mandated audit workload, such as audits involving EIC.³ For example, local programs may involve the exchange of tax information with states. At least one service center analyses a variety of database extracts for its area to determine potentially noncompliant issues, such as the individual retirement account penalty.

After identifying returns with audit potential, the next step in the selection process is a review to classify returns that have been identified as having issues worth auditing. IRS requires the returns to be manually classified to either accept the return as filed or to identify all potential audit issues on the return. Identifying all potential audit issues is important because IRS generally has one opportunity to audit a tax return. Classification is also important in determining whether to audit through correspondence or a face-to-face meeting.

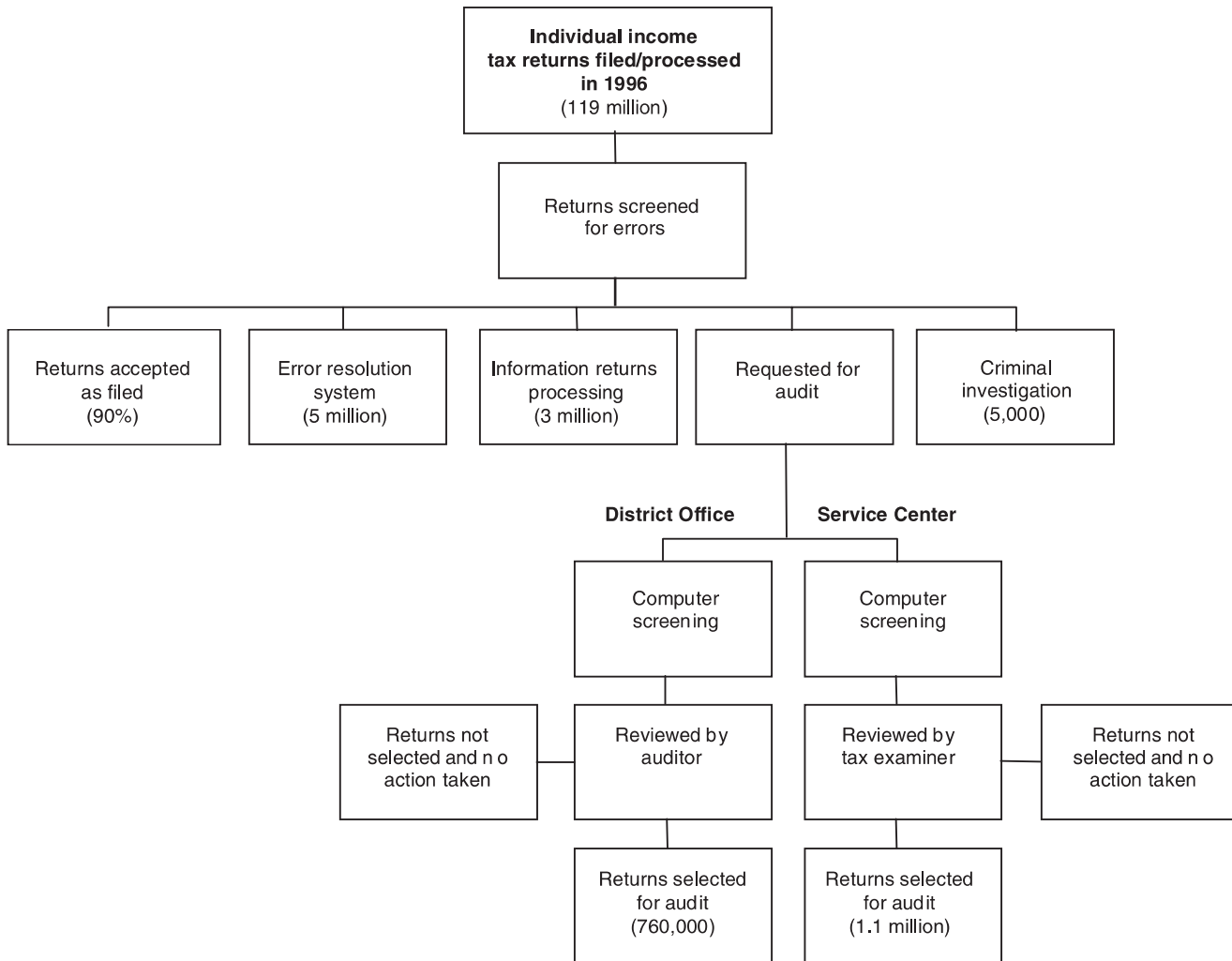
IRS' processes of checking and requesting individual returns for audit is shown in figure I.1.

²Beyond these sources, decisions about which returns to audit involve taking into account the number and type of auditors, existing workload by type of audit, and planned audit rate across groups of taxpayers. The scope of our work did not cover these decisions and factors.

³In fiscal years 1992 and 1993, the discretionary workload was much larger than the mandated workload. During fiscal years 1995 and 1996 (when service centers did many EIC audits), mandated audits accounted for 75 percent of all workload. In fiscal years 1994 and 1997, discretionary and mandatory workloads were almost equal.

Appendix I
Overview of Audit Processes at Service Centers and District Offices

Figure I.1: Process for Selecting Individual Tax Returns for Audit



() Numbers in parentheses indicate the approximate number of returns processed under that category. Where there are no numbers, IRS was unable to provide us with definitive data.

Source: GAO summary of IRS data.

IRS' Auditing Standards and Key Elements for Correspondence Audits

This appendix shows IRS' auditing standards as addressed in IRM 4015.5, Exhibit 4010-2, Center Examination Quality Measurement Rating Guide. These standards are used to define the "quality" of completed casework and to measure the accuracy and effectiveness of the correspondence examination process.

Table II.1: IRS' Audit Standards and Key Elements for Correspondence Audits

Audit standard	Key elements
1. Adequate consideration of significant items	All classified items considered. Scope of examination appropriate to include all significant items for determination of tax liability. Prior- and subsequent-year returns considered.
2. Examination depth and conclusions reached	Adequate examination and sampling techniques used, proper source documents requested and evaluated, and taxpayer and third-party contacts made as needed. Correct conclusion reached from developed facts and circumstances.
3. Workpapers support conclusions	Examination procedures, audit trail, findings, and conclusions fully disclosed. Workpapers are clear, concise, legible, labeled, dated, organized, and indexed. Adjustments in workpapers agree with examination report. Examination activities adequately documented in the case file.
4. Report writing procedures followed	Appropriate report writing procedures followed. Tax computation was correct and used the method of most benefit to the taxpayer.
5. Penalties properly considered	The case file reflected consideration of and appropriate assertion or abatement of all applicable penalties as necessary. If they were necessary, penalties computed correctly.
6. Timely actions and time charged appropriate	Time charges are relevant to the issues raised and documented in the case file, as are other problems that affect use of time. All examination actions, such as requests for documents and information were timely.
7. Case administration	Appropriate and correct correspondence used to respond to or notify taxpayer. Statute controls followed. Case properly assembled in accordance with local procedures. Case accurately completed with proper forms, closing instructions, and computer research and updates in accordance with local procedures. Power of attorney and disclosure procedures followed.

Source: GAO summary of IRS data.

Sampling and Data Analysis Methodology

This appendix describes how we identified the study population of correspondence audits closed during fiscal year 1996 and our sampling methodology. In addition, it discusses our methodology for analyzing Individual Master File data for the tax returns in our study population.

Sample Selection Methodology

We identified a population of tax returns related to correspondence audits that closed during fiscal year 1996. We chose that year because it was the latest completed fiscal year at the time we began our effort. Our computer analysis of IRS' databases identified a total population of 1.1 million correspondence audits closed during fiscal year 1996. With the concurrence of Customer Service Compliance Branch officials, we excluded the EIC audits with missing or invalid Social Security numbers that are no longer in the correspondence audit program. These officials also advised us to exclude Tax Equity and Fiscal Responsibility Act (TEFRA) flow-through returns from our population because these returns were actually audited in district offices, and service centers only made adjustments to taxpayers' accounts. By excluding the EIC math-error and TEFRA cases, our study population of tax returns audited was 335,050. The Compliance Branch officials told us that this population more closely represented traditional correspondence audit tax returns.

We selected a stratified random sample of 502 audits from IRS' AIMS file. The strata were defined by whether the taxpayer responded to IRS' final letter and the additional taxes recommended from the audits. These strata variables were selected because we believed there might be a relationship between them and the issues we were studying, such as the number of audits, the time to do the audits, and the results of the audits.

To allocate the sample, audits were first separated into three groups: (1) those taxpayers who responded to IRS' letters, (2) those taxpayers who did not respond to IRS' letters, and (3) those tax returns closed with no change in the reported tax liability. The number of sample audits allocated to each group was approximately proportional to the number of audits in the group. For audited tax returns in the first two groups, the number of audits sampled in each stratum was a compromise between a proportional allocation of the number of taxpayers in each stratum and a proportional allocation based on absolute dollar amounts represented by audits in that stratum.

Within each stratum, we sorted audits by IRS service center, and we systematically selected audits for inclusion in the sample. This ensured that tax returns audited by all 10 service centers were included in our

sample. However, our sample was not designed to statistically project to the practices of specific service centers.

Response Rates

We received 446 audit files from the 502 tax returns in our sample, or an 89-percent response rate. The difference is partly due to the fact that some audit files were being used by IRS projects and others could not be located. Sampling weights, which included nonresponse adjustments, were assigned to each tax return in our sample. As such, the 446 sampled tax returns are statistically projectable to the 335,050 tax returns audited nationwide during fiscal year 1996.

Sampling and Nonsampling Errors for Key Estimates Used in the Report

Because our study population results come from samples, all results are estimates that are subject to sampling errors. We calculated sampling errors for all of the study population results presented in this report. These sampling errors measure the extent to which samples of these sizes and structure can be expected to differ from their total populations. Each of the sample estimates is surrounded by a 95-percent confidence interval. This interval indicates that we are 95-percent confident that the results for the total population fall within this interval. Except where noted, the 95-percent confidence intervals for proportions do not exceed 10 percentage points. All numeric estimates other than proportions have sampling errors smaller than 10 percent of the value of those estimates, unless otherwise noted.

In addition to the reported sampling errors, the practical difficulties of conducting any case study may introduce other types of errors, commonly referred to as nonsampling errors. For example, differences in how a particular question is interpreted, in the sources of information that are available, or in the types of files not available, introduce unwanted variability into the study population results. We included steps in our audit to minimize such nonsampling errors. For example, we carefully pretested the data collection instrument, discussed our study population results with officials responsible for these audits at the National Office and four service centers we visited, and made follow-up requests to all of the compliance chiefs at the 10 service centers nationwide to help us accurately interpret the data.

Data Analysis

To assess the strength of association between the degree of documented support and other characteristics of the audit, such as the amount of audit time charged and the assessed amount of the correspondence audit, we conducted correlation and regression analyses. We also reviewed scatterplots of the relationships between the variables. We found a relationship between the amount of audit time charged and the degree of

documented support. However, we did not find a statistically significant relationship between the assessed amount of a correspondence audit and the degree of documented support of the audit.

Additional Comparisons of IRS Service Center Workloads

This appendix shows, by IRS service center, correspondence audit workload by number of returns, dollars recommended and direct audit hours for fiscal years 1992 through 1997. The following tables exclude the service center TEFRA workload because correspondence audit officials indicated that these cases are atypical and do not reflect the traditional correspondence audit workload. The data come from IRS' AIMS closed case database. The service center listing is IRS', which goes from the Northeast to the West.

Table IV.1: Correspondence Examination Workload by Service Center for Fiscal Year 1992

Service center	Returns	Percent	Additional taxes		Hours	Percent
			recommended	Percent		
Andover	26,267	8	\$41,490,702	6	28,465	10
Brookhaven	28,728	8	87,083,199	12	30,026	11
Philadelphia	20,062	6	40,867,034	5	11,196	4
Atlanta	42,126	12	76,690,155	10	25,958	9
Memphis	29,290	9	75,105,888	10	27,176	10
Cincinnati	31,796	9	75,996,439	10	27,285	10
Kansas City	30,640	9	91,533,907	12	28,122	10
Austin	18,422	5	53,103,406	7	16,731	6
Ogden	29,900	9	85,334,668	12	51,701	19
Fresno	81,889	24	112,859,555	15	27,084	10
Total	339,120	100	\$740,064,953	100	273,744	100

Source: GAO analysis of IRS data.

Table IV.2: Correspondence Examination Workload by Service Center for Fiscal Year 1993

Service center	Returns	Percent	Additional taxes		Hours	Percent
			recommended	Percent		
Andover	18,657	8	\$28,419,988	5	22,047	9
Brookhaven	25,855	11	70,660,954	12	32,277	13
Philadelphia	10,500	5	12,025,126	2	7,036	3
Atlanta	21,546	9	85,547,848	15	20,355	8
Memphis	20,716	9	37,425,722	6	21,240	9
Cincinnati	28,280	12	51,125,797	9	36,571	15
Kansas City	22,782	10	59,825,149	10	22,400	9
Austin	40,009	17	101,576,093	18	36,776	15
Ogden	16,031	7	41,278,786	7	30,783	13
Fresno	27,861	12	88,840,216	15	16,205	7
Total	232,237	100	\$576,725,679	100	245,690	100

Source: GAO analysis of IRS data.

Appendix IV
Additional Comparisons of IRS Service Center Workloads

Table IV.3: Correspondence Examination Workload by Service Center for Fiscal Year 1994

Service center	Returns	Percent	Additional taxes		Hours	Percent
			recommended	Percent		
Andover	23,250	7	\$32,291,962	5	34,456	10
Brookhaven	26,514	8	48,404,805	8	30,974	9
Philadelphia	26,459	8	47,026,981	8	25,092	7
Atlanta	21,218	6	64,637,249	10	22,871	7
Memphis	16,635	5	21,335,944	3	28,247	8
Cincinnati	30,364	9	38,977,595	6	49,037	15
Kansas City	22,193	6	49,113,827	8	29,525	9
Austin	44,380	13	97,056,666	16	41,844	12
Ogden	24,414	7	50,020,761	8	34,576	10
Fresno	117,169	33	172,534,464	28	40,372	12
Total	352,596	100	\$621,400,254	100	336,994	100

Source: GAO analysis of IRS data.

Table IV.4: Correspondence Examination Workload by Service Center for Fiscal Year 1995

Service center	Returns	Percent	Additional taxes		Hours	Percent
			recommended	Percent		
Andover	49,781	5	\$56,199,233	4	59,808	8
Brookhaven	105,246	10	94,756,307	7	57,184	8
Philadelphia	113,970	11	132,568,342	10	61,950	9
Atlanta	60,844	6	118,095,996	9	51,800	7
Memphis	41,346	4	38,893,068	3	46,507	7
Cincinnati	54,926	5	103,448,080	8	44,518	6
Kansas City	75,131	7	97,576,557	7	47,811	7
Austin	91,562	9	112,925,152	8	72,009	10
Ogden	97,826	9	90,330,991	7	62,908	9
Fresno	363,941	35	523,562,111	38	199,354	28
Total	1,054,573	100	\$1,368,355,837	100	703,851	100

Source: GAO analysis of IRS data.

Appendix IV
Additional Comparisons of IRS Service Center Workloads

Table IV.5: Correspondence Examination Workload by Service Center for Fiscal Year 1996

Service center	Returns	Percent	Additional taxes		Hours	Percent
			recommended	Percent		
Andover	52,882	5	\$72,162,081	4	61,133	8
Brookhaven	92,375	8	175,271,688	10	51,680	7
Philadelphia	93,406	8	142,672,368	8	63,367	8
Atlanta	84,519	8	167,652,022	9	77,920	10
Memphis	64,150	6	85,741,692	5	45,269	6
Cincinnati	57,164	5	155,350,831	9	52,933	7
Kansas City	85,704	8	135,828,778	8	41,258	6
Austin	135,078	12	155,873,552	9	74,807	10
Ogden	113,862	10	160,284,785	9	77,872	10
Fresno	334,506	30	515,079,489	29	202,819	27
Total	1,113,646	100	\$1,765,917,286	100	749,058	100

Source: GAO analysis of IRS data.

Table IV.6: Correspondence Examination Workload by Service Center for Fiscal Year 1997

Service center	Returns	Percent	Additional taxes		Hours	Percent
			recommended	Percent		
Andover	55,477	7	\$156,542,174	7	46,582	8
Brookhaven	74,246	10	180,023,302	8	59,003	10
Philadelphia	50,561	7	141,764,403	7	37,202	7
Atlanta	43,527	6	163,020,469	8	42,868	8
Memphis	51,960	7	162,861,282	8	20,355	4
Cincinnati	60,763	8	299,380,616	14	65,066	11
Kansas City	52,220	7	156,219,970	7	29,728	5
Austin	48,987	6	97,644,618	4	45,553	8
Ogden	100,115	13	231,952,120	11	70,788	12
Fresno	219,814	29	581,062,259	27	155,811	27
Total	757,670	100	\$2,170,471,213	100	572,957	100

Source: GAO analysis of IRS data.

Comments From the Internal Revenue Service



DEPUTY COMMISSIONER

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

March 12, 1999

Mr. James R. White
Director, Tax Policy and
Administration Issues
U. S. General Accounting Office
441 G Street, N. W.
Washington, D.C. 20515

Dear Mr. White:

Thank you for the opportunity to review the draft report of "IRS Audits: Weaknesses in Selecting and Conducting Correspondence Audits" - (Job Code 268777). Your report contains a number of recommendations with which we agree. We appreciate your recognizing that the Service Center Correspondence Examination completed two-thirds of the audits conducted during Fiscal Year 1996, representing some 1.1 million tax returns and \$1.7 billion in recommended assessed dollars. We also welcome your highlighting the challenges faced in managing such a massive compliance operation.

RECOMMENDATION

The Internal Revenue Service (IRS) Commissioner improve controls to better ensure that IRS' correspondence audit processes adhere to existing audit requirements and standards on:

1a. Classifying all tax returns selected for an audit to identify all tax issues worth auditing and, in doing so, referring returns with complex tax issues to staff with sufficient knowledge to classify these returns.

COMMENTS

We concur with this recommendation. As was the case with the 1996 inventory reviewed by the General Accounting Office (GAO), much of the work we are starting in Service Center Examination is referred using the automated classification technology of District Office Research and Analysis units and of the Office of Refund Fraud. Their technology uses pre-identified selection criteria developed specifically for Service Center Examination, so there is little need for further classification of these returns. Other audit work involves information referred to the IRS through the Federal/State Exchange Program. The IRS assessments are based upon completed state examinations. Since these issues are pre-identified and resolved at the state level, additional classification is not required. Fifteen percent of GAO sampled cases involved information referred to IRS through the Federal/State Exchange Program.

2

In addition, we will reinforce with the service centers via memorandum that returns with complex tax issues which are being classified should be referred to appropriate technical staff for review. The centers have already provided additional training to employees of their technical staffs who are charged with return classification.

RECOMMENDATION

1b: Documenting the support for audit findings and recommendations in the workpaper files.

COMMENTS

We concur with this recommendation. The Earned Income Tax Credit (EITC) cases handled by Correspondence Examination for tax year 1996 contained reports of proposed tax changes systemically prepared, rather than manually prepared by tax examiners as is the normal practice. This enhancement was developed specifically for this tax year to improve the examination process for EITC returns. In instances where taxpayers did not respond to the proposed adjustment, no additional tax examiner involvement was required and Statutory Notices of Deficiency and Assessments were based upon the original proposed assessment. This contributed to the fact that cases reviewed by GAO contained little or no evidence of tax examiner action. In instances where taxpayers provided responses, tax examiners were required to annotate workpapers with comments related to actions taken on the case, according to established procedures.

Also, because the tax year 1996 EITC cases resulted in much larger taxpayer response rates than anticipated, inventory levels in the service centers exceeded what would be considered normal and resulted in our waiving of workpaper documentation requirements at the discretion of a service center division chief. This local decision was made so that taxpayer mail could be more expeditiously answered and taxpayers not unduly burdened. To reduce the potential for recurrences of this situation, current Service Center Examination inventories have been reduced to provide a more achievable workload for the individual centers. Additionally, we are also requiring the centers to adhere to existing Internal Revenue Manual (IRM) requirements for workpaper documentation. Modifications to the IRM for Service Center Examination (21.8) and Quality Review (21.10) will also reinforce conformity with the auditing standards.

RECOMMENDATION

1c: Ensuring consistency in the treatment of audited EITC claims by collecting and using the information required, including verification from third parties, to justify the claims.

3

COMMENTS

We concur with this recommendation. In order to achieve consistency in taxpayer treatment, adherence to audit requirements and standards is an integral part of the examination process. However, issues of tax law frequently fall into areas that are sometimes difficult to identify. While eligibility requirements will not be eased, different forms of verification for the eligibility requirements will be considered acceptable. For this reason, tax examiners are trained to use sound judgment when evaluating information provided by taxpayers.

Consistent taxpayer treatment remains a primary goal of IRS, as is fair and sound interpretation of the tax law based on the facts and circumstances of the case. To ensure conformity with the auditing standards, we enhanced the Fiscal Year 1999 EITC guidelines to Service Center Examination tax examiners to provide uniform guidance in working EITC cases and in considering verification received from taxpayers and third parties. In addition, we revised Form 886H (Supporting Documents) and Notice 1230 (General Requirements) to provide clarification to taxpayers on the appropriate documentation required to substantiate an EITC claim. Changes to Service Center Examination and Quality Review IRMs will also emphasize the importance of consistently reviewing information gathered in justifying EITC claims.

RECOMMENDATION

1d: Including all types of closed audits across the 10 service centers in the samples for measuring audit quality.

COMMENTS

We concur with this recommendation. We are in the process of replacing the Service Center Correspondence Examination Quality Measurement System with the Quality Review Data Base (QRDB). The new system is in the implementation stages and will include all types of in-process and closed audits for review, regardless of disposition type. The revised Quality Review IRM will also include this provision so that in the future local decisions to vary from agency requirements are not made.

RECOMMENDATION

GAO recommends that the IRS Commissioner:

2a: Require supervisors in the service centers to document their reviews of audit work papers.

COMMENTS

We concur with this recommendation. We will require through memorandum and IRM change that Service Center Examination managers indicate that a case has been reviewed by annotating workpapers in the case file.

4

RECOMMENDATION

2b: Eliminate the discretion that service centers have to exclude audits that lack documentation on the audit steps and support for audit recommendations from the calculations IRS does to measure adherence to the audit quality standard on workpaper documentation.

COMMENTS

We concur with this recommendation. Current instructions to quality reviewers permit designation of Not Applicable when evaluating tax examiner workpaper comments on cases where taxpayers did not respond to IRS letters and provided no information for examiner review. The new QRDB, which is currently being piloted, will include instructions to quality reviewers to require more descriptive language when evaluating the various audit standards, including workpaper documentation. Additionally, changes to the Quality Review IRM will emphasize this issue.

RECOMMENDATION

2c: Determine the reasons, through statistically valid and cost-effective means, for taxpayers' not responding to IRS' audit letters so that IRS can identify ways to encourage more taxpayers to respond.

COMMENTS

We concur with this recommendation. There are numerous reasons why taxpayers do not respond to examination letters and notices of deficiency. For example, a third of GAO's sample involved taxpayers who do not voluntarily file tax returns and which have traditionally been found to be nonresponsive to IRS letters.

The appropriate IRS offices will work together to develop a statistically valid and cost-effective means of determining why taxpayers choose not to respond to IRS notices and letters, in an effort to improve our response rates. We are currently drafting a prospectus.

If you have any questions, please call Floyd Williams, National Director for Legislative Affairs, at 202-622-3720.

Sincerely,



Bob Wenzel
Deputy Commissioner Operations

Major Contributors to This Report

General Government Division, Washington, D.C.

Sidney Schwartz, Senior Mathematical Statistician
Patricia McGuire, Senior Computer Specialist
Susan Baker, Computer Specialist
Elizabeth W. Scullin, Communications Analyst

Kansas City Field Office

Kirk Boyer, Evaluator-in-Charge
Joseph F. Lenart, Jr., Senior Evaluator
Thomas Bloom, Senior Computer Specialist
Marge Vallazza, Evaluator

Ordering Information

The first copy of each GAO report and testimony is free. Additional copies are \$2 each. Orders should be sent to the following address, accompanied by a check or money order made out to the Superintendent of Documents, when necessary. VISA and MasterCard credit cards are accepted, also. Orders for 100 or more copies to be mailed to a single address are discounted 25 percent.

Order by mail:

**U.S. General Accounting Office
P.O. Box 37050
Washington, DC 20013**

or visit:

**Room 1100
700 4th St. NW (corner of 4th and G Sts. NW)
U.S. General Accounting Office
Washington, DC**

Orders may also be placed by calling (202) 512-6000 or by using fax number (202) 512-6061, or TDD (202) 512-2537.

Each day, GAO issues a list of newly available reports and testimony. To receive facsimile copies of the daily list or any list from the past 30 days, please call (202) 512-6000 using a touch-tone phone. A recorded menu will provide information on how to obtain these lists.

For information on how to access GAO reports on the INTERNET, send e-mail message with "info" in the body to:

info@www.gao.gov

or visit GAO's World Wide Web Home Page at:

<http://www.gao.gov>

**United States
General Accounting Office
Washington, D.C. 20548-0001**

Bulk Rate Postage & Fees Paid GAO Permit No. G100

**Official Business
Penalty for Private Use \$300**

Address Correction Requested

