

**The Internal Revenue Service Can Better
Use Collectibility Information
During the Examination Process**

September 2000

Reference Number: 2000-30-165

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



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

September 29, 2000

MEMORANDUM FOR COMMISSIONER ROSSOTTI

A handwritten signature in cursive script that reads "Pamela J. Gardiner".

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – The Internal Revenue Service Can Better
Use Collectibility Information During the Examination Process

This report presents the results of our review of the Internal Revenue Service's (IRS) use of collectibility information during the examination process. The overall objectives of our review were to determine whether the field Examination function appropriately considered collectibility before opening examinations, limited the scope of examinations in process once there was an indication of low collection potential, and took appropriate actions to collect additional tax identified when closing examinations.

In summary, we found that payment solicitation efforts on agreed examinations were frequently successful. However, examiners sometimes conducted examinations on taxpayers who may be a collection risk. In addition, collectibility indicators that are supposed to warn employees of a potential collection risk appear on some accounts that may not actually present a collection risk.

We recommended that the Director, Compliance (Small Business/Self-Employed Division), monitor and stress the importance of considering collectibility indicators before and during examinations with both managers and examiners and consider making the indicator more obvious on the tax return charge out. In addition, the computer program to identify taxpayers' accounts that were closed as not collectible should be modified to exclude those accounts where collection was not or may no longer be at risk.

Management's response was due on September 27, 2000. As of September 28, 2000, management had not responded to the draft report.

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 your staff may call Gordon C. Milbourn III, Associate Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-3837.

**The Internal Revenue Service Can Better Use Collectibility
Information During the Examination Process**

Table of Contents

Executive Summary.....	Page i
Objectives and Scope.....	Page 1
Background	Page 1
Results	Page 2
Payment Solicitation Efforts on Agreed Examinations Were Frequently Successful.....	Page 3
Examiners Conduct Examinations on Taxpayers Who May Be a Collection Risk	Page 4
Collectibility Indicators Appear on Accounts That May Not Present a Collection Risk.....	Page 7
Collectibility Indicators Were Not Included in a New System That Will Be Used to Screen Tax Returns for Examination Potential.....	Page 8
Conclusion.....	Page 8
Appendix I – Detailed Objectives, Scope, and Methodology	Page 9
Appendix II – Major Contributors to This Report.....	Page 14
Appendix III – Report Distribution List.....	Page 15
Appendix IV – Outcome Measures.....	Page 16
Appendix V – Source of Examinations Reviewed.....	Page 18

The Internal Revenue Service Can Better Use Collectibility Information During the Examination Process

Executive Summary

The Examination function of the Internal Revenue Service (IRS) examines tax returns to determine whether taxpayers accurately report their tax liabilities. If the liability was not accurately reported, examiners recommend changes to adjust the liability to an amount that reflects income and expenses which are supported with documentation provided by the taxpayer.

For years, managers and examiners paid little attention to whether taxpayers could pay any additional taxes due resulting from examinations. In the early 1990's, the IRS became concerned about the sources of the growing volume of accounts that were not collectible. One reason for the increase in these accounts was the additional tax identified during examinations. To address the problem, the Examination function developed procedures to consider the potential collectibility of accounts before selecting or examining tax returns of taxpayers with known collection problems and to solicit payments from taxpayers when closing examinations.

Our overall objectives were to determine whether the field Examination function appropriately considered collectibility before opening examinations, limited the scope of examinations in process once there was an indication of low collection potential, and took appropriate actions to collect additional tax identified when closing examinations. We focused our review on tax returns filed by self-employed and small corporate taxpayers who will generally come under the IRS' new Small Business/Self-Employed (SB/SE) Division.

Results

The Examination function's payment solicitation efforts were frequently successful when closing cases where the taxpayer agreed with the recommended tax changes. However, our review of cases with collectibility indicators¹ showed that examiners sometimes conduct examinations on taxpayers who appear to be a collection risk. On the other hand, collectibility indicators appear on some accounts that may not actually present a collection risk; these tax returns may inappropriately be kept from being examined. In addition, at the time of our review, the collectibility indicator was not part of the design of a new system that will be used to screen tax returns for examination potential.

¹ The collectibility indicator appears on an IRS control form and computer system when the taxpayer applied for bankruptcy, had accounts closed as currently not collectible, or has accounts currently assigned for collection by field employees.

The Internal Revenue Service Can Better Use Collectibility Information During the Examination Process

Payment Solicitation Efforts on Agreed Examinations Were Frequently Successful

The Examination function's payment solicitation efforts were frequently successful when closing cases where the taxpayer agreed with the recommended tax changes. A payment or payment arrangement was made prior to issuance of the first balance due notice in 83 (66 percent) of the 125 agreed cases we reviewed. IRS reports also indicate payment solicitation is mostly successful. For Fiscal Year (FY) 1999, these reports show that 68.5 percent of the tax and interest the Examination function assessed to taxpayers' accounts was collected before issuance of the second balance due notices.

Examiners Conduct Examinations on Taxpayers Who May Be a Collection Risk

Of the 90 cases we reviewed with collectibility indicators, 35 (39 percent) showed poor collection potential when the examination started. The managers and examiners did not document in the case files why these examinations were conducted, nor was there evidence of an overriding compliance justification for conducting the examinations. National Examination statistics also showed that collectibility was not always considered. For FY 1999, the Examination function's quality review process determined that collectibility was not considered prior to first contact in about 28 percent of the applicable cases reviewed.

Managers were not effectively addressing collectibility before assigning cases. In addition, not all examiners were fully aware of how to identify collectibility indicators on cases, and most felt that once they were assigned a case they were responsible for conducting the examination.

As a result, only 4 of the 35 cases have been fully paid. Full payment is not likely in another 18 of the cases because they were removed from the active collection inventory, closed as not collectible or the taxpayers applied for bankruptcy or an offer in compromise. The remaining cases are currently in one of the various collection stages and ultimately may not be collected.

Collectibility Indicators Appear on Accounts That May Not Present a Collection Risk

Of the 90 cases mentioned in the preceding section, 63 had the "uncollectible" collectibility indicator. Thirteen (21 percent) of the 63 cases may not actually be a collection risk. The indicator in these cases shows that the taxpayer has an account previously closed as not collectible, but in:

- Six cases the "uncollectible" liabilities were fully paid before the current examination started.

The Internal Revenue Service Can Better Use Collectibility Information During the Examination Process

- Five cases the accounts were closed as not collectible because of the minimal amount due (tolerance) on the account.
- Two cases the accounts were closed as not collectible up to 13 years ago, and the collection statute on the accounts expired at least 4 years ago, well before the current examination started. A long time span between an uncollectible determination and a subsequent examination may not be a valid indication of the taxpayer's current ability to pay.

This occurred because the computer program to identify taxpayers that may present a potential collection risk was not working properly.

Payment results on the current examination liability show that these conditions do not necessarily indicate poor collection potential. Only 2 of the 13 cases have been closed as not collectible. We could not determine how many potential examinations were closed primarily because the uncollectible indicator was present.

Collectibility Indicators Were Not Included in a New System That Will Be Used to Screen Tax Returns for Examination Potential

The IRS plans to implement a new system for screening tax returns to identify examination potential. However, this system does not include collectibility indicators. Based on our inquiries, the Examination function initiated corrective action by preparing a request to have collectibility indicators added to the new system.

Summary of Recommendations

We recommend that the Director, Compliance (SB/SE Division), monitor and stress the importance of considering collectibility indicators before and during examinations with both managers and examiners and consider making the indicator more obvious on the tax return charge out.² In addition, the computer program to identify taxpayers' accounts that were closed as not collectible should be modified to exclude those accounts where collection was not or may no longer be at risk.

² The Examination Return Charge Out (Form 5546) is used to show where a tax return pulled from storage files is located. It also contains information about past examinations and collectibility indicators.

**The Internal Revenue Service Can Better Use Collectibility
Information During the Examination Process**

Management's Response: Management's response was due on September 27, 2000. As of September 28, 2000, management had not responded to the draft report.

The Internal Revenue Service Can Better Use Collectibility Information During the Examination Process

Objectives and Scope

We reviewed the IRS' procedures to consider collectibility before and during examinations and to solicit payment when closing examinations.

Our overall objectives were to determine whether the Internal Revenue Service's (IRS) field Examination function appropriately considered collectibility before opening examinations, limited the scope of examinations in process once there was an indication of low collection potential, and took appropriate actions to collect additional tax identified when closing examinations. We focused our review on tax returns filed by self-employed and small corporate taxpayers who will generally come under the IRS' new Small Business/Self-Employed (SB/SE) Division.

To accomplish our objectives, we held discussions with personnel in the National Headquarters and in the Illinois, Ohio, and Southern California Districts. We also reviewed cases selected from a nationwide file of Fiscal Year (FY) 1999 examination closures. We conducted the review from February to July 2000 in accordance with *Government Auditing Standards*.

Details of our audit objectives, scope, and methodology are presented in Appendix I. Major contributors to this report are listed in Appendix II.

Background

The Examination function of the IRS examines tax returns to determine whether taxpayers accurately report their tax liabilities. These tax returns are identified through computer and manual screening processes that include identifying specific items to verify during the examination. Once selected, these tax returns are provided to managers for assignment to examiners. If the liability was not accurately reported, examiners recommend changes to adjust the liability to an amount that reflects income and expenses which are supported with documentation provided by the taxpayer. The Examination function's management information

The Internal Revenue Service Can Better Use Collectibility Information During the Examination Process

The volume of accounts not collected was due, in part, to the fact that examiners paid little attention to the taxpayer's collection potential.

system, the Audit Information Management System (AIMS), is used to control tax returns through the various examination phases.

For years, managers and examiners paid little attention to whether the taxpayer could pay any additional taxes due resulting from examinations. In the early 1990's, the IRS became concerned about the sources of the growing volume of accounts that were not collectible. One reason for the increase in these accounts was the additional tax identified during examinations. To address the problem, the Examination function developed procedures to consider the potential collectibility of accounts before selecting or examining tax returns of taxpayers with known collection problems and to solicit payments from taxpayers when closing examinations.

During FY 1999, 26,939 (6 percent) of the tax returns controlled on the AIMS had an indicator showing that the taxpayer could be a poor collection risk. Examinations were conducted on 47 percent of these tax returns. In contrast, of the other 94 percent of the tax returns controlled on the AIMS, the IRS examined only 29 percent.

Results

The Examination function has emphasized collectibility in several ways. Collectibility was included as an emphasis area in the FY 1999 Examination Program Letter and is a measure in Examination's quality review process. In addition, collectibility procedures were recently combined into a new handbook in the Internal Revenue Manual (IRM).

Examination's payment solicitation efforts were frequently successful when closing cases where taxpayers agreed with the recommended tax changes. However, our review of cases with collectibility

The Internal Revenue Service Can Better Use Collectibility Information During the Examination Process

indicators¹ showed that examiners sometimes conduct examinations on taxpayers who appear to be a collection risk. On the other hand, collectibility indicators appear on some accounts that may not present a collection risk; these tax returns may inappropriately be kept from being examined. In addition, at the time of our review, the collectibility indicator was not part of the design of a new system that will be used to screen tax returns for examination potential.

Payment Solicitation Efforts on Agreed Examinations Were Frequently Successful

Examiners are instructed to use a tiered interview approach to secure payment when closing cases where the taxpayer agrees with the recommended tax changes. The tiered approach consists of discussing various payment options, starting with requesting full payment.

The Examination function also developed a payment information sheet that is part of the Examination report provided to taxpayers. The sheet provides information on the various payment options. It explains that paying as soon as possible reduces the amount of interest charged to the taxpayer since interest accrues until balances due are paid.

Our review showed that the Examination function's payment solicitation efforts, when closing an examination, were frequently successful. A payment was made or payment plan was arranged prior to issuance of the first balance due notice in 83 (66 percent) of the 125 agreed cases we reviewed. IRS reports also indicate payment solicitation is mostly successful. For FY 1999, these reports show that 68.5 percent of tax and interest the Examination function

Examiners provide an information sheet to taxpayers that explains payment options.

A payment was made or payment plan was arranged in 66 percent of the cases we reviewed.

¹ The collectibility indicator appears on an IRS control form and computer system when the taxpayer applied for bankruptcy, had accounts closed as currently not collectible, or has accounts currently assigned for collection by field employees.

The Internal Revenue Service Can Better Use Collectibility Information During the Examination Process

assessed to taxpayers' accounts was collected before issuance of the second balance due notice.

Examiners Conduct Examinations on Taxpayers Who May Be a Collection Risk

The Examination function developed indicators to alert personnel that a taxpayer could be a poor collection risk.

Collectibility indicators that appear on Examination documents and on the AIMS alert Examination function employees that a taxpayer could be a poor collection risk. The indicators show that the taxpayer filed for bankruptcy, had accounts previously closed as not collectible, or has accounts currently assigned for collection by field employees. FY 1999 Examination data showed that obtaining a payment or payment arrangement was nearly three times more likely on examined cases without the indicator than on cases with it.

Examiners conducted examinations on 35 of 90 tax returns when the taxpayers could be a collection risk.

Collection was at risk in 35 (39 percent) of the 90 examinations we reviewed.² These cases had the collectibility indicators present prior to starting the examinations. Documentation was not in the case files explaining why these examinations were conducted when the collectibility indicator was present, nor was there an overriding compliance justification for conducting the examinations. Six of the 35 cases had information sheets showing what issues should be examined, but there was no explanation on the sheet of why the tax return was selected for examination even though the collectibility indicator was present.

Though the exception rate is not as high as that indicated by our review, national Examination statistics also showed that collectibility was not always considered. For FY 1999, the Examination quality review process determined that collectibility was not considered prior to first contact in about 28 percent of the applicable cases reviewed.

² Appendix V shows the Source Codes for the 90 cases.

The Internal Revenue Service Can Better Use Collectibility Information During the Examination Process

Managers and examiners did not effectively consider collectibility.

Conducting examinations on cases when the taxpayers present a collection risk was caused by a number of factors.

- Managers assigned cases for examination without effectively addressing collectibility. As noted above, no documentation was in the case file explaining why the examination should be conducted even though the collectibility indicator was present on the tax return charge out.³
- Managers and examiners may not be aware of collectibility issues when the case is assigned before it is controlled on the AIMS. In these cases, there will not be a charge out containing the indicator. In our sample of cases, this mainly occurred on cases where the taxpayers did not file their tax returns and the Examination function was responsible for establishing the returns on the Masterfile, which is the IRS' computer file containing taxpayer account information.
- Not all examiners were fully aware of how to identify cases with a potential collectibility issue. The collectibility indicator consists of one letter that appears on the tax return charge out between other information. Unless examiners know exactly where to look on the charge out, the indicator could easily be overlooked. The IRM Examination Collectibility Handbook does not explain where to find the indicator or contain an exhibit showing the indicator's location on the charge out.
- Examiners advised us that once they are assigned a case, they believe they are responsible for conducting the examination if issues with adjustment potential are present.

³ The Examination Return Charge Out (Form 5546) is used to show where a tax return pulled from storage files is located. It also contains information about past examinations and collectibility indicators.

The Internal Revenue Service Can Better Use Collectibility Information During the Examination Process

As a result, only 4 of the 35 cases reviewed have been fully paid.

As a result of conducting examinations on cases with questionable collection potential, only 4 of the 35 cases have been fully paid, and full payment is not likely in 18 of the cases. These 18 cases were removed from the active collection inventory or closed as not collectible, or the taxpayers applied for bankruptcy or an offer in compromise. The remaining cases are currently in one of the various collection stages and ultimately may also not be collected.

Recommendations

The Director, Compliance (SB/SE Division), should:

1. Stress the need for first-line managers and examiners to become more involved in collectibility determinations. This should be monitored during operational reviews.
2. Instruct managers and employees to make a collectibility determination on cases when an examination starts before the case is established on the AIMS, especially on taxpayers who are not voluntarily filing tax returns. This can be accomplished by reviewing a summary of each taxpayer's account. The corrective action for this recommendation should be coordinated with the new non-filer strategy being developed for taxpayers who are not voluntarily filing tax returns.
3. Revise the IRM Examination Collectibility Handbook to explain how to identify the collectibility indicator and consider making the indicator more obvious on the tax return charge out.

Management's Response: Management's response was due on September 27, 2000. As of September 28, 2000, management had not responded to the draft report.

The Internal Revenue Service Can Better Use Collectibility Information During the Examination Process

Collectibility Indicators Appear on Accounts That May Not Present a Collection Risk

Computer programming for collectibility indicators can be improved to better identify collection risk.

Of the 90 cases mentioned in the preceding section, 63 had the “uncollectible” collectibility indicator. Thirteen (21 percent) of the 63 cases may not actually be a collection risk. The indicator in these cases shows that the taxpayer has an account previously closed as not collectible, but in:

- Six cases the “uncollectible” liabilities were fully paid before the current examination started.
- Five cases the accounts were closed as not collectible because of the minimal amount due (tolerance) on the account.
- Two cases the accounts were closed as not collectible up to 13 years ago, and the collection statute expired on the accounts at least 4 years ago, well before the current examination started. A long time span between an uncollectible determination and a subsequent examination may not be a valid indication of the taxpayer’s current ability to pay.

This occurred because the computer program to identify taxpayers that may present a potential collection risk was not working properly.

Payment results on the current examination liability show that these conditions do not truly indicate poor collection potential. Only 2 of these 13 cases have been closed as not collectible.

While the uncollectible indicator may be present on a return, employees are instructed to also consider other factors, such as the taxpayer’s current financial condition, as part of the collectibility assessment. We could not determine how many potential examinations were closed because the uncollectible indicator was present.

The Internal Revenue Service Can Better Use Collectibility Information During the Examination Process

Recommendation

4. The Director, Compliance (SB/SE Division), should request a revision to the collectibility indicator programming to exclude accounts where collection was not or no longer may be at risk, such as those we identified above.

Collectibility Indicators Were Not Included in a New System That Will Be Used to Screen Tax Returns for Examination Potential

As a result of our inquiries, the Examination function prepared a request to add collectibility indicators to a new examination screening system.

The Examination function plans to implement a new system for screening tax returns to identify examination potential. This system allows for screening tax returns with electronic information rather than using the physical tax return. Through inquiries, we determined that collectibility indicators were not available on the new system. Based on our inquiries, the Examination function initiated corrective action by preparing a request to have the collectibility indicator added to the new system.

Conclusion

The IRS' Examination function needs to effectively apply its limited resources to examinations with the greatest potential for collection of any additional taxes owed. However, the Examination function sometimes uses resources to conduct examinations on taxpayer accounts when the additional tax is not likely to be collected. These resources could be used more productively by conducting examinations on taxpayers who do not have known collectibility risks. On the other hand, some tax returns may inappropriately be eliminated from examination when collectibility indicators are not really valid.

The Internal Revenue Service Can Better Use Collectibility Information During the Examination Process

Appendix I

Detailed Objectives, Scope, and Methodology

Our overall objectives were to determine whether the Internal Revenue Service's (IRS) field Examination function appropriately considered collectibility before opening examinations, limited the scope of examinations in process once there was an indication of low collection potential, and took appropriate actions to collect deficiencies when closing examinations.

We selected two national samples of cases from Examination's Fiscal Year (FY) 1999 Closed Case Data Files obtained from National Headquarters Examination. To limit the sample selection to self-employed and small corporate cases, we included only individual tax returns with Schedules C or F and corporate tax returns with assets under \$5 million. Neither sample was statistically valid due to the large number of cases that would have needed to be reviewed. Therefore, judgmental samples were selected using a random number generator.

- Sample one involved case closures where there is a collectibility indicator¹ present on the module and a source code of 02, 05, 10, 12, 20, 24, 40, 44, 50, 62, 64, 65 or 70 (these were the source codes agreed to in advance by Examination). The universe of cases meeting the criteria was 9,566. We reviewed 90 of these cases to determine if the examination should have been surveyed² or limited in scope.
 - Sample two involved case closures with an agreed disposal code (03). The universe of cases meeting the criteria was 41,015. We reviewed 125 of these cases to determine if Examination was soliciting payments when the case was being closed.
- I. Determined whether field Examination employees effectively used collectibility indicators to survey an examination or limit the examination's scope.
 - A. Interviewed the national Examination Collectibility analyst and 29 employees in 3 districts to determine collectibility procedures.

¹ The collectibility indicator appears on an IRS control form and computer system when the taxpayer applied for bankruptcy, had accounts closed as currently not collectible, or has accounts currently assigned for collection by field employees.

² A process Examination uses to close a case when they decide not to conduct an examination.

The Internal Revenue Service Can Better Use Collectibility Information During the Examination Process

1. Determined who reviews the cases with collectibility indicators for an examination determination and what procedures are followed.
Determined what procedures are in effect for contacting the Collection function to obtain additional insight on the indicators.
 2. Determined how collectibility is determined when the return charge out is not available during the classification process.
 3. Determined what group managers do to consider collectibility before assignment.
 4. Determined how group managers become involved to limit the examination scope if collectibility becomes an issue during the examination.
 5. Determined if group managers provided feedback to individual examiners regarding the need to consider collectibility. Determined if group managers addressed collectibility when reviewing cases for closing.
 6. Determined how collectibility procedures were monitored and if any trending was done in an effort to identify problems.
 7. Obtained overall thoughts, concerns, and opinions about the existing collectibility program and any recommendations for improvement.
- B. Reviewed the adequacy of national instructions for collectibility, including the Internal Revenue Manual (IRM), Law Enforcement Manual (LEM), Examining Officer's Guide, and national memoranda.
- C. Obtained Examination's Closed Case Data File for FY 1999 and selected a random sample of 90 cases that had the collectibility indicator present.
- D. Performed a case review on the selected 90 cases.
1. Examined the return charge out, if available, to see if collectibility indicators were present. If the indicator or charge out was not present, reviewed case files and Masterfile³ transcripts to determine when the case first met collectibility indicator criteria.
 2. If the indicator should have been available at the time the return was classified, determined if the indicator was addressed by the classifier on the classification sheet.
 3. Identified the type of collectibility issue to determine if it appeared that collection was at risk.

³ The IRS database that stores various types of taxpayer account information.

The Internal Revenue Service Can Better Use Collectibility Information During the Examination Process

4. Reviewed case file documentation to determine if there was any explanation showing why the examination continued or was not limited in scope and the source of the information (group manager, examiner, etc.).
 5. If there was no documentation regarding limiting the examination scope, tried to determine from the case file if new issues were raised after the collectibility information should have been known.
 6. Made an overall assessment of whether collectibility was adequately considered before or during the examination.
 7. Identified the current status and the status during the examination of all tax periods to determine the potential impact on collectibility.
 8. Determined if Taxpayer Levy Source and Contact Information (Form 9440) was prepared on deficiency cases that were not fully paid.
 9. Noted any Audit Information Management System (AIMS) data discrepancies identified during the case review.
- II. Determined whether field Examination function employees solicited payments or installment agreements on agreed deficiencies.
- A. Interviewed the national Examination Collectibility analyst and 33 employees in 3 districts to determine payment solicitation procedures and perceived success with the policy.
1. Determined how the program was monitored and if any trending was done to identify problems. Determined what efforts were made to correct any problems identified.
 2. Determined if Examination Quality Management System (EQMS) and Enforcement Revenue Information System reports were made available and how the results were used at the group level.
 3. Determined if group managers reviewed cases at closing to ensure that adequate efforts were made to secure payment. Determined if group managers addressed problems identified with responsible examiners.
 4. Determined how the Examination function emphasizes the need to arrange for payment of agreed deficiencies when closing cases.
 5. Determined how the Examination and Collection functions coordinate to secure payment on agreed deficiencies.
- B. Reviewed the adequacy of national instructions to solicit payment on agreed deficiencies, including the IRM, LEM, Examining Officer's Guide, and national memoranda.

The Internal Revenue Service Can Better Use Collectibility Information During the Examination Process

- C. Obtained Examination's Closed Case Data File for FY 1999 and selected a random sample of 125 cases to review that were closed agreed.
- D. Performed a case review on the 125 selected cases. We reviewed the examination case files and Masterfile transcripts in 30 cases. For the other 95 cases, we only reviewed Masterfile transcripts.
 - 1. Reviewed case file documentation (30 cases) and Masterfile transcript information (125 cases) to determine what efforts were made to arrange for paying the deficiency.
 - 2. When full payment was not possible, determined if the deficiency amount was within the Examination function's installment agreement authority and, if so, if an installment agreement was discussed (30 cases).
 - 3. When the deficiency amount was outside the Examination function's installment agreement authority, determined what efforts were made to put the taxpayer in contact with the Collection function (30 cases).
 - 4. When the deficiency was \$100,000 and over or collection was at risk, determined if the Examination function put the taxpayer in contact with the Collection function (30 cases).
 - 5. If the taxpayer had other unpaid balances when the Examination function was closing the case, determined if these were included in the payment solicitation or installment agreement (30 cases).
 - 6. Determined if Form 9440 was prepared on deficiency cases that were not fully paid (30 cases).
 - 7. Determined how much of the deficiency was paid prior to case closing, between case closing and issuance of the first notice, and between issuance of the first and second notices (125 cases).
 - 8. Noted whether the payment and installment agreement solicitation entries to the AIMS were correct (125 cases).
- III. Determined if there was adequate review and oversight of the program to ensure it was operating effectively.
 - A. Interviewed the national Examination collectibility analyst to determine how the overall success of the collectibility and payment solicitation programs was monitored (e.g., management information system reports, the EQMS, visitations/reviews, etc.).
 - B. Reviewed monitoring reports to determine if problem trends were apparent. Determined if the trends were identified and what actions were taken to correct the problems.

**The Internal Revenue Service Can Better Use Collectibility
Information During the Examination Process**

- C. Compared our case review results to applicable management information system report statistics.
- D. Interviewed the national Examination collectibility analyst and EQMS personnel to determine how they interpreted EQMS results and what actions were taken to correct any overall problems identified.

**The Internal Revenue Service Can Better Use Collectibility
Information During the Examination Process**

Appendix II

Major Contributors to This Report

Gordon C. Milbourn III, Associate Inspector General for Audit (Small Business and Corporate Programs)

Parker F. Pearson, Director

Amy L. Coleman, Audit Manager

Joseph P. Snyder, Senior Auditor

Donald Evans, Auditor

Janice A. Murphy, Auditor

Janis Zuika, Auditor

**The Internal Revenue Service Can Better Use Collectibility
Information During the Examination Process**

Appendix III

Report Distribution List

Deputy Commissioner Operations C:DO
Chief Operations Officer OP
Commissioner, Small Business/Self-Employed Division S
Assistant Commissioner, Examination OP:EX
Director, Compliance (Small Business/Self-Employed Division) S
Director, Illinois District D
Director, Ohio District D
Director, Southern California District D
Director, Legislative Affairs CL:LA
Office of Management Controls M:CFO:A:M
Office of the Chief Counsel CC
Director, Office of Program Evaluation and Risk Analysis M:OP
National Taxpayer Advocate C:TA
Audit Liaison:
 Assistant Commissioner (Examination) OP:EX:MA

The Internal Revenue Service Can Better Use Collectibility Information During the Examination Process

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.

Finding and recommendation:

Examination employees were not always effectively considering collectibility when examining tax returns. Collectibility indicators appear on tax return charge outs and Examination's management information system, the Audit Information Management System (AIMS), to warn that a taxpayer could be a poor collection risk. However, examiners conducted examinations on tax returns when these indicators were present. This resulted in foregone revenue of approximately \$8.1 million (see Page 4).

We recommended that the Director, Compliance (Small Business/Self-Employed Division), address this issue by:

- Stressing the need for first-line managers and examiners to become more involved in collectibility determinations.
- Instructing managers and employees to make collectibility determinations on cases using account summary information when the examination starts before the case is established on the AIMS.
- Revising the Internal Revenue Manual Examination Collectibility Handbook to explain how to identify the collectibility indicator and consider requesting a program change to make the indicator more obvious on the tax return charge out.

Type of Outcome Measure:

Increased Revenue - \$8.1 million (Potential)

Value of the Benefit:

We estimate that the cost of conducting examinations on taxpayers who may not be able to pay any additional tax assessed at approximately \$8.1 million.

Methodology Used to Measure the Reported Benefit:

We did not select a statistically valid sample due to the large number of returns that would need to be reviewed. However, if our results are representative of the universe,

The Internal Revenue Service Can Better Use Collectibility Information During the Examination Process

Examination spent almost 20 staff years in Fiscal Year (FY) 1999 conducting examinations where collection was at risk when the examination started. This equates to \$8.1 million in foregone revenue for the government.

We calculated this estimate using information obtained from Examination's Closed Case Data Files and provided by Internal Revenue Service (IRS) management. We computed the average dollars recommended per hour in FY 1999 from an Examination Report (Table 37) using only small business and self-employed taxpayer examination results.

Measure	
Number of small business cases examined with the collectibility indicator	9,566
Exception rate of cases we reviewed (35/90)	.388888
Potential number of cases that should not have been examined	3,720
Average hours per case for exception cases	10.66
Potential hours spent on cases that should not have been examined	39,655
Average dollars recommended per hour on small business and self-employed activity code cases (Revenue Agents & Tax Auditors FY 1999)	\$480.31
Potential total dollars recommended	\$19,046,693
Ratio of Examination dollars collected/recommended (factor provided by IRS Research Division)	.45
Estimated foregone revenue	\$8,571,012
Potential revenue collected on cases that should not have been examined (based on the revenue collected on exception cases in our sample) ¹	\$497,584
Total Estimated Foregone Revenue ²	\$8,073,428

¹ This is based on the amount collected on the exception cases in our sample as of July 26, 2000. Only 13 of the 35 were still in one of the active collection stages.

² We estimate that \$2 million of this amount is attributable to cases on taxpayers who did not voluntarily file tax returns.

**The Internal Revenue Service Can Better Use Collectibility
Information During the Examination Process**

Appendix V

Source of Examinations Reviewed

Source Code	Explanation	Sample Universe	Exception Cases
02	Computer Scored	35	10
20	Regular Classification	3	0
24	Non-filer/Refusal to File	37	19
62	Information Gathering Project	8	4
65	Collection Referral	4	1
70	Referral	3	1
Total		90	35

Note: Source codes for cases that indicated a multiple year pick-up were converted to the original tax period's source code.