

**Not All Available Information Was Considered
When Self-Employment Income Was
Examined During the Fiscal Year 2000
Earned Income Tax Credit Initiative**

June 2003

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

June 13, 2003

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED
DIVISION
COMMISSIONER, WAGE AND INVESTMENT DIVISION

Gordon C. Milbourn

FROM: Gordon C. Milbourn III
Acting Deputy Inspector General for Audit

SUBJECT: Final Audit Report - Not All Available Information Was
Considered When Self-Employment Income Was Examined
During the Fiscal Year 2000 Earned Income Tax Credit Initiative
(Audit # 200340036)

This report presents the results of our review to determine whether Internal Revenue Service (IRS) employees appropriately closed correspondence examinations¹ and considered available systemic information, specifically where it related to the self-employment income reported by taxpayers and the Earned Income Tax Credit (EITC) available to them.

This review is a continuation of our work that began with an allegation made by IRS employees that the Correspondence Examination function at the IRS' Austin Campus² inappropriately closed correspondence examination cases during the Fiscal Year (FY) 2000 EITC Initiative. In December 2002, we completed our initial review and issued a report on the Austin Campus' activities.³ We reported that IRS employees inappropriately closed tax returns examined as part of this initiative without considering available systemic information to verify taxpayers' self-employment income. IRS management agreed with our findings and stated that they would request guidance from

¹ The Correspondence Examination function is located at each IRS campus and examines tax returns for questionable issues that can be resolved with taxpayers through written correspondence. Issues generally involve overstating deductions and credits, claiming the improper filing status, or failing to report self-employment taxes.

² The campuses are the data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the computing centers for analysis and posting to taxpayer accounts.

³ *Not All Available Information Was Considered When Examining Tax Returns at the Austin Campus During the Fiscal Year 2000 Earned Income Credit Initiative* (Reference Number 2003-40-037, dated December 2002).

the IRS' Office of Chief Counsel to determine the effect of the disallowance of the self-employment income on Social Security quarter credits and taxpayers' rights.

In summary, tax returns examined as part of the FY 2000 EITC Initiative at all 10 IRS campuses were closed inappropriately without considering available systemic information to verify taxpayers' self-employment income. This resulted in approximately 3,547 taxpayers losing Social Security quarter credits and the Federal Government losing approximately \$8.3 million in unassessed taxes. This happened because the national guidelines for working correspondence examination cases during this initiative were confusing and in conflict with general IRS Examination guidelines. IRS employees were instructed to make adjustments to taxpayers' income tax returns without first researching an IRS computer system⁴ to verify income reported by third parties.⁵ Adjustments included disallowing reported self-employment income and related expenses, decreasing or eliminating the self-employment tax, and disallowing the EITC claimed. Additionally, whether an adjustment was made depended on when the correspondence examination case was processed or if the campus Examination Quality Assurance (QA) group⁶ reviewed the case and considered non-verification of third-party information as an error. This resulted in unequal treatment of taxpayers.

Further, the Correspondence Examination function examined tax returns that should not have been selected for the EITC Schedule C Preparer Tax Year (TY) 1999 and EITC Schedule C TY 1999 projects, or should have been referred to the Field Examination function.⁷ This occurred because most of the campuses did not properly research or classify⁸ the tax returns as required by the project guidelines and IRS Examination procedures. Consequently, the campuses incurred extra examination time that could have been put to better use.

We recommended that the Commissioners, Small Business/Self-Employed (SB/SE) and Wage and Investment (W&I) Divisions, consult with the IRS' Office of Chief Counsel to determine the effect on taxpayers' rights and entitlements when valid self-employment income was disallowed for some of the taxpayers examined under the FY 2000 EITC Initiative. In addition, they should ensure that IRS campuses properly research and classify tax returns for all future EITC initiatives, especially for those tax returns that cannot be electronically screened.

⁴ The IRS computer system, the Integrated Data Retrieval System, is capable of retrieving or updating stored information; it works in conjunction with a taxpayer's account records.

⁵ Payors of self-employment income are required to report to the IRS the amounts paid, using Miscellaneous Income (Form 1099-MISC), when they pay at least \$600 to an individual. When received, the IRS enters this third-party information into its computer system.

⁶ The QA groups perform reviews of Correspondence Examination cases worked in the IRS campuses to ensure all procedures and standards have been properly followed.

⁷ IRS campuses refer tax returns too complex for correspondence examination to the Field Examination function. Field examinations take place at the taxpayer's place of business or are conducted through interviews at an IRS office.

⁸ Classification is a pre-screening process to determine if a tax return should be examined and what issues should be questioned.

Management's Response: IRS management stated that they agreed that the guidelines for examining tax returns in connection with this initiative were unclear. In February 2003, IRS management asked the IRS' Office of Chief Counsel to determine if any taxpayers' rights or entitlements were violated as a result of disallowing the Schedule C income and related EITC, and if so, how to rectify these violations.

In addition, IRS management stated that in January 2002, filters were developed in the SB/SE Division to "look back" to prior years for Schedule C activity. Tax returns that did not meet the parameters of the Schedule C EITC filters were assigned a specific project code. Due to the complexity of the Schedule C issues, the IRS manually classified these tax returns. In January 2003, the IRS refined its filters. While the filters continue to "look back" to identify any historical Schedule C activity, tax returns that do not meet filter parameters are now classified through an automated process. IRS management also stated that the vast majority of tax returns selected for review in the W&I Division would not contain any additional issues that would require manual screening.

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

Copies of this report are also being sent to the IRS managers who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Michael R. Phillips, Assistant Inspector General for Audit (Wage and Investment Income Programs), at (202) 927-0597.

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Background

This review is a continuation of our work that began with an allegation made by Internal Revenue Service (IRS) employees that the Correspondence Examination function¹ at the IRS' Austin Campus² inappropriately closed correspondence examination cases during the Fiscal Year (FY) 2000 Earned Income Tax Credit (EITC) Initiative. Specifically, the allegation was that IRS employees were directed by management to close correspondence examinations for assessment without researching the Integrated Data Retrieval System (IDRS)³ to verify self-employment income reported by taxpayers who also claimed the EITC on their tax returns.

In December 2002, we completed our initial review and issued a report on the Austin Campus' activities.⁴ We found that some tax returns examined as part of the IRS' FY 2000 EITC Initiative at the Austin Campus were closed inappropriately without considering systemic information to verify taxpayers' self-employment income. This happened because national guidelines for working these correspondence examination cases during this initiative were confusing and in conflict with general IRS Examination guidelines. IRS management agreed with our findings and stated that they would request guidance from the IRS' Office of Chief Counsel to determine the effect of the disallowance of the self-employment income on Social Security quarter credits and taxpayers' rights.

¹ The Correspondence Examination function is located at each IRS campus and examines tax returns for questionable issues that can be resolved with taxpayers through written correspondence. Issues generally involve overstating deductions and credits, claiming the improper filing status, or failing to report self-employment taxes.

² The campuses are the data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the computing centers for analysis and posting to taxpayer accounts.

³ The IDRS is a computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer's account records.

⁴ *Not All Available Information Was Considered When Examining Tax Returns at the Austin Campus During the Fiscal Year 2000 Earned Income Credit Initiative* (Reference Number 2003-40-037, dated December 2002).

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These cases were included in two projects⁵ worked as part of the IRS' FY 2000 EITC Initiative. These projects were developed through IRS research on taxpayers who intentionally filed tax returns with erroneous information in order to maximize their tax refunds. Criteria were developed to identify tax returns with pre-determined characteristics that were considered at high risk for refund fraud. These criteria were then loaded into the IRS' Electronic Fraud Detection System (EFDS)⁶ as filters. If the tax returns met filter criteria, the system selected them for examination.

Although the EFDS filters had other criteria, the distinguishing selection criterion for these tax returns was that the taxpayers reported self-employment income and claimed the EITC. The majority of the tax returns included in the FY 2000 EITC Initiative were for TY 1999, but late-filed TYs 1997 and 1998 tax returns, and some TYs 2000 and 2001⁷ tax returns, were also included.

The National Headquarters Examination function froze the tax refunds and sent initial contact letters to the taxpayers examined under the two FY 2000 EITC Initiative projects. These letters informed taxpayers that the IRS had frozen their tax refunds and would be examining their tax returns. The returns were then assigned to individual IRS campuses to be classified⁸ and examined. However, due to confusing national project guidelines, delays caused by problems with the Report Generation System (RGS),⁹ inadequate resources, and other priorities, the majority of the tax returns selected for these two projects were not classified.

⁵ The review focused on returns that were in the EITC Schedule C Preparer Tax Year (TY) 1999 and EITC Schedule C TY 1999 projects.

⁶ The EFDS is an IRS computer system that accesses all electronically filed returns that have been scored for potential fraud.

⁷ The IRS tax examiners selected these related tax returns during the initial audit of taxpayers' TYs 1999 or earlier tax returns.

⁸ Classification is a pre-screening process to determine if a return should be examined and what issues should be questioned.

⁹ The RGS is a software program that tax examiners use to generate examination reports.

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After the tax returns were examined, letters were sent to the taxpayers requesting information to support their self-employment income and EITC claims. If the taxpayers responded to these letters with support for their self-employment income and the EITC, the returns were accepted as filed. If the taxpayers responded but could not provide sufficient support, if the taxpayers did not respond, or if the letters were returned to the IRS as undeliverable, the IRS issued Statutory Notices of Deficiency¹⁰ and the taxpayers' accounts were adjusted by either one or all of the following:

- Disallowing the reported self-employment income and related expenses.
- Disallowing exemptions for the qualifying children and EITC claimed.
- Decreasing the income tax.
- Decreasing or eliminating the self-employment tax.

Throughout the examination process, the IRS offers taxpayers who disagree with proposed adjustments the opportunity to appeal the proposed adjustments. Taxpayers can appeal proposed adjustments to a local Appeals Office, which is separate from and independent of the local IRS office or campus. After the Statutory Notice of Deficiency is issued, taxpayers have the right to file a petition with the Tax Court.

We conducted testing in the Small Business/Self-Employed (SB/SE) Division Headquarters in Lanham, Maryland; the Wage and Investment (W&I) Division Headquarters in Atlanta, Georgia; the Andover, Atlanta, Austin, Brookhaven, Cincinnati, Fresno, Kansas City, Memphis, Ogden, and Philadelphia Campuses; and the Taxpayer Advocate Service offices in New York, New York and Washington, D.C., between November 2002 and March 2003.

¹⁰ This is the final notice that is issued to the taxpayer on an unagreed or defaulted case before the IRS assesses additional tax.

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Taxpayer Accounts Were Adjusted Without Consideration of All Available Systemic Information

The audit was conducted in accordance with *Government Auditing Standards*. Detailed information on our audit objectives, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

Tax returns examined under the EITC Schedule C Preparer TY 1999 and EITC Schedule C TY 1999 projects as part of the IRS' FY 2000 EITC Initiative were closed inappropriately without IRS employees considering systemic information to verify taxpayers' self-employment income. This happened because the national guidelines for working correspondence examination cases under these projects were confusing and in conflict with general IRS Examination guidelines.

A review of 319 cases sampled from a total population of 32,251¹¹ correspondence examination cases worked at the 10 IRS campuses during this initiative showed that the IRS adjusted the self-employment net earnings reported on 43 tax returns (13.5 percent) even though it had valid third-party information¹² supporting the taxpayers' claims of self-employment income. The IRS also disallowed the exemptions for the dependents claimed by the taxpayers. Eliminating the dependent exemption and adjusting the self-employment net earnings resulted in the disallowance of the EITC. As a result, taxpayers lost rights and entitlements because the IRS reported incorrect information to the Social Security Administration (SSA), and the Federal Government lost revenue through lost self-employment and income taxes. For a more detailed description of the results, see Appendix IV.

¹¹ The 10 IRS campuses closed a total of 55,260 correspondence examinations between FYs 2000-2002. However, due to limited historical third-party information available on the IDRS, we restricted our sampling population to TYs 1998 and later, where the IRS coded the Correspondence Examination cases as no taxpayer response, undeliverable notice, or insufficient taxpayer support.

¹² Payors of self-employment income are required to report to the IRS the amounts paid, using Miscellaneous Income (Form 1099-MISC), when they pay at least \$600 to an individual. When received, the IRS enters this third-party information into its computer system.

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Specifically, of the 43 taxpayers that had valid self-employment net earnings adjusted:

- Thirty-five taxpayers lost 129 Social Security quarter credits to which they are entitled. Applying our sample results to the overall population, approximately 3,547 taxpayers¹³ lost 13,074 Social Security quarter credits. The remaining eight taxpayers did not lose Social Security quarter credits even though the IRS disallowed the self-employment net earnings and reduced the self-employment taxes. This occurred because in one instance the IRS, when closing the correspondence examination case, did not properly code it to advise the SSA to remove the taxpayer's quarter credits. In addition, seven other taxpayers had enough wages to earn the maximum Social Security quarter credits for the year.

The IRS reports adjustments to self-employment net earnings to the SSA. The SSA uses the IRS' information to adjust the taxpayers' Social Security quarter credits. When, and if, these taxpayers realize they did not receive the credits for these quarters, they will have to prove they earned this income to the SSA before they will be eligible to receive the correct amount of Social Security benefits.

- Forty-three taxpayers had \$60,625 in unassessed self-employment taxes. Applying our sample results to the overall population, the IRS did not assess approximately \$6.1 million in self-employment taxes. In addition, the revenue from the interest and penalties that should have been assessed for these unpaid taxes was lost.
- Thirty-five taxpayers had \$21,849 in unassessed income taxes. Applying our sample results to the overall population, the IRS did not assess approximately \$2.2 million in income taxes. In addition, the revenue from the interest and

¹³ The total population we used to project our sample excludes the four cases that we previously reported on the Austin Campus' examination practices.

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penalties that should have been assessed for these unpaid taxes was lost. The remaining eight taxpayers did not have any income taxes due after considering the standard deduction and personal exemptions from their earnings. In addition, these taxpayers would not have received any refunds because either they did not have any withholding or the self-employment taxes still owed would have been more than the refunds.

Research was not performed before classification and was not always considered when examining the cases

The Internal Revenue Manual (IRM) requires that research be performed before returns are assigned for examination, including researching the IRS' computers to determine:

- The taxpayer's complete filing history.
- Detailed information on individual tax years.
- Taxpayer sources of income and payor information.

The IRM also lists standards that should be met for quality examinations. Two of these standards measure whether:

- Consideration is given to large, unusual, or questionable items during the course of the examination.
- The examined issues are completed to the extent necessary to provide the examiner sufficient information to determine the substantially correct tax based on the correct application of tax law.

Management at six IRS campuses stated that they did not classify the FY 2000 EITC Initiative tax returns or research the IDRS for historical information to determine if the taxpayers had a history of self-employment income or current self-employment income before assigning the cases.

Campus management decided not to classify the tax returns because (1) they believed the National Headquarters Examination function pre-selected the tax returns, (2) the classifiers did not have access to the IDRS, (3) resources were limited, and (4) TY 1999 third-party information was

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not available when the processing for these tax returns began.¹⁴

The guidelines for the EITC Schedule C Preparer TY 1999 and EITC Schedule C TY 1999 projects relied heavily on advice that the IRS' Office of Chief Counsel provided in Calendar Year 1998. This advice was in response to a question from the Chief, Examination Branch, at the Brookhaven Campus about the appropriateness of disregarding net earnings from self-employment income when taxpayers claimed the EITC. This advice stated that when taxpayers do not comply with requests for substantiation of the income or if record keeping requirements have not been met, the net earnings from self-employment income may be disregarded, thereby eliminating the taxpayers' EITC. However, the advice did not address whether the IRS should research its own computer systems and consider income information reported by third parties prior to disallowing the taxpayers' claims.

The local Correspondence Examination procedures at 9¹⁵ of the 10 IRS campuses required employees to research third-party information that might support taxpayers' claims if the taxpayers responded to the IRS' request for information. However, no research was to be done on cases once a Statutory Notice of Deficiency was issued.

Research was not performed when third-party information became available

By the time third-party information for TY 1999 became available on the IDRS, the IRS had already issued Statutory Notices of Deficiency to many of the taxpayers examined under these projects. IRS procedures do not require additional research on cases where the taxpayers have been issued this notice. This policy normally applies when deductions or credits are being denied and there is no additional information available on the IDRS.

¹⁴ Third-party information provided by the payor is generally not available on the IDRS until September of the year in which the tax return is required to be filed.

¹⁵ Local procedures at the other IRS campus did not require research of any third-party information.

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The FY 2000 EITC Initiative continued for more than a year after the initial processing started, and initial research for third-party information had not been performed on these cases. Although we believe the IRS' policy of not performing additional research after issuance of a Statutory Notice of Deficiency is reasonable under normal circumstances, we believe that additional research should have been performed on these cases before the final assessments were made to taxpayers' accounts to ensure taxpayers were not adversely affected.

Employees at two IRS campuses believed that the IRS' actions of disallowing self-employment net earnings supported by third-party information would negatively affect the taxpayers' Social Security benefits. Yet, the Correspondence Examination function's policy at these two campuses was to consider current third-party information only when taxpayers responded to the IRS' information requests.

A lack of response from taxpayers in EITC examinations does not necessarily mean the taxpayers' reported information is incorrect. The Taxpayer Advocate Service stated in its FY 2002 report to the Congress that:

“A variety of reasons have been put forth as to why taxpayers do not respond in EITC examinations, including language and literacy barriers, non-receipt of notices, lack of time or resources to gather documentation, lack of telephone access, lack of representation, feeling of intimidation, and fear of government intrusion....”

Some Examination Quality Assurance (QA) groups¹⁶ took exception to cases where their research showed third-party income reported to the IRS

The Examination QA groups at all of the campuses reviewed a small sample of the FY 2000 EITC Initiative

¹⁶ The QA groups perform reviews of Correspondence Examination cases worked in the IRS campuses to ensure all procedures and standards have been properly followed.

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correspondence examinations. At six campuses, when the QA groups determined that the tax examiners¹⁷ did not consider all available third-party information, they returned the cases to the tax examiners to complete the research and counted these cases as having errors. Three of these six QA groups did so only for cases where taxpayers responded to the information requests, while the remaining three did not distinguish between cases where taxpayers responded and those where taxpayers did not respond. At the remaining four campuses, the QA groups did not regard non-consideration of all available current third-party information as an error because they believed the cases were pre-selected or the verification of IDRS research was outside their scope of review.

The actions taken by the IRS during its FY 2000 EITC Initiative resulted in unequal treatment of taxpayers. Even though nine campuses continued these practices for the FY 2001 EITC Initiative, Austin Campus Correspondence Examination function management issued new procedures requiring its tax examiners to research the IDRS for historical third-party information before disallowing self-employment net earnings.

In FY 2002, the IRS implemented automated screening filters nationwide to consider historical self-employment income data prior to assigning the case to a tax examiner. The filter system automatically checks prior tax year third-party reported income data if a Schedule C tax return meets certain income, self-employment expense, number of qualifying children, and filing status criteria. Those Schedule C tax returns that fall outside the automated filter criteria would have to be manually classified before assignment in accordance with the IRM.

Recommendation

1. The Commissioners, SB/SE and W&I Divisions, should consult with the IRS' Office of Chief Counsel to

¹⁷ Tax examiners review the filed tax returns, research the IDRS, and contact taxpayers for additional information needed to process the cases. They adjust tax liabilities based on the available information.

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determine the effect on taxpayers' rights and entitlements when valid self-employment income was disallowed for some of the taxpayers examined under the FY 2000 EITC Initiative.

Management's Response: IRS management stated that they agreed that the guidelines for examining tax returns in connection with this initiative were unclear. In February 2003, IRS management asked the IRS' Office of Chief Counsel to determine if any taxpayers' rights or entitlements were violated as a result of disallowing the Schedule C income and related EITC, and if so, how to rectify these violations.

Campuses Could Have Expended Correspondence Examination Resources More Effectively

IRS campuses selected and examined tax returns that should not have been worked by the Correspondence Examination function under the EITC Schedule C Preparer TY 1999 and EITC Schedule C TY 1999 projects. This occurred because most of the IRS campuses did not properly research or classify the FY 2000 EITC Initiative tax returns before assigning these cases for examination.

The guidelines for these projects state that Schedule C tax returns must be classified. Only those cases with little or no Schedule C expenses and little or no wages should be worked under the FY 2000 EITC Initiative.

Our review of 319 sampled cases showed that the IRS campuses examined 142 tax returns (44.5 percent) that either should have been sent to the Field Examination function¹⁸ or should not have been worked under these projects. As a result, the IRS could have realized cost savings in funds put to better use.

Specifically, we estimate that the IRS campuses spent approximately 2 hours more per case examining tax returns that should not have been worked by the Correspondence Examination function under these project codes. Tax examiners in the Correspondence Examination function are

¹⁸ IRS campuses refer tax returns too complex for correspondence examination to the Field Examination function. Field examinations take place at the taxpayer's place of business or are conducted through interviews at an IRS office.

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not trained to examine the more complex issues associated with business income and expenses. This caused the campuses' examination rates for these tax returns to average 2 hours more than the typical EITC Schedule C Preparer TY 1999 or EITC Schedule C TY 1999 project correspondence examination rate. Applying our sample results to the overall population, the IRS would have realized approximately \$460,000 in cost savings had it selected and reviewed the proper cases for these projects.

Recommendation

2. The Commissioners, SB/SE and W&I Divisions, should ensure that IRS campuses properly research and classify tax returns for all future EITC initiatives, especially for those tax returns that cannot be electronically screened.

Management's Response: IRS management stated that in January 2002, filters were developed in the SB/SE Division to "look back" to prior years for Schedule C activity. Tax returns that did not meet the parameters of the Schedule C EITC filters were assigned a specific project code. Due to the complexity of the Schedule C issues, the IRS manually classified these tax returns. In January 2003, the IRS refined its filters. While the filters continue to "look back" to identify any historical Schedule C activity, tax returns that do not meet filter parameters are now classified through an automated process. IRS management also stated that the vast majority of tax returns selected for review in the W&I Division would not contain any additional issues that would require manual screening.

Detailed Objectives, Scope, and Methodology

The overall objective of this review was to determine whether Internal Revenue Service (IRS) employees appropriately closed correspondence examinations¹ and considered available systemic information, specifically where it related to the self-employment income reported by taxpayers and the Earned Income Tax Credit (EITC) available to them. In addition, we verified whether controls were in place to ensure available systemic information is considered during current correspondence examinations. We conducted the following tests to accomplish these objectives:

- I. Interviewed Reporting Compliance management from the Small Business/Self-Employed and Wage and Investment Divisions and managers from the Correspondence Examination function and the Examination Quality Assurance (QA) groups at each of the 10 campuses² on the guidance provided to tax examiners for the EITC Schedule C Preparer Tax Year (TY) 1999 and EITC Schedule C TY 1999 projects. Additionally, we gathered information on Correspondence Examination function practices used during the Fiscal Year (FY) 2000 EITC Initiative.
- II. Reviewed a statistical sample of 319 tax returns out of a total population of 32,251 EITC Schedule C Preparer TY 1999 and EITC Schedule C TY 1999 project cases closed by the IRS campuses.³
 - A. Determined the following:
 1. Which tax returns should have been worked by the Correspondence Examination function.
 2. Whether IRS campuses spent extra time on correspondence examinations of non-EITC Schedule C Preparer TY 1999 and EITC Schedule C TY 1999 project tax returns or Field Examination function⁴ tax returns.

¹ The Correspondence Examination function is located at each IRS campus and examines tax returns for questionable issues that can be resolved with taxpayers through written correspondence. Issues generally involve overstating deductions and credits, claiming the improper filing status, or failing to report self-employment taxes.

² The campuses are the data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the computing centers for analysis and posting to taxpayer accounts.

³ The 10 IRS campuses closed a total of 55,260 correspondence examinations between FYs 2000-2002. However, due to limited historical third-party information available on an IRS computer system, we restricted our sampling population to TYs 1998 and later, where the IRS coded the Correspondence Examination cases as no taxpayer response, undeliverable notice, or insufficient taxpayer support.

⁴ IRS campuses refer tax returns too complex for correspondence examination to the Field Examination function. Field examinations take place at the taxpayer's place of business or are conducted through interviews at an IRS office.

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3. Whether the IRS inappropriately disallowed valid self-employment income that was supported by third-party⁵ reported information.
 4. The amount of income and self-employment taxes that the IRS should have assessed.
 5. The Social Security impact on the affected taxpayers.
- B. Reviewed Correspondence Examination function case files to verify whether the self-employment net earnings were disallowed. We derived the sample size by using the following: population of 32,251 cases; confidence level of 95 percent; precision level of ± 4 percent; and expected error rate of 16 percent.
- III. Interviewed the managers from the Correspondence Examination function and the QA groups at each of the 10 campuses to identify corrective actions the IRS took to rectify the disallowance of valid self-employment income on cases where third-party reported information supported the taxpayers' claims. Additionally, we judgmentally selected and reviewed the correspondence examination cases of 20 TY 2001 Schedule C tax returns claiming the EITC, which had been closed by the Brookhaven and Philadelphia campuses⁶ during FY 2002, to determine whether current case selection filters would research systemic information during the classification process.

⁵ Payors of self-employment income are required to report to the IRS the amounts paid, using Miscellaneous Income (Form 1099-MISC), when they pay at least \$600 to an individual. When received, the IRS enters the third-party information into its computer system.

⁶ Starting in FY 2001, the Brookhaven and Philadelphia campuses assumed sole responsibility for reviewing Schedule C tax returns claiming the EITC.

Major Contributors to This Report

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Appendix III

Report Distribution List

Commissioner N:C
Deputy Commissioner, Services and Enforcement N:DC
Acting Deputy Commissioner, Small Business/Self-Employed Division S
Deputy Commissioner, Wage and Investment Division W
Director, Compliance S:C
Director, Compliance W:CP
Director, Strategy and Finance W:S
Chief Counsel CC
National Taxpayer Advocate TA
Director, Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis N:ADC:R:O
Office of Management Controls N:CFO:AR:M
Audit Liaisons:
 Chief, Customer Liaison, Small Business/Self-Employed Division S:COM
 Program/Process Assistant Coordinator, Wage and Investment Division W:HR

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Appendix IV

Outcome Measures

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

Type and Value of Outcome Measure:

- Taxpayer Rights and Entitlements – Potential; 3,547 taxpayers affected when the Internal Revenue Service (IRS) disallowed the taxpayers' valid self-employment income for a total loss of 13,074 Social Security quarter credits (see page 4).

Methodology Used to Measure the Reported Benefit:

We reviewed a statistical sample of 319 Earned Income Tax Credit (EITC) Schedule C Preparer Tax Year (TY) 1999 and EITC Schedule C TY 1999 project tax returns closed¹ by the IRS campuses.² We researched the Integrated Data Retrieval System (IDRS)³ and contacted the Social Security Administration to calculate the number of Social Security quarter credits these taxpayers lost. Using our sample results of 35 taxpayers that lost 129 Social Security quarter credits, we calculated the percentage of taxpayers that lost Social Security quarter credits.

- $35/319 = .110$ or 11.0 percent

We then calculated the average number of Social Security quarter credits lost per case.

- $129/35 = 3.6857$

Applying these calculations to the overall population of 32,247⁴ cases (32,251 – 4), we estimate that 3,547 taxpayers ($32,247 \times .110$) lost approximately 13,074 Social Security quarter credits ($32,247 \times .110 \times 3.6857$).

¹ The 10 IRS campuses closed a total of 55,260 correspondence examinations between Fiscal Years (FY) 2000 and 2002. However, due to limited historical third-party information available on an IRS computer system, we restricted our sampling population to TYs 1998 and later, where the IRS coded the Correspondence Examination cases as no taxpayer response, undeliverable notice, or insufficient taxpayer support.

² The campuses are the data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the computing centers for analysis and posting to taxpayer accounts.

³ The IDRS is a computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer's account records.

⁴ The total population we used to project our sample excludes the four cases that we previously reported on the Austin Campus' examination practices.

Not All Available Information Was Considered When Self-Employment Income Was Examined During the Fiscal Year 2000 Earned Income Tax Credit Initiative

Type and Value of Outcome Measure:

- Increased Revenue – Potential; the IRS did not assess approximately \$6.1 million in self-employment taxes (see page 4).

Methodology Used to Measure the Reported Benefit:

For our sample of 319 EITC Schedule C Preparer TY 1999 and EITC Schedule C TY 1999 project tax returns, we researched the IDRS to calculate the amount of self-employment taxes that should have been assessed by the IRS. Using our sample results of 43 taxpayers with \$60,625 in unassessed self-employment taxes, we calculated the percentage of unassessed self-employment tax cases.

- $43/319 = .135$ or 13.5 percent

We then calculated the average amount of unassessed self-employment taxes per case.

- $\$60,625/43 = \$1,409.88$

Applying these calculations to the overall population of 32,247 cases, we estimate that the IRS did not properly assess approximately \$6,137,694 in self-employment taxes ($32,247 \times .135 \times \$1,409.88$).

Type and Value of Outcome Measure:

- Increased Revenue – Potential; the IRS did not assess approximately \$2.2 million in income taxes (see page 4).

Methodology Used to Measure the Reported Benefit:

For our sample of 319 EITC Schedule C Preparer TY 1999 and EITC Schedule C TY 1999 project tax returns, we researched the IDRS to calculate the amount of income tax that should have been assessed by the IRS. Using our sample results of 35 taxpayers with \$21,849 in unassessed income taxes, we calculated the percentage of unassessed income tax cases.

- $35/319 = .110$ or 11.0 percent

We then calculated the average amount of unassessed income taxes per case.

- $\$21,849/35 = \624.26

Applying these calculations to the overall population of 32,247 cases, we estimate that the IRS did not properly assess approximately \$2,214,356 in income taxes ($32,247 \times .110 \times \624.26).

Not All Available Information Was Considered When Self-Employment Income Was Examined During the Fiscal Year 2000 Earned Income Tax Credit Initiative

Type and Value of Outcome Measure:

- Inefficient Use of Resources – Potential; approximately \$460,000 spent examining tax returns in the Correspondence Examination function⁵ that should not have been selected for the EITC Schedule C Preparer TY 1999 and EITC Schedule C TY 1999 projects, or should have been referred to the Field Examination function⁶ (see page 10).

Methodology Used to Measure the Reported Benefit:

Based on case selection criteria that were to be used during the FY 2000 EITC Initiative, we classified the 319 tax returns in our sample (with the assistance of a Wage and Investment Division Program Analyst) to identify the type of examinations required. We obtained the examination hours incurred from the Audit Information Management System (AIMS)⁷ and computed the average examination hours by the type/location of examination as determined by the Wage and Investment Division Program Analyst. For our 319 sampled tax returns, the IRS spent on average an extra 1.94 hours examining tax returns that should not have been worked by the Correspondence Examination function under the EITC Schedule C Preparer TY 1999 and EITC Schedule C TY 1999 projects. For FYs 2000-2001, the IRS estimated the cost of tax examiners at \$16.50 per direct hour. The campuses incurred an extra \$4,545 in expenses from reviewing 142 tax returns that should not have been selected for examination under the 2 projects. Using our sample results, we calculated the percentage of cases that should not have been worked by the Correspondence Examination function under the EITC Schedule C Preparer TY 1999 and the EITC Schedule C TY 1999 projects.

- $142/319 = .445$ or 44.5 percent

We then calculated the additional average cost per case as a result of the Correspondence Examination function working these cases under the EITC Schedule C Preparer TY 1999 and the EITC Schedule C TY 1999 projects.

- $\$4,545/142 = \32.01

Applying these calculations to the overall population of 32,247 cases, we estimate that the IRS could have realized approximately \$459,341 in cost savings ($32,247 \times .445 \times \32.01) had it selected the proper cases to work under the EITC Schedule C Preparer TY 1999 and the EITC Schedule C TY 1999 projects.

⁵ The Correspondence Examination function is located at each IRS campus and examines tax returns for questionable issues that can be resolved with taxpayers through written correspondence. Issues generally involve overstating deductions and credits, claiming the improper filing status, or failing to report self-employment taxes.

⁶ IRS campuses refer tax returns too complex for correspondence examination to the Field Examination function. Field examinations take place at the taxpayer's place of business or are conducted through interviews at an IRS office.

⁷ The AIMS is a computer system designed to give Examination information about current tax returns in inventory, as well as tax returns that have been closed.

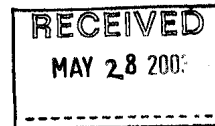
Not All Available Information Was Considered When Self-Employment Income Was Examined During the Fiscal Year 2000 Earned Income Tax Credit Initiative

Appendix V

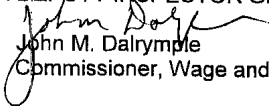
Management's Response to the Draft Report



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308
May 28, 2003



MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: 
John M. Dalrymple
Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report: Not All Available Information Was Considered When Self-Employment Income Was Examined During the Fiscal Year 2000 Earned Income Tax Credit Initiative (Audit #200340036)

The Fiscal Year (FY) 2000 Earned Income Tax Credit (EITC) Initiative included the examination of tax returns referred to Service Center Examination by Criminal Investigation because certain high-risk characteristics were present that caused us to question the taxpayers' net earning from self-employment, as reported on Schedule C. As a result, we questioned the taxpayers' EITC eligibility and, indirectly, any entitlements offered by the various Social Security laws, which accrue from self-employment earnings.

You found that tax returns examined as part of this initiative were "closed inappropriately" because we did not fully consider systemic information to verify taxpayers' self-employment income. We agree our guidelines for examining tax returns in connection with this initiative were unclear. We issued new procedures during the FY 2001 initiative requiring tax examiners to research the IRS' computer system for historical third party information before disallowing self-employment and related EITC claims. We also added this step to the automated screening filters, which look at prior year Form 1099s (U.S. Information Return) to establish that a business existed. If the system shows prior 1099s, we will not select the return for the questionable 1040 Schedule C issue. These procedures are in place for the nationwide processing of the FY 2003 EITC Initiative.

In February 2003, we asked Chief Counsel to determine whether we were correct in disallowing this income and the related EITC. We also asked Chief Counsel if we violated any taxpayers' rights or entitlements because we disallowed this income, and if so, how we can rectify any violation. We are anticipating Chief Counsel's guidance by June 1, 2003.

Your outcome measures are realistic. However, we cannot fully concur with them until we obtain the requested guidance from Chief Counsel.

**Not All Available Information Was Considered When Self-Employment Income
Was Examined During the Fiscal Year 2000 Earned Income Tax Credit Initiative**

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If you have any questions or need additional information regarding this response, please contact Jim Grimes, Director, Reporting Compliance, at (404) 338-7643.

Attachment

Not All Available Information Was Considered When Self-Employment Income Was Examined During the Fiscal Year 2000 Earned Income Tax Credit Initiative

Attachment

RECOMMENDATION #1

The Commissioners, Small Business/Self-Employed and Wage and Investment Divisions, should consult with the Office of Chief Counsel to determine the effect on taxpayers' rights and entitlements when valid self-employment income was disallowed for some of the taxpayers examined under the FY 2000 EITC Initiative.

CORRECTIVE ACTIONS

We have requested guidance from Chief Counsel. We will share this guidance with the Director, Reporting Compliance (Small Business/Self-Employed Division) and take appropriate action, as recommended by Chief Counsel.

IMPLEMENTATION DATES

Proposed: June 1, 2003

RESPONSIBLE OFFICIALS

Director, Reporting Compliance, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

N/A

RECOMMENDATION #2

The Commissioners, Small Business/Self-Employed and Wage and Investment Divisions, should ensure that IRS campuses properly research and classify tax returns for all future EITC initiatives, especially for those tax returns that cannot be electronically screened.

CORRECTIVE ACTIONS

Small Business/Self-Employed Division

In January 2002, we developed filters to select the Schedule C EITC inventory for tax year 2001 returns. The filters automatically "look back" to prior years for Schedule C activity for the taxpayer. Cases that did not meet the parameters of the filters were assigned a specific project code. Due to the complexity of the Schedule C issues, we manually classified these cases for selection by the Area offices.

We refined the filters in January 2003. They continue to look back for 2 years to identify any history of Schedule C activity. However, if a case does not meet the parameters of the filter, it is classified through the automated Discriminant Function process.

Wage and Investment Division (W&I)

The vast majority of returns W&I selects for review would not contain any additional issues that require manual screening. In most instances, W&I looks at EITC, dependencies and filing status. All of these issues have electronic filters in place.

**Not All Available Information Was Considered When Self-Employment Income
Was Examined During the Fiscal Year 2000 Earned Income Tax Credit Initiative**

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IMPLEMENTATION DATE

Completed January 31, 2003 (filters refined)

RESPONSIBLE OFFICIAL(S)

Director, Reporting Compliance, Small Business/Self-Employed Division

Director, Reporting Compliance, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

N/A