

National Taxpayer Advocate

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**AN ANALYSIS OF THE
IRS EXAMINATION STRATEGY:
SUGGESTIONS TO MAXIMIZE
COMPLIANCE, IMPROVE
CREDIBILITY, AND RESPECT
TAXPAYER RIGHTS**

An Analysis of the IRS Examination Strategy: Suggestions to Maximize Compliance, Improve Credibility, and Respect Taxpayer Rights¹

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¹ The principal author of this study is Karen Sheely, Systemic Advocacy Examination Technical Liaison.

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EXECUTIVE SUMMARY

In the 2008 Annual Report to Congress, the National Taxpayer Advocate discussed concerns about the suitability of the IRS examination process, and questioned whether audit results reflect a correct determination of tax or a taxpayer's inability to navigate the system.² Instead of focusing on meeting taxpayer needs and increasing personal communication to determine the correct tax liability, the IRS increased its use of automated, streamlined examination processes and reduced personal contacts. In fiscal year (FY) 2010, 86 percent of individual audits were conducted by correspondence, and 42 percent concluded with no personal contact with the IRS whatsoever.³ The examination process has become so removed that more than 25 percent of the EITC taxpayers surveyed for a TAS Research study were not even aware the IRS had audited their returns.⁴

The IRS is continuing to expand its automated examination, and examination-like procedures. It recently began to expand "audit coverage" using Accounts Management employees (instead of Examination employees) to "audit" cases previously considered "below tolerance" for Examination.⁵ In addition, in FY 2010 the IRS made about 15 million contacts that many taxpayers may regard as examinations because they involve IRS attempts to match third-party income reporting to the return filed, or correct an error or omission.⁶ The IRS has taken the position that these contacts do not constitute an examination because the IRS is not examining books or records but merely asking the taxpayer to explain a discrepancy.⁷ By designating this contact as "not an examination," the IRS does not trigger a taxpayer's right to avoid unnecessary examinations and reserves the right to examine the books and records later.⁸ The National Taxpayer Advocate is concerned that these new streamlined procedures bypass key taxpayer rights the IRS routinely provides to taxpayers subject to "real" examinations.

There is no doubt that the IRS needs automation to administer tax laws and tax-based social programs efficiently. However, instead of looking forward to identify new ways of doing business, the IRS examination strategy relies on outdated communication methods that do not meet the needs and preferences of taxpayers. The future of examination requires the IRS to use automation and technology in a way that benefits taxpayers. For example, the implementation of a virtual face-to-face audit appointment system could

² National Taxpayer Advocate 2008 Annual Report to Congress 227-242.

³ For FY 2010, 86 percent of all individual tax return audits were correspondence audits and 42 percent concluded without personal contact. Automated Information Management System (AIMS) from the CDW FY 2010 (Dec. 2011).

⁴ National Taxpayer Advocate 2007 Annual Report to Congress vol. 2, 103.

⁵ IRS, Pre-Refund Program (PRP), *Executive Steering Committee Briefing* (July 25, 2011).

⁶ The IRS conducted 1,581,394 examinations of individuals, closed 4,336,000 "Automated Underreporter" contact cases, sent 8,445,374 math error notices, and made 793,132 Automated Substitute for Return (ASFR) assessments in FY 2010. IRS, Collection Activity Report NO-5000-139, *National Delinquent Return Activity Report* (2010) (ASFR data); IRS Data Book, *Table 14, Information Reporting Program* (FY 2010) (AUR data); IRS Data Book, *Table 15, Math Errors on Individual Income Tax Returns by Type of Error Calendar Year 2010* (FY 2010) (math error data); IRS Data Book, *Table 9a, Examination Coverage* (FY 2010) (examination data).

⁷ See Rev. Proc. 2005-32, § 4.03 2005-1 C.B. 1206.

⁸ IRC § 7605(b).

increase communications and provide prompt, personal auditor contacts that could ultimately reduce expensive downstream compliance costs such as repeat contacts, appeals, audit reconsiderations, and the assistance of the Taxpayer Advocate Service.

The purpose of this analysis is to look at the IRS examination strategy and identify ways to use the audit process to protect taxpayer rights, increase compliance, and preserve IRS credibility. This study indicates that a more effective examination strategy must include a greater emphasis on taxpayer communication and provide that every audit, or similar examination process, no matter the dollar amount involved, must instill and protect due process and taxpayer rights.

The National Taxpayer Advocate challenges the IRS to ensure that for every audit, or similar examination process, no matter the dollar amount involved, the IRS should:

1. In light of the information available in the 21st century, review and reassess the audit processes deemed “not an examination” and instead use the audit process to protect taxpayer rights, increase compliance, and preserve IRS credibility.
2. Provide a clear, concise, and understandable initial contact letter that places taxpayers on notice as to whether they are under audit and explains the rights associated with the process.
3. Whenever possible, verbally discuss the audit process and appeal rights with the taxpayer during the first interview to ensure that the taxpayer understands the process, what he or she needs to do, and his or her appeal rights.
4. Train all examiners in the tax law, not just IRS publications, so they are capable of and comfortable with discussing issues and the basis for determinations with taxpayers and practitioners.
5. Revisit the definition of “computer-generated letter,” provide taxpayers with direct contact information for the assigned examiner, and permit taxpayers to contact and discuss the case with one examiner who will work that case to resolution.

Additionally, the National Taxpayer Advocate offers the following specific recommendations to the correspondence examination program to meet taxpayer needs and preferences and in doing so maximize compliance:

1. Conduct a comprehensive review of the work of correspondence examination and its staffing needs, today and in the future — and determine how to best incorporate virtual service delivery and other technologies such as a remote office audit to facilitate better interaction and service to taxpayers.
2. Whenever reasonable, use the term “audit” in place of “examination.” Words like “review” or “exam” confuse taxpayers. “Audit” alerts the taxpayer to the importance of the IRS action.
3. Limit correspondence audits to returns with specific, clear-cut issues. Returns requiring income probes or issues that generally require voluminous records, such as

employee business records, are best handled by Tax Compliance Officers in an office or field setting.

4. Include in all correspondence involving determinations the name, telephone number, and unique identifying number of the IRS employee making the determination, as required by RRA 98.
5. Reinstate procedures under which, if they would benefit the taxpayer, one IRS employee is assigned to handle a case until it is resolved.
6. Test the ability to establish a telephone audit appointment, where an examiner can hold an initial interview, explain the examination process and appeal rights, discuss documentation, and define the next steps.
7. Redesign correspondence audit letters to increase comprehension, reduce redundant phone calls, and meet the requirements of the Plain Writing Act of 2010.
8. Improve training for Tax Examiners and provide them the technical guidance they need to be completely comfortable handling calls and inquiries.
9. Update the transfer request guidance to bring the regulation into conformity with the structure in place for more than a decade and describe situations where a request for a face-to-face audit is appropriate and will be considered.
10. Institute a technical review process to preserve the “presumption of correctness” of the Statutory Notice of Deficiency and resulting assessments. The review should focus on making sure the correct amount of tax is assessed against the correct taxpayer only after full consideration and discussion of any documentation submitted.

INTRODUCTION

The IRS examination process serves a critical role in tax administration.

The IRS is authorized by Congress to administer and supervise the execution and application of the nation’s tax laws as detailed in the Internal Revenue Code (IRC).⁹ As a matter of policy, the IRS Internal Revenue Manual (IRM) emphasizes that, “A tax system based on voluntary assessment would not be viable without enforcement programs to ensure compliance.”¹⁰ The IRS examination process helps ensure compliance by carrying out the authority granted in IRC § 7602(a)(1) to examine any books, papers, records, or other data that may be relevant to ascertain the correctness of any return.¹¹

IRS examinations can leave a lasting impression — even on individuals who have never experienced an audit. IRS Oversight Board studies of taxpayer attitudes indicate that fear of an examination is a major influence to report taxes honestly. In 2010, 64 percent of taxpayers surveyed cited fear of an examination as a factor that influenced their voluntary

⁹ IRC §§ 7801 and 7803.

¹⁰ IRM 1.2.14.1.1 (Aug. 18, 1994).

¹¹ IRC § 7602.

compliance. The impact on compliance is reflected by a smaller percentage (12 percent) of taxpayers believing it was acceptable to cheat on their income taxes in 2010 than in 2009 (13 percent).¹²

While the IRS accepts most federal income tax returns as filed, it audits a certain number each year to verify accuracy and enforce compliance. The IRS conducts each audit (also called an examination or exam) in one of three ways: (1) in the field; (2) in an office; or (3) by correspondence. In fiscal year 2010, the IRS conducted 1,735,083 audits of returns.¹³ Also in FY 2010, the IRS made about 15 million contacts that many taxpayers may regard as examinations because they involve IRS attempts to match third-party income reporting to the return filed, or correct an error or omission.¹⁴

DISCUSSION

Some fear of an IRS audit may be warranted.

The prospect of an IRS audit can create anxiety for any taxpayer. Some argue there is nothing voluntary about our voluntary tax compliance system; it is only the fear of an audit that inspires the filing of returns and payment of taxes.¹⁵ Some fear, or perhaps more appropriately trepidation, is justified because in an IRS audit the taxpayer generally bears the burden of proof.¹⁶ That is, if the taxpayer does not rebut the IRS's determination, the court will assume the IRS is correct.

Previously, IRS Revenue Agents conducted audits with such a high level of professionalism, technical expertise, and oversight that IRS assessments generally deserved the

¹² IRS Oversight Board, *Taxpayer Attitude Survey 2* (Jan. 2011).

¹³ IRS Data Book, *Table 9a, Examination Coverage* (FY 2010).

¹⁴ The IRS conducted 1,581,394 examinations of individuals, closed 4,336,000 "Automated Underreporter" contact cases, sent 8,445,374 million math error notices, and made 793,132 Automated Substitute for Return (ASFR) assessments in FY 2010. IRS, Collection Activity Report NO-5000-139, *National Delinquent Return Activity Report* (2010) (ASFR data); IRS Data Book, *Table 14, Information Reporting Program* (FY 2010) (AUR data); IRS Data Book, *Table 15, Math Errors on Individual Income Tax Returns by Type of Error Calendar Year 2010* (FY 2010) (math error data); IRS Data Book, *Table 9a, Examination Coverage* (FY 2010) (examination data).

¹⁵ IRS Oversight Board studies of taxpayer attitudes showed that fear of an examination is a major factor influencing taxpayers to report taxes honestly. In 2010, 64 percent of taxpayers surveyed cited fear of an examination as a factor that influenced their voluntary compliance (up from 63 percent in 2009). IRS Oversight Board, *Taxpayer Attitude Survey 5* (Jan. 2011).

¹⁶ Tax deficiency assessments determined by the IRS generally carry a presumption of correctness, and this presumption imposes upon the taxpayer the burden of proving that the assessment is erroneous. See, e.g., *United States v. Janis*, 428 U.S. 433, 440 (1976). Exceptions exist to the presumption of correctness. For example, the IRS bears the burden of proof in fraud cases. Also, under IRC § 6201(d) if a taxpayer reasonably disputes an item of income reported on an information return by a third party and the taxpayer has fully "cooperated," the IRS has the burden of producing reasonable and probative information concerning such deficiency in addition to such information return. IRC § 6201(d) was enacted following the IRS's loss in *Portillo v. Comm'r*, 932 F.2d 1128 (5th Cir. 1991) where the IRS relied on an information return from a third party (a customer of the taxpayer) to assert under-reported income. Although the IRS established the taxpayer was a painter, engaged in painting during the period in question, the court held the proposed assessment was "arbitrary and erroneous" and not entitled to a presumption of correctness because the IRS failed to establish that the taxpayer received the unreported income after the taxpayer cooperated and raised reasonable concerns about the accuracy of the third-party reporting.

“presumption of correctness” granted by the courts.¹⁷ Proposed assessments were based on detailed face-to-face interviews, a reconciliation of books and records, and thorough tax law research by accounting professionals. While taxpayers sometimes disagreed with the IRS’s legal interpretations, the reliability of its accounting work was generally accepted. Unagreed cases were subject to significant internal review before the IRS would issue a Statutory Notice of Deficiency.¹⁸ Before preparing the Statutory Notice, the Quality Review unit would contact the taxpayer or authorized representative to ensure that he or she understood the purpose and function of the notice.¹⁹ Statutory Notices were not only reviewed by the Chief of Quality Review, but were inspected by IRS District Counsel and signed by the District Director.²⁰

The IRS now relies on a centralized, automated correspondence examination process for the majority of individual audits.

The IRS now relies on centralized, automated procedures that inspire less confidence.²¹ The IRS moved the bulk of its examination work from local offices conducting face-to-face audits to campus correspondence examination units.²² Most individual audits are now conducted by correspondence using an automated batch system.²³ Instead of an interview and review of books and records by a Revenue Agent, Tax Examiners (and even some Accounts Management employees), process examinations with limited taxpayer contact and review only selected documents.²⁴ These employees rely upon IRS forms and publications for guidance rather than the IRC. Audit reconsiderations, previously considered a rarity, are now common.²⁵ The Statutory Notice of Deficiency, once a closely reviewed legal document issued only after all administrative remedies were exhausted, is now automated, signed electronically without review, and casually referred to as a “SNOD.”

¹⁷ The justification given by courts for why the IRS’s notice of deficiency is presumed correct include: (1) the government’s need for the swift collection of revenues; (2) the inequality of information in the possession of the IRS relative to the taxpayer; and (3) to encourage taxpayers to keep records. See, e.g., *Zuhone v. Comm’r*, 883 F.2d 1317, 1326 (7th Cir. 1989); *Carson v. United States*, 560 F.2d 693, 696 (5th Cir. 1977); *Portillo v. Comm’r*, 932 F.2d 1128, 1133 (5th Cir. 1991). As a general rule, a court will not “look behind” a notice of deficiency by examining the IRS’s evidence, motives, or administrative policies or procedures. *Id.*

¹⁸ A Statutory Notice of Deficiency is required by IRC § 6212. It provides the taxpayer with the right to petition the Tax Court if he or she disagrees with the proposed deficiency. Taxpayers have 90 days (150 days if they are outside the United States) from the date of the notice to petition the Tax Court. IRC § 6213(a). The 90-day period cannot be extended and the Tax Court will not accept any late filed petitions.

¹⁹ IRM 4419, *Handbook for Quality Review, Section 242* (Dec. 22, 1981 Revision from IRS Archives).

²⁰ IRM 4460, *Notices of Deficiency* (Aug. 5, 1981 Revision from IRS Archives).

²¹ For a detailed discussion of the legal, demographics, and administrative factors that included the IRS’s drive to automation, see *From Tax Collector to Fiscal Automaton: Demographic History of Federal Income Tax Administration, 1913-2011*, *supra*.

²² During fiscal year (FY) 2010, more than 82 percent of the examinations of individuals were performed by correspondence. Treasury Inspector General for Tax Administration (TIGTA), Ref. No. 2011-30-071, *Trends in Compliance Activities Through Fiscal Year 2010* 11 (July 18, 2011).

²³ Batch processing, now called Automated Correspondence Exam (ACE), is an IRS-developed, multifunctional software application that fully automates the initiation, processing, and closing of correspondence examination cases. Using the ACE, Correspondence Exam processes cases with minimal to no Tax Examiner involvement until a taxpayer reply is received. IRM 4.19.20.1 (Jan. 1, 2011).

²⁴ Revenue Agents make tax determinations on field audits, Tax Examiners make determinations on Correspondence Examinations and Automated Underreporter cases, and Accounts Management employees provide taxpayer assistance on the IRS toll-free line.

²⁵ Taxpayers who disagree with the outcome of an audit may ask the IRS to reconsider the examiner’s determination if they have information not previously considered. See IRC § 7605(b). Audit reconsideration cases have increased about 190 percent, from 163,567 in FY 2006 to 474,581 in FY 2009. IRS, ERIS SBD 721 SBD 721 Database (July 27 & 28, 2010).

Field audits and correspondence audits differ in many ways.

Procedures for field and office audits reinforce the IRM requirement that “examiners have the ongoing responsibility to ensure all taxpayer rights are protected and observed, whether these rights are specified by statute or policy.”²⁶ Revenue Agents, who generally work on large cases where the taxpayer is represented by a tax professional familiar with the audit process, must fully explain appeal rights and provide their direct contact information in case there are any questions.²⁷ Conversely, Tax Examiners, who generally work with lower income individuals who are more likely to be unrepresented and unfamiliar with the tax administration process, mail the taxpayers a copy of Publication 1, *Your Rights as a Taxpayer*, and do not have a direct telephone number.²⁸ Tax Examiners work with low and middle income taxpayers who are less likely to be able to communicate effectively with the IRS and respond with relevant information that would enable the IRS to reach an accurate determination.

In Correspondence Examination, the IRS is less likely to ask questions that would yield an accurate determination. While all face-to-face audits include an analysis and examination of income to determine whether taxable income has been accurately reported, correspondence audits do not.²⁹ Correspondence examinations address one tax year only, while field auditors inspect and if necessary adjust prior and subsequent year returns.³⁰ Revenue Agents are required to consider “Badges of Fraud” and prepare a detailed analysis of case facts and circumstances before proposing a fraud penalty.³¹ Tax Examiners, however, process returns pre-identified (often through automated screens and filters) as fraudulent and propose strict liability penalties without any conversation with the taxpayer. For example, when the IRS detects an error on a return, automated systems assess an accuracy-related penalty before communicating with the taxpayer to determine whether he or she had the requisite intent or a reasonable cause for the violation.³²

The IRS is continuing to automate its examination procedures in ways that may reduce the accuracy of its determinations. It recently expanded “audit coverage” using Accounts Management employees to audit cases previously considered “below tolerance” for

²⁶ IRM 4.10.1.6 (May 14, 1999).

²⁷ IRM 4.10.1.6.3 (May 14, 1999).

²⁸ IRM 4.19.20.1.1 (Jan. 1, 2008). The batch system used to create the initial contact letter creates a letter, which is printed by the National Print Site and includes Publication 1, *Your Rights as a Taxpayer*, as a stuffer. The move to a Universal Call Routing system with no direct number was highlighted in IRS, W&I Compliance, *Compliance Chat* (Spring 2008).

²⁹ IRM 4.10.4 (Aug. 9, 2011).

³⁰ TIGTA, Ref. No. 2010-30-024, *Significant Tax Issues Are Often Not Addressed During Correspondence Audits of Sole Proprietors* 3-4 (Feb. 24, 2010).

³¹ Common factors used to make a determination of fraudulent intent are referred to as the “Badges of Fraud” by IRS Counsel and the courts. Although no single factor or badge will establish fraud, the existence of several indicators may constitute persuasive circumstantial evidence of fraudulent intent. IRM 25.1.2.3 (Jan. 1, 2003).

³² See National Taxpayer Advocate 2007 Annual Report to Congress 275 (*The Accuracy-Related Penalty in the Automated Underreporter Units*). For an in-depth analysis of the civil tax penalty regime, see National Taxpayer Advocate 2008 Annual Report to Congress vol. 2, 2 (*A Framework for Reforming the Penalty Regime*). We have recommended legislation to prevent the IRS from automatically assessing accuracy-related penalties without managerial review. See National Taxpayer Advocate 2008 Annual Report to Congress vol. 2, 18.

An Analysis of the IRS Examination Strategy: Suggestions to Maximize Compliance, Improve Credibility, and Respect Taxpayer Rights

Examination.³³ Efforts to expand coverage and streamline cases come at the expense of both examination quality and taxpayer rights. In one proposal, the IRS would identify a discrepancy between information reported on the return and information reflected in third-party data and then send out letters disallowing a tax benefit.³⁴ The contact letters for these returns did not mention the word “audit” or discuss appeal rights, but they did include a “SNOD.”³⁵ The IRS’s internal plan stated that if a question arises, Accounts Management employees with no examination or tax law research experience would be available to assist — when not answering other calls on the toll-free line.³⁶ Although not explicitly stated, the plan reflects a disturbing view that a case below the tolerance level for the Examination process is also below the tolerance level for due process and rights. The National Taxpayer Advocate continues to insist that the IRS instill and protect due process and taxpayer rights in every work plan.

The IRS could use automation and technology to increase the public’s confidence in the accuracy of its determinations while preserving taxpayer rights. For example, technology could help each taxpayer reach the employee working on his or her case and ensure that the IRS does not send correspondence to the wrong address. However, if the IRS continues to use automation in ways that do not inspire confidence in the accuracy of its determinations, those determinations may lose their presumption of correctness in court.³⁷

The public could also lose confidence in the IRS. Increasing audit coverage at the expense of quality and taxpayer rights may actually reduce voluntary compliance.³⁸ For example, audits that do not detect underreporting could hurt compliance if they show taxpayers the limits of the IRS’s ability to detect cheating. Enforcement activities and procedures that reduce trust in the government or the tax system could harm compliance. Unless the IRS reverses current trends and revises its future plans, its determinations could become a joke both in court and in the court of public opinion and voluntary compliance may suffer.

³³ IRS, Pre-Refund Program (PRP), *Executive Steering Committee Briefing* (July 25, 2011). Audit coverage, or the number of audits conducted, takes into consideration various tolerances specified in the Law Enforcement Manual (LEM) where the resources needed to complete an audit do not justify (from a cost-basis only) the potential tax adjustments. These cases are deemed “below tolerance” for Examination.

³⁴ IRS, *Overview of the Accelerated Refund Assurance Program (ARAP)*, Discussion Document (Oct. 16, 2011).

³⁵ Draft Form 4800 C on file with author.

³⁶ IRS, *Overview of the Accelerated Refund Assurance Program (ARAP)*, Discussion Document (Oct. 16, 2011).

³⁷ For example, in one case the IRS’s SNOD was “arbitrary and erroneous” and not entitled to a presumption of correctness because the IRS failed to establish that the taxpayer received the unreported income shown on a Form 1099, which the taxpayer disputed. *Portillo v. Comm’r*, 932 F.2d 1128 (5th Cir. 1991). Because the IRS concluded that this case was “susceptible to wholesale application to the IRP program and all 1099s,” it was concerned that the determinations issued as a result of its matching programs would not necessarily carry a presumption of correctness. LGM TL-100 (1994). Its fears materialized in 1996, when Congress enacted IRC § 6201(d), which provided a limited exception to the presumption of correctness. If a “cooperative” taxpayer asserts a reasonable dispute with respect to any item of income reported on an information return, under IRC § 6201(d) the IRS generally has the burden of producing other “reasonable and probative information” concerning the deficiency. Thus, under current law the “presumption of correctness” does not apply to a SNOD that increases the taxpayer’s income based solely on information provided on information returns, provided the taxpayer has cooperated and raises a reasonable dispute.

³⁸ For additional discussion of research in this area, see, e.g., National Taxpayer Advocate 2007 Annual Report to Congress vol. 2, 138-150 (Marjorie E. Kornhauser, *Normative and Cognitive Aspects of Tax Compliance*) (surveying tax compliance literature); National Taxpayer Advocate 2010 Annual Report to Congress vol. 2, 71 (*Researching the Causes of Noncompliance: An Overview of Upcoming Studies*) (surveying literature and proposing research into the causes of noncompliance).

Different parts of the IRS conduct different types of examinations.

The IRS identifies returns for examination through various methods, including computer scoring and document matching programs. Once selected for examination, the type of return (individual, business, or tax-exempt), the size of the entity, and the nature of the inquiry usually determine which IRS operating division will conduct the audit.³⁹

The Large Business & International Operating Division (LB&I) employs Revenue Agents who conduct audits at the taxpayer's place of business. Most LB&I taxpayers are high-asset corporations, whose returns involve large-dollar, complex issues requiring an extensive review of their books and records.⁴⁰ Similarly, Small Business/Self-Employed Operating Division (SB/SE) Revenue Agents conduct audits at the taxpayer's place of business. SB/SE field audits generally include smaller corporations, partnerships, and larger sole proprietorships.⁴¹ SB/SE Tax Compliance Officers, in contrast, conduct audits in an office setting, where individual taxpayers typically bring records for inspection.⁴²

The Wage and Investment Operating Division (W&I) and SB/SE employ Tax Examiners who conduct correspondence examinations from campus processing centers. These audits focus on a limited number of specific, clear-cut issues that would not normally require a full-scale field audit.⁴³

The IRS has increased its use of correspondence examinations as a low-cost way to increase the "audit coverage ratio."

The IRS examination strategy is based on the conclusion that more audits (audit coverage) generally lead to more compliance. According to IRS estimates, the indirect effect of an examination on voluntary compliance is between six and 12 times the direct effect, *i.e.*, *the amount of the adjustment*.⁴⁴ To expand audit coverage and theoretically increase the indirect effect of these audits, the IRS increasingly relies on an automated correspondence examination environment.⁴⁵ By using the Automated Correspondence Exam (ACE) system, the IRS has increased the individual tax returns audited to 1,581,394 (or one of every 90)

³⁹ IRS Pub.1, *Your Rights as a Taxpayer* (Rev. May 2008); IRS Pub. 556, *Examination of Returns, Appeals Rights, and Claims for Refund*, 2-3 (Rev. May 2008); IRS Pub. 3498-A, *The Examination Process (Examinations by Mail)* (Dec. 2006).

⁴⁰ IRM 4.46.1 (July 22, 2011).

⁴¹ IRM 4.10.2 (Aug. 2007); IRM 4.10.3 (Mar. 2003).

⁴² *Id.*

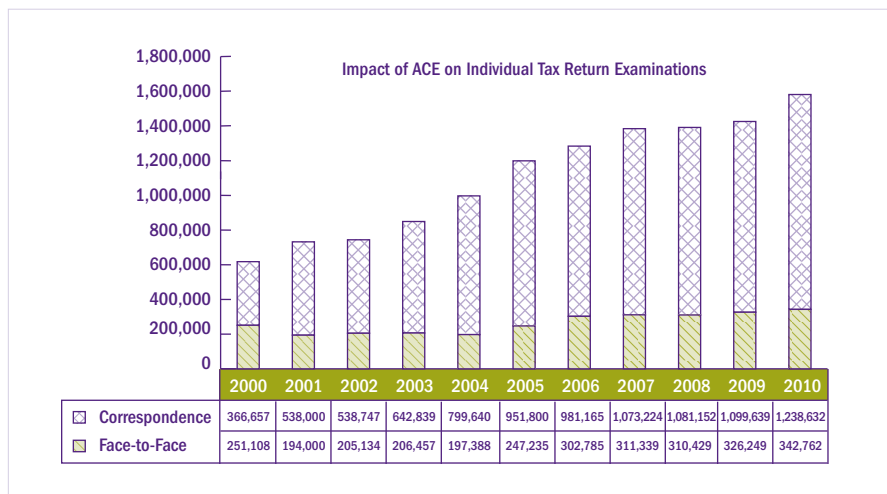
⁴³ IRM 4.10.3.16 (Mar. 1, 2003).

⁴⁴ See Alan H. Plumley, *The Impact of the IRS on Voluntary Tax Compliance: Preliminary Empirical Results*, Nat. Tax Assoc. 95th Annual Conf. on Taxation 8 (Nov. 2002), <http://www.irs.gov/pub/irs-soi/irsvtc.pdf> (11.7 times the proposed adjustment); Alan H. Plumley, Pub. 1916, *The Determinants of Individual Income Tax Compliance: Estimating the Impacts of Tax Policy, Enforcement, and IRS Responsiveness* 35-36 (Oct. 1996); Jeffrey A. Dubin, *Criminal Investigation Enforcement Activities and Taxpayer Noncompliance* 19 (May 2004), <http://www.irs.gov/pub/irs-soi/04dubin.pdf> (between six and seven times the proposed adjustment).

⁴⁵ TIGTA, Ref. No. 2010-30-024, *Significant Tax Issues Are Often Not Addressed During Correspondence Audits of Sole Proprietors* 3 (Feb. 24, 2010).

in FY 2010.⁴⁶ In FY 2010, correspondence examinations accounted for 73 percent of all examinations and more than 82 percent of all individual exams.⁴⁷

FIGURE 1, Impact of ACE on Individual Tax Return Examinations FY 2000-2010⁴⁸



Correspondence examinations may not have a positive ripple effect on voluntary compliance.

The business decision to devote resources to correspondence examination instead of face-to-face audits is contrary to the recommendations of a recent Government Accountability Office (GAO) study.⁴⁹ The study suggests that increasing enforcement efforts by field agents would be among the most effective steps the IRS could take to address the tax gap, though by no means the only step needed. One study participant made the point that field compliance efforts generally have a ripple effect and may have a larger impact on compliance than the actual audits.⁵⁰

The ripple effect of a correspondence examination, however, may be negligible.⁵¹ A correspondence audit that does not detect unreported income may actually reduce voluntary compliance if taxpayers conclude and tell others that the IRS did not uncover cheating.⁵² On the other hand, if the correspondence audit results in an incorrect assessment that

⁴⁶ TIGTA, Ref. No. 2011-30-071, *Trends in Compliance Activities Through Fiscal Year 2010 10-11* (July 18, 2011).

⁴⁷ *Id.*

⁴⁸ IRS Data Book, *Examination Coverage Table 10*, Fiscal Years 2000, and 2002 through 2005; TIGTA, Ref. No. 2002-30-184, *Management Advisory Report: Analysis of Trends in Compliance Activities 4-5*, (Sept. 2002) Through Fiscal Year 2001; IRS Data Book, *Examination Coverage Table 9*, Fiscal Years 2006-2007; IRS Data Book, *Examination Coverage Table 9a*, 2008-2010.

⁴⁹ See GAO, GAO-08-703SP, *Highlights of the Joint Forum on Tax Compliance: Options for Improvement and Their Budgetary Potential 7* (June 20, 2008).

⁵⁰ See *id.*

⁵¹ For an in-depth analysis of how the IRS Correspondence Examination Program does not promote voluntary compliance, see National Taxpayer Advocate 2008 Annual Report to Congress 158-167.

⁵² See, e.g., Alan H. Plumley, Pub. 1916, *The Determinants of Individual Income Tax Compliance: Estimating the Impacts of Tax Policy, Enforcement, and IRS Responsiveness 18* (Oct. 1996) (discussing this possibility).

requires the taxpayer to expend significant time and resources to correct, that taxpayer's experience may alienate others and encourage participation in the "cash" (*i.e.*, untrackable) economy.

The shift to automation can benefit the IRS examination strategy.

The IRS needs automation to administer tax laws and compliance-based programs such as Correspondence Examination efficiently. Automation can enhance speed and accuracy while promoting consistency. Automated processes that provide taxpayers with clear notices, ample response time, and appropriate assistance are used every day to handle everything from an erroneous cable bill to a traffic violation.

Automation also provides the IRS much-needed flexibility to meet customer demands. For example, the ability to shift work electronically from office to office has helped keep IRS offices experiencing a disaster up and running. Correspondence Examination moved in 2008 to a Universal Call Routing (UCR) system that directs incoming calls to the first available Tax Examiner and reduces waiting time.⁵³

Automation created a notable shift in Examination personnel.

Revenue Agents, listed as the largest group of employees in the IRS in a 1991 hiring brochure, are now outnumbered by Tax Examiners.⁵⁴ From 18,000 in 1991, the number of Revenue Agents dropped to 11,886 by 2001 and remained at this level through FY 2010.⁵⁵ Conversely, the number of Tax Examiners increased to 15,259 in FY 2010.⁵⁶

FIGURE 2, Tax Examiner/Revenue Agent Staffing Levels by FY



⁵³ The move to a Universal Call Routing system with no direct number was highlighted in IRS, W&I Compliance, *Compliance Chat* (Spring 2008).

⁵⁴ The brochure states, "Revenue Agents are the largest group of employees in the Service. In fact, with over 18,000 Revenue Agents, the IRS is the largest single employer of professional accountants in the world. Revenue Agents are professional accountants who examine and audit the books of individual and corporate taxpayers to determine correct federal tax liabilities." Recruitment brochure on file with author.

⁵⁵ TIGTA, Ref. No. 2011-30-071, *Trends in Compliance Activities Through Fiscal Year 2010* 9 (July 18, 2011); TIGTA, Ref. No. 2002-30-184, *Management Advisory Report: Analysis of Trends in Compliance Activities Through Fiscal Year 2001* 13 (Sept. 2002).

⁵⁶ Treasury Integrated Management Information System (TIMIS) on-roll data for the GS 592, Tax Examiner series as of Sept. 28, 2011.

In terms of production, the work of both Revenue Agents and Tax Examiners is impressive. In FY 2010, Tax Examiners processed 1,272,952 correspondence examinations resulting in tax assessments of \$8,394,819,000.⁵⁷ In FY 2010, Revenue Agents closed 462,131 cases resulting in assessments of \$36,415,664,000.⁵⁸

Revenue Agents and Tax Examiners have different educational backgrounds and receive different training.

One notable difference between field and correspondence examination is the educational requirements for the employees conducting the audits. It takes a well-trained tax accounting professional to apply increasingly complex tax laws in a global market. As such, it is not surprising that the requirements for a Revenue Agent include a four-year degree along with 30 semester hours of accounting coursework.⁵⁹ Similarly, Tax Compliance Officers who handle office audits are usually business majors and others who possess six semester hours of accounting or can pass an accounting proficiency test.⁶⁰ Once hired, Revenue Agents and Tax Compliance Officers go through extensive technical classroom instruction interspersed with on-the-job training to develop interview and audit techniques.⁶¹ What may be surprising is the work of the correspondence examination program, now the backbone of the IRS examination strategy, is completed by Tax Examiners, an entry-level position that requires a high school diploma or General Educational Development (GED) certificate.⁶²

Revenue Agents and Tax Examiners have different expectations.

Current hiring brochures extol that as a Revenue Agent,

“...you’ll be a proactive decision-maker, working side-by-side with customers, businesses, CFOs, CEOs and the legal and financial communities. You’ll use the latest in computers, telecommunications and data management systems. Interacting with taxpayers, businesses, tax-exempt organizations and more, you’ll display a keen knowledge of changing tax laws and accounting practices, as well as various types of businesses and industries. Your work will be to educate, assist and counsel.”⁶³

⁵⁷ IRS Data Book, *Examination Coverage Table 9a* (FY 2010).

⁵⁸ *Id.*

⁵⁹ See www.usajobs.gov for a complete list of requirements for a Revenue Agent, GS-512 series position.

⁶⁰ See www.usajobs.gov for a complete list of requirements for a Tax Compliance Officer, GS-526 series position. See also <http://jobs.irs.gov/midcareer/accounting-budget-finance.html#TaxComplianceOfficer>.

⁶¹ IRS Publication 4149, *Careers at the IRS - Internal Revenue Agent* (Mar. 2007).

⁶² Many Tax Examiners begin their IRS careers at Grade 5, which requires a candidate to have 12 months of specialized experience at the next lower grade, a bachelors' degree or four years of education above high school in any field of study from an accredited college or university, or combination of education and experience equivalent to that described above. The Grade 4 Tax Examiner position, which can provide specialized experience at the next lowest grade level, requires a high school diploma or GED certificate. See www.usajobs.gov for a complete list of requirements for a Tax Examiner, GS-592 series position.

⁶³ See <http://jobs.irs.gov/midcareer/internal-revenue-agentel.html> (last visited Dec. 16, 2011).

The duties described for a Tax Examiner are more rudimentary,

“If you want to apply your accounting skills to a role that puts you directly in touch with numbers, you should be one of our Tax Examiners. This position reviews tax returns for accuracy and completeness, reviews and codes tax returns for computer processing, resolves errors, and corresponds with taxpayers to obtain any missing information.”⁶⁴

In practice, Revenue Agents are expected to focus on problem solving and assist taxpayers in solving any tax problems identified during an examination, even if the problems are not related to the examination.⁶⁵ Conversely, Tax Examiners are told to transfer taxpayers to other offices to deal with issues not related to the audits.⁶⁶ Guidance to Revenue Agents recognizes that “effective communication with taxpayers is a significant factor in conducting a quality examination and in minimizing taxpayer burden.”⁶⁷ In focus groups held with Tax Examiners, employees reported that they are “...told to work the paper and get off the phone quickly.”⁶⁸ Perhaps because of such guidance, Tax Examiners close 42 percent of their correspondence examinations without any personal taxpayer contact.⁶⁹

The IRS does not fully train Tax Examiners on interview techniques or the tax law.

Tax Examiners receive technical training based on IRS publications, not the Code, regulations, or case law. Classroom training includes topics such as “Telephone Contacts”, but does not cover telephone interview techniques. When managers are asked why Tax Examiners are hesitant to discuss cases on the phone, they often respond that the employees are afraid they will not know the answers to the questions.⁷⁰ Until the policy recently changed (at the insistence of the Taxpayer Advocate Service), seasoned Tax Examiners auditing employee business expenses were not properly trained on accountable versus non-accountable plans — a key concept in determining deductibility.⁷¹

To best utilize employees without a tax accounting background as tax accountants, the IRS creates “If – Then” guidance. For example, “If” a taxpayer has a birth certificate and full-year school record for his or her child, “Then” the child meets the relationship and residency requirements for the Earned Income Tax Credit (EITC). “If” a taxpayer has a birth certificate where the paternal information is blank and the child is too young to be in

⁶⁴ See <http://jobs.irs.gov/seasonal/tax-examiner.html> (last visited Dec. 16, 2011).

⁶⁵ IRM 4.10.1.5.1 (May 14, 1999).

⁶⁶ IRM 4.19.19.3.4.2 (Aug. 5, 2011).

⁶⁷ IRM 4.10.1.5.3 (May 14, 1999).

⁶⁸ IRS, Phone Optimization Team, *Team Briefing* (June 29, 2009).

⁶⁹ For FY 2010, 86 percent of all individual tax return audits were correspondence audits and 42 percent concluded without personal contact. AIMS from the CDW FY 2010 (Dec. 2011).

⁷⁰ In employee focus groups, employees reported that they are “rushed” to the phones without proper training and receive calls on issues they are not training to work. IRS, Phone Optimization Team, *Team Briefing* (June 29, 2009).

⁷¹ Treas. Reg. § 1.62-2(c). See also National Taxpayer Advocate 2008 Annual Report to Congress, *Suitability of the Examination Process Recommendations* 242.

school or have a personal relationship with a pastor who could attest to residency, “Then” the taxpayer is simply out of luck. Alternative sources of documentation are neither offered, nor considered.⁷²

The correspondence examination process discourages communications between the IRS and taxpayers.

IRS examinations may not be what taxpayers expect.

Humorist Dave Barry described an IRS audit this way: “All that happens is, you take your financial records to the IRS office and they put you into a tank filled with giant, stinging leeches. Many taxpayers are pleasantly surprised to find that they die within hours.”⁷³ While some taxpayers may share this impression, the reality is that 86 percent of individual audits are conducted by correspondence, and 42 percent conclude with no personal contact with the IRS whatsoever.⁷⁴ The examination process has become so removed that more than 25 percent of the EITC taxpayers surveyed for a TAS Research study were not even aware the IRS had audited their returns.⁷⁵

The correspondence examination process discourages telephone communications.

Since Correspondence Examination adopted the UCR system, which routes incoming calls to the first available Tax Examiner, the IRS has no longer provided taxpayers with the examiner’s direct phone number. Prior to this change, the initial contact letter gave the taxpayer the general toll-free number for Correspondence Examination and listed the Operations Manager as the contact person. When the unit received correspondence, it updated the case and assigned it to a specific Tax Examiner. All future correspondence provided the taxpayer with contact information for the assigned employee, including his or her identifying number and direct extension on the toll-free line.

Under the new UCR system, the IRS does not provide a specific examiner name and extension, just the general toll-free number for the examination unit and the name of the Operations Manager.⁷⁶ As a result, no single employee is responsible and accountable for a case from receipt of correspondence until final determination, and taxpayers no longer have one specific point of contact most familiar with their cases.

When the IRS conducted research before making this substantial organizational change, it learned that taxpayers found it difficult to contact the assigned Tax Examiner and were frustrated by the wait times on toll-free lines.⁷⁷ Focus group interviews indicated that

⁷² IRM 4.19.14.5.8, *Filing Status* (Jan. 1, 2010), and IRM 4.19.14.5.9, *Child Tax Credit* (June 9, 2007), provide an example of the narrow “If – Then” guidance provided to Tax Examiners to disallow a filing status and a related child tax credit.

⁷³ Jeffery L. Yablon, *As Certain as Death, Quotations About Taxes*, Tax Analysts (2010 Edition).

⁷⁴ For FY 2010, 86 percent of all individual tax return audits were correspondence audits and 42.3 percent concluded without personal contact. AIMS from the CDW FY 2010 (Dec. 2011).

⁷⁵ National Taxpayer Advocate 2007 Annual Report to Congress vol. 2, 103.

⁷⁶ IRM 4.19.10.1.6.(6) (Jan. 1, 2011).

⁷⁷ Pacific Consulting Group, *Compliance Center Examination (CC Exam) SB/SE National Report, January Through March 2008* (July 2008).

the ease of reaching a person outweighed the desire to speak to the person making the determination. Focus group participants agreed that they would not mind speaking to different people about their cases as long as the employees were “on the same page” and “knew what they were doing.”⁷⁸ Accordingly, the IRS instituted call routing with the idea that this would be a better way to answer calls in a timely manner.

When taxpayers call, however, the employees who answer the phone are not all “on the same page.” When the IRS receives correspondence, the information is scanned and loaded on the Correspondence Imaging System (CIS), which is then uploaded to Correspondence Examination Automation Support (CEAS).⁷⁹ Any authorized examination employee can access a taxpayer’s case electronically and review the correspondence and substantiation. Tax examiners spend blocks of time working on correspondence or answering routed phone calls. Accordingly, the Tax Examiner who makes a determination on a case may not be the one the taxpayer reaches by phone.

Ideally, the IRS should document every case in a manner that allows anyone to review the file and determine why a particular decision was made, with all relevant conversations transcribed and details of determinations and decisions noted. The reality is that Tax Examiners update files between incoming calls, in what is referred to as “wrap time.”⁸⁰ Conversation notes are supposed to be summarized while on a call with the taxpayer, not during wrap time.⁸¹ However, when a taxpayer is on the line and a Tax Examiner knows additional callers are waiting, he or she is likely to take shortcuts and abbreviate notes. What might make perfect sense to the employee making the determination could be a mystery to the Tax Examiner answering a follow-up call. As such, taxpayers and practitioners now find they are not speaking to employees “on the same page”; nor are they satisfied with this new process. Taxpayers rightfully complain that they are frustrated about talking to Tax Examiners who do not have their files, having to resubmit paperwork, not having documentation acknowledged, having to repeat conversations, not receiving return calls, and not being able to get their cases resolved while on the phone.⁸²

Taxpayers have trouble getting through to anyone at the correspondence examination unit by phone: What is so difficult about a telephone conversation?

The inability to reach someone by telephone to discuss a correspondence examination is a common taxpayer complaint reflected in customer satisfaction surveys.⁸³ However, once

⁷⁸ *Id.*

⁷⁹ IRM 4.19.21.2 (Jan. 1, 2011).

⁸⁰ IRM 4.19.19.2 (Aug. 5, 2011).

⁸¹ See *id.*, informing Tax Examiners that wrap time should not be used to document CEAS notes such as call summaries.

⁸² Phone Optimization Project (POP) Team Recommendations, *Solutions to Improve Taxpayer Satisfaction in Correspondence Examination Briefing Document* (June 21, 2010).

⁸³ The IRS Restructuring and Review Act of 1998 (RRA '98) required the IRS to establish a “fair and equitable treatment of taxpayers” retention standard for all employees to provide assurance that employee performance is focused on providing quality service to taxpayers instead of achieving enforcement results. Pub. L. No. 105-206, § 1204(b), 112 Stat. 685, 722 (1998) (codified at IRC § 7804). To achieve assurance the RRA '98 required the IRS to develop taxpayer service surveys. See *id.* at § 1201 (codified at 5 U.S.C. §§ 9505(b) and 9508(a)(2)(A)).

taxpayers actually speak with Tax Examiners, they consistently rate the employees' courtesy and professionalism highly. A number of internal IRS teams, and most recently the cross-functional Correspondence Examination Taxpayer Satisfaction Improvement Initiative, have tried to figure out why it is so difficult for taxpayers to reach an examiner. Team research, analysis, and focus group interviews revealed that telephone access problems fall into three categories: repeat callers, hesitant employees, and organizational structure issues.⁸⁴ The initiative offered the following findings and solutions:

Repeat Callers — The lines are jammed with repeat callers.

It may be difficult to reach a Tax Examiner on the toll-free line because the system is overloaded. Telephone research determined that for calls received in the correspondence examination units:

- 62 percent of the callers are repeat callers;
- 13 percent phone more than eight times to resolve their issues;
- 28 percent of all repeat calls are from taxpayers wanting to know if the IRS received their correspondence; and
- 26 percent of repeat calls are questions about what to send or if their documentation was sufficient.⁸⁵

To reduce calls, the team recommended the IRS create understandable, taxpayer-friendly, initial contact letters and acknowledge correspondence upon receipt. These suggestions were pursued by the Taxpayer Correspondence Taskgroup (TACT), now called Return Integrity and Correspondence Services (RICS), but never fully implemented.

Hesitant Employees — Employees are afraid of difficult questions.

Managers told the team some employees were hesitant to return calls because they were afraid they would be asked a question they could not answer. This seemed especially prevalent in Employee Business Expense (EBE) audits where an employee would not only need to know what is and is not deductible, but what would be considered an ordinary and necessary expense for a wide variety of occupations.⁸⁶

The team recommended and the IRS initiated an in-depth training course for Tax Examiners on EBE. The IRS also created an occupation-specific online tool to help identify which expenses are ordinary and necessary, and determine what expenses are deductible and why.⁸⁷

⁸⁴ POP Team Recommendations, *Solutions to Improve Taxpayer Satisfaction in Correspondence Examination Briefing Document* (June 21, 2010).

⁸⁵ *Id.* at 6.

⁸⁶ IRC § 162.

⁸⁷ POP Team Recommendations, *Solutions to Improve Taxpayer Satisfaction in Correspondence Examination, Briefing Document* (June 21, 2010).

Organization Structure — Some employees believe that as Tax Examiners, they will not have to talk to taxpayers.

Some employees said they accepted Tax Examiner positions, at a lower pay grade than an Accounts Management employee, to “get off the phones.” Despite numerous conversations with employees where IRS executives shared that they too speak with taxpayers on the phone, some employees remain reluctant to do so. When asked specifically why they did not see the phone as a useful tool, one employee insightfully said, “Well, it *is* called *correspondence* examination.”⁸⁸

The team recommended, and the IRS initiated, training for all Tax Examiners that focuses on using the phone to:

- Reduce callbacks;
- Expedite closing cases;
- Reduce audit reconsideration cases;
- Increase taxpayer satisfaction; and
- Increase employee satisfaction.

The IRS’s failure to give taxpayers a single point of contact may violate the law.

The lack of direct contact and access may be more than frustrating: it may be illegal. To make the IRS more accessible, the IRS Restructuring and Review Act of 1998 (RRA 98) required the IRS to include in all manually-generated correspondence the name, telephone number, and unique identifying number of the employee the taxpayer may contact regarding the correspondence.⁸⁹ RRA 98 further instructed the IRS to develop procedures that, if practical for the IRS and beneficial to the taxpayer, would assign one employee to handle an issue from start to finish.⁹⁰ Current correspondence examination procedures do not meet this requirement.

In practice, the IRS sometimes avoids the requirement to include contact information on manually-generated correspondence, which the IRM defines as “correspondence issued as a result of an IRS employee exercising his/her judgment in working/resolving a specific taxpayer case or correspondence, or where the employee (Tax Examiner, Revenue Agent, Revenue Officer, etc.) is asking the taxpayer to provide additional case-related information.”⁹¹ The IRS relies on the literal definition of “manually-generated” to conclude that computer-generated correspondence is not subject to these requirements.⁹²

⁸⁸ Comment arose during employee focus groups held as part of the information gathering phase of the Examination Customer Satisfaction Improvement Initiative.

⁸⁹ Pub. L. No. 105-206, § 3705(a), 112 Stat. 685, 777 (1998) (codified at IRC § 7801).

⁹⁰ *Id.*

⁹¹ IRM 21.3.3.4.17.2 (2) (Oct. 25, 2007).

⁹² IRM 4.19.10.1.6 specifies that letters mailed on cases in the W&I corporate inventory (that is, letters included in the inventory of letters that are system-generated) will include the W&I corporate toll free number, “tax examiner” as person to contact and site specific identification number.

For example, a Tax Examiner may find that after a review of documentation, the IRS needs additional substantiation to resolve the issue. In this instance, the employee has exercised judgment and is asking for additional case-related information, which seems to meet the definition of manually-generated correspondence. However, because the employee will issue a Letter 565, *Acknowledgement and Request for Additional Information*, through an automated system, the IRS considers this a computer-generated letter and does not include any identifying information for the employee making the determination. The National Taxpayer Advocate does not agree that an employee's use of machines to generate letters should exclude IRS correspondence from the legal requirements applicable to manually-generated correspondence. The fact that an employee uses an automated correspondence system to generate documents does not negate the fact that the correspondence is issued as a result of an IRS employee exercising judgment and making a decision on a specific case. The IRS interpretation of this requirement means that in the 21st century, with the extensive use of electronic word-processing, almost no taxpayer will be provided the protection of direct contact information for an IRS employee working the taxpayer's case, and no IRS employees will be accountable. This situation subverts both the requirements and the intent of RRA 98.

IRS letters often fail to reach taxpayers who are undergoing a correspondence examination.

The IRS sends over 200 million pieces of mail to taxpayers each year, including refunds, notices, and other official correspondence.⁹³ A relatively large volume of this mail never reaches the taxpayers. Although the IRS does not itself track how much mail is returned as "undeliverable as addressed," a TIGTA audit estimated that during FY 2009, approximately 19.3 million pieces of mail, or ten percent of the total, were returned to the IRS at an estimated cost of \$57.9 million.⁹⁴ When an undeliverable piece of mail is the first letter sent to a taxpayer under correspondence audit, he or she may experience a significant adverse impact. As noted above, correspondence examination cases have minimal to no Tax Examiner involvement until the taxpayer replies to the IRS's letters. If a taxpayer never receives the initial contact letter, the proposed tax could be assessed by default.

Even taxpayers who receive the IRS letters may not be able to understand or respond in writing.

The IRS conducts most (60 percent) EITC audits by correspondence before issuing refunds and paying the credit.⁹⁵ Almost 70 percent of these taxpayers do not respond to the audit

⁹³ IRS, Wage and Investment (W&I) Division, CARE/M&P Mail Management Project Office, Distribution Media and Publications; *Correspondence Production Services (CPS) Volume History*; and National Print Site Data (National Print Sites) Warehouse, available at [http://nps.web.irs.gov/print%20warehouse/CPS%20FY-09-Site-Summ%20\(2\).xls](http://nps.web.irs.gov/print%20warehouse/CPS%20FY-09-Site-Summ%20(2).xls) (last visited July 6, 2010).

⁹⁴ TIGTA, Ref. No. 2010-40-055, *Current Practices Are Preventing a Reduction in the Volume of Undelivered Mail 1* (May 14, 2010). See also 2010 National Taxpayer Advocate Annual Report to Congress 221-234.

⁹⁵ TIGTA, Ref. No.2011-40-023, *Reduction Targets and Strategies Have Not Been Established to Reduce the Billions of Dollars in Improper Earned Income Tax Payments Each Year 29* (Feb. 7, 2011).

inquiry letters from the IRS,⁹⁶ which then denies the EITC. A 2004 TAS Research study of EITC audit reconsideration cases found that in cases originally closed as “no response,” approximately 43 percent of the taxpayers had some or all of their EITC restored. They received on average about 96 percent of what they originally claimed on their returns.⁹⁷

Taxpayers who actually receive an initial contact letter have trouble understanding it and struggle to prepare a response that meets the needs of the IRS. Even a taxpayer with expert writing skills might find it difficult to put into a letter the fluid living arrangements parents make on a sometimes daily basis over the residency of their children.⁹⁸ A simple telephone call would be so much easier.

IRS letters also confuse wise and savvy taxpayers. The SB/SE operating division sometimes works cases that involve neither small business (SB) nor self-employed (SE) taxpayers. A surprising number of taxpayers respond to SB/SE customer surveys with comments such as:

“I do not understand why the audit by small business/self-employed was used since I do not own a small business and I am not self-employed. This audit should have been handled by another department of the IRS.”

“First off I wanted to comment that we are not a small business or self-employed. We won a prize that we had to pay taxes on that created this whole problem.”

“Once again, I do not know why you are sending this to me. I am NOT self-employed or have a small business. Whenever I received any correspondence from the IRS I would call to ask why they sent it and no one knew why — nobody had a clue.”⁹⁹

Within the general U.S. population, the use of correspondence is declining, but telephone contact, face-to-face visual streaming, and Internet access via cell phones are on the rise. More than 83 percent of American adults own a cell phone.¹⁰⁰ Forty-four percent of African-Americans and Latinos are smartphone users and have high rates of usage across a wide range of mobile applications.¹⁰¹ While it used to be difficult to reach taxpayers at home, cell phones now seem to be everywhere. Even with this ready access, the number of

⁹⁶ IRS AIMS FY 2010 (Oct. 2011) (ranging from 63 to 73 percent).

⁹⁷ See National Taxpayer Advocate 2004 Annual Report to Congress vol. 2, 9 (*EITC Reconsideration Study*).

⁹⁸ See Most Serious Problem: *Expansion of Math Error Authority and Lack of Notice Clarity Create Unnecessary Burden and Jeopardize Taxpayer Rights*, *supra*.

⁹⁹ Pacific Consulting Group, *Compliance Center Examination (CC Exam) SB/SE National Report, Verbatim Comments, January Through March 2008* (July 2008).

¹⁰⁰ Pew Research Center Publications, *Americans and Their Cell Phones* (Aug 15, 2011).

¹⁰¹ Pew Research Center Publication, *35% of American Adults Own a Smartphone* (July 11, 2011).

return calls from Tax Examiners is low.¹⁰² Thus, the IRS is not using technology to increase taxpayer contact and obtain both taxpayer engagement and more accurate audit results.

In some cases, the IRS does not even tell taxpayers they are being audited because it does not want to trigger the taxpayer's right to avoid unnecessary or repetitive examinations.

As previously noted, taxpayers who receive exam notices often do not realize they are under audit.¹⁰³ This seems odd until we consider language in a recently proposed initial contact letter for a pilot project involving credits which the IRS believed to be “very likely” incorrect:

“While we were reviewing your tax return for [XXXX], we found certain items that we have questions about as explained in this letter. Therefore, we are proposing a change that will increase the tax and/or decrease the credits shown on your tax return. We based this change on information reported to us by employers, banks, or other payers under your name and social security number.”

The Taxpayer Advocate Service suggested adding some version of the following language:

“We are auditing your [XXXX] return. You claimed credits that appear unallowable. We’re proposing to deny these credits and increase your tax. If you don’t agree, you need to respond now.”

Our suggestion meets the requirements of the Plain Writing Act of 2010 and informs the taxpayer in no uncertain words that they are under audit.¹⁰⁴ “Review” or “exam” may confuse taxpayers,¹⁰⁵ but “audit” is always clear. This clarity is critical, both because taxpayers will be far more likely to pay attention to the letter and respond if they realize they are under audit, and because audits trigger certain rights. For example, under IRC § 7605(b) taxpayers have a right to not be subject to unnecessary, repetitive examinations, and if examined, to be subject to only one inspection of their books of account. To invoke these rights, taxpayers need to be placed on notice that they are under audit. The IRS contends these rights will not be abridged because the taxpayers in the pilot test will most likely not be subject to future audits. This is poor reasoning and poor tax administration. Taxpayer rights should not be hidden or ignored simply because they may not be needed.

The IRS has taken the position that an attempt to resolve a discrepancy between the taxpayer’s return and data available from a third party does not constitute an examination because the IRS is not examining books or records but merely asking the taxpayer to explain

¹⁰² An FY 2008 analysis of voice mail versus outbound calls revealed 39 percent of voice mail messages were not returned within 24 hours. See IRS, Phone Optimization Team, *Team Briefing* (June 29, 2009).

¹⁰³ See National Taxpayer Advocate 2004 Annual Report to Congress vol. 2 (*EITC Audit Reconsideration Study*).

¹⁰⁴ The Plain Writing Act of 2010 requires federal agencies to use plain writing in nearly every document newly created or revised. Pub. L. No. 111-274, 124 Stat. 2861 (codified at 5 U.S.C. § 301).

¹⁰⁵ Pacific Consulting Group Focus Group Interviews, conducted at fieldwork, Chicago, IL (Sept. 4, 2008).

a discrepancy.¹⁰⁶ The IRS does not want to call such contact an audit because it does not want to trigger the taxpayer's right to avoid unnecessary examinations.¹⁰⁷ Accordingly, it reserves the right to examine the books and records later without violating IRC § 7605(b). It is interesting to note that while the IRS does not consider these contacts an examination, it mails the CP2000 notice to explain discrepancies along with Publication 3498-A, *The Examination Process (Examinations by Mail)*. While the IRS may not consider this an examination, it is easy to understand why a taxpayer would.

The IRS has frequently expanded the list of audit-like checks that it will not consider to be an audit for purposes of IRC § 7605(b).¹⁰⁸ Decade by decade, the IRS adds to the list. For example, a Revenue Procedure indicates that looking at a tax return, such as those times when a Revenue Agent may inspect a prior or subsequent year return, is not considered an examination of the books and records. This guidance also states that a contact to verify a discrepancy between the taxpayer's return and an information return, or between a tax return and information otherwise in the IRS's possession, is not considered an examination. The IRS has broadly construed the application to the Automated Underreporter program, which matches income information filed with the IRS to individual filings. The AUR program is under expansion and will now reconcile business income to merchant card reporting. Any resolution would most likely require the IRS to review books and records, yet this currently falls under the IRS category of "not an examination." Simply by using this naming convention, the IRS could subject business taxpayers to repeated examinations of the books and records for one tax year.

The IRS sometimes sends confusing "combo" letters.

In an effort to streamline examination processes, the IRS has a tendency to revert to the use of combination or "combo" letters, which can also confuse taxpayers. Combo letters merge two distinct audit letters: (1) the initial contact letter and (2) the 30-day letter that includes the preliminary audit report and describes the taxpayer's appeal rights. The National Taxpayer Advocate has consistently expressed concern about their use.¹⁰⁹ Combo

¹⁰⁶ See Rev. Proc. 2005-32, § 4.03 2005-1 C.B. 1206.

¹⁰⁷ IRC § 7605(b).

¹⁰⁸ For example, the 1959 version of this revenue procedure provided the IRS would generally not reopen a case "unless there has been substantial error, both in amount and in relation to the total tax liability, or there is evidence of fraud, malfeasance, collusion, concealment or the misrepresentation of a material fact." See Rev. Proc. 59-25, 1959-2 C.B. 938, *superseded by* Rev. Proc. 63-9, 1963-1 C.B. 488, *superseded by* Rev. Proc. 63-9, 1963-1 C.B. 488, *superseded by* Rev. Proc. 64-40, 1964-2 C.B. 971, *superseded by* Rev. Proc. 68-28, 1968-2 C.B. 912, *superseded by* Rev. Proc. 68-28, 1968-2 C.B. 912, *superseded by* Rev. Proc. 72-40, 1972-2 C.B. 819, *superseded by* Rev. Proc. 72-40, 1972-2 C.B. 819, *superseded by* Rev. Proc. 74-5, 1974-1 C.B. 416, *superseded by* Rev. Proc. 74-5, 1974-1 C.B. 416, *superseded by* Rev. Proc. 81-35, 1981-2 C.B. 588, *superseded by* Rev. Proc. 81-35, 1981-2 C.B. 588, *superseded by* Rev. Proc. 83-19, 1983-1 C.B. 677, *superseded by* Rev. Proc. 83-19, 1983-1 C.B. 677, *superseded by* Rev. Proc. 85-13, 1985-1 C.B. 514, *superseded by* Rev. Proc. 94-68, 1994-2 C.B. 803, *superseded by* Rev. Proc. 94-68, 1994-2 C.B. 803, *superseded by* Rev. Proc. 2005-32, 2005-1 C.B. 1206.

¹⁰⁹ Concerns about the use of the combination letter in Examination were raised in the National Taxpayer Advocate 2001 Annual Report to Congress 20-22, National Taxpayer Advocate 2002 Annual Report to Congress 55-63, National Taxpayer Advocate 2003 Annual Report to Congress 87-98, National Taxpayer Advocate 2004 Annual Report to Congress 163-180, National Taxpayer Advocate 2005 Annual Report to Congress 95-122, National Taxpayer Advocate 2006 Annual Report to Congress 289-310, National Taxpayer Advocate 2007 Annual Report to Congress 222-241, and National Taxpayer Advocate 2008 Annual Report to Congress 227-259.

letters are confusing because taxpayers do not know whether to respond to the exam and risk forfeiting their appeal rights, file an appeal and risk annoying the examiner, or both.

In recent years, the IRS has acknowledged these concerns, initially ending the use of combo letters in EITC audits and more recently discontinuing their use in other areas. However, current proposals to expand compliance coverage seemingly turn back the clock and reinstate the letters. For example, the IRS is testing an Automated Questionable Refund program where a Letter 4800C, which is essentially a truncated version of a combo letter, is issued with a report and followed by a SNOD.

Correspondence examinations are ineffective in many situations — one size does not fit all.

We are not alone in our concerns about the correspondence examination process. The GAO questioned the suitability and volume of correspondence examinations in a 1999 study that found more than half of taxpayers audited by correspondence did not respond to the IRS's letters.¹¹⁰ When asked why, the IRS indicated it had not studied the issue but speculated taxpayers may be overwhelmed or intimidated by the letters and may not be comfortable with responding; some may not understand the letters or know how to respond; and others may know they owe additional tax but hope their non-responsiveness discourages the IRS from trying to collect. More recently, TIGTA commented on the disparity between correspondence audits and field audits in the area of income probes — an important tool in the battle to close the tax gap.¹¹¹

There are times when a transfer from a correspondence audit to a local office is absolutely necessary to meet the needs of the taxpayer and the demands of the situation. For example, visually impaired taxpayers may require an office audit so readers can accompany them. In some situations, the books and records may be too voluminous, or, like trucking logs, a size difficult to copy for correspondence audit. What seems to be a reasonable request by a taxpayer for accommodation is seldom granted.¹¹²

¹¹⁰ GAO, GAO/GGD-99-48, *IRS Audits—Weaknesses in Selecting and Conducting Correspondence Audits* 3 (Mar. 1999).

¹¹¹ TIGTA, Ref. No.: 2010-30-024, *Significant Tax Issues Are Often Not Addressed During Correspondence Audits of Sole Proprietors* (Feb. 24, 2010).

¹¹² Taxpayer Advocacy Panel, *Correspondence Examination Briefing* (Feb. 24, 2011).

In Publication 3498-A, *The Examination Process, Examinations by Mail*, Frequently Asked Question #2 on page 4 asks:

Can I request a face-to-face interview?

Yes, but usually we are able to resolve most cases by telephone or correspondence. Face-to-face conferences are reserved for complex issues or substantial volumes of documentation. To discuss whether a face-to-face conference might be best for you, call the contact number provided on your most recent letter.

When a taxpayer calls the IRS to request a transfer, the IRM directs the Tax Examiner to ask for the request in writing,¹¹³ and if one is made, to phone the taxpayer or representative and assure them that the issue can be resolved at the campus.¹¹⁴ The result is essentially an automatic denial of the transfer request, which makes one wonder why the IRS burdened the taxpayer to make the request in writing in the first place. In the case of voluminous books and records, the IRM now includes provisions for Tax Examiners to sample receipts.¹¹⁵ This technique is seldom used in correspondence examination. It would be difficult for even the most experienced examiners to sample receipts when they have no sense of the entirety of the books and records available.

When it comes to transfer requests, the cards are stacked in favor of the IRS. The IRC states that the time and place of an examination may be fixed by the Secretary and reasonable under the circumstances.¹¹⁶ The regulations introduce the concept of considering, on a case-by-case basis, written requests by taxpayers to change the audit location established by the IRS.¹¹⁷ These regulations, last updated in 1993, still reference the now-extinct district structure and do not mention correspondence audit or when a transfer would be appropriate. The volumes of work in Correspondence Examination have the impact of rendering transfer relief useless. Because the regulation specifically states that the IRS need not transfer an audit to an office that lacks the resources to conduct it, the IRS can almost always plead the case for inadequate resources.¹¹⁸ The office examination unit only has 1,400 Tax Compliance Officers nationwide, and they already have a full caseload.¹¹⁹ While the IRS clearly cannot accommodate every transfer request, it should update its guidelines to describe situations where a request is appropriate and will be considered.

The time has come to incorporate technology into the examination process.

The IRS has deployed numerous technological advances to further workforce efficiency and development. Employees use laptops and wireless services to work remotely and keep

¹¹³ IRM 4.19.19.6 (Aug. 5, 2011).

¹¹⁴ IRM 4.19.13.14 (Jan. 1, 2010) instructs employees to "Telephone POA or taxpayer to provide assurance that the issue can be resolved at the Campus."

¹¹⁵ IRM 4.19.13.14 (Jan. 1, 2010).

¹¹⁶ IRC § 7605(a).

¹¹⁷ Treas. Reg. § 301.7605-1.

¹¹⁸ Treas. Reg. § 301.7605-1(e)(B)(5).

¹¹⁹ TIGTA, Ref. No. 2011-30-071, *Trends in Compliance Activities Through Fiscal Year 2010* 8-9 (July 18, 2011).

up with assignments. Secured email and encryption software programs facilitate quick transfers of sensitive data. Travel vouchers, previously completed on paper with stacks of stapled receipts, are now finalized online with documentation that is either scanned or uploaded by fax and immediately available for review — oftentimes by remote managers. Training once held face-to-face is now conducted via Interactive Video Teleconferences (IVTs). Office Communicator systems provide the ability to share desktops, review documents, and work collaboratively across the country. These advances, once rare but now common to IRS employees, remain unavailable our customers — the taxpayers. Instead, the IRS continues to rely on outdated modes of communication. Correspondence, which is not always received by the taxpayer nor acknowledged by the IRS, remains the foundation of its examination process. Landline conversations are preferred to cell phones due to security concerns. Perhaps the most outdated convention is the notion that a fax cover-sheet with a disclosure statement telling the reader that the communication is private and confidential will be heeded.

There is no doubt that the IRS needs automation to administer tax laws and tax-based social programs efficiently. The volume, use, and availability of information reporting forced the IRS to use automation to process this data. A viable future for examination requires the IRS to use automation and technology in a positive way for taxpayers. Indeed, the IRS should provide the same accommodations to taxpayers as employees. Consider the possibilities:

- The IRS could employ a virtual service delivery system to keep work in campus locations, but conduct the equivalent of an office audit through live-stream video conferencing. Video cameras available on most computers and many smartphones would permit face-to-face contact with Powers of Attorney (POAs) and taxpayers from their offices and homes. The U.S. Tax Court’s Electronic Courtroom already uses similar technology.¹²⁰
- Taxpayers could submit digital documents electronically to ensure receipt and provide instant confirmation. Similar technology is already in place in the GovTrip system that federal employees use to arrange and account for travel.
- Reports could be shared and viewed together online to discuss adjustments and seek agreement. Current computer systems such as Office Communicator already provide for document sharing and collaboration.
- For cases requiring elevation to Appeals for resolution, the electronic file, complete with all digital documentation, could be transferred with the push of a button to an available Appeals Officer with the expertise to settle the dispute, eliminating months of delay in transferring a paper file.

The same technical expertise and communication skill expected of a Revenue Agent in the field would be required for a successful auditor in a Virtual Delivery Service environment.

¹²⁰ http://www.ustaxcourt.gov/electronic_courtroom/electronic_courtroom_guidelines.pdf.

The use of highly skilled, trained technicians would mitigate the problems identified that arise from poorly trained employees. Instead of dumbing down correspondence examination, the IRS should be staffing-up with higher graded positions. The IRS should be planning for a technological expansion to the public now, including all of the staffing and training implications.

RECOMMENDATIONS

The National Taxpayer Advocate acknowledges that the examination of returns is an important compliance tool and offers the following suggestions for the IRS examination strategy to maximize compliance, improve credibility, and respect taxpayer rights.

Instill and Protect Taxpayer Rights in the Examination Strategy

The National Taxpayer Advocate challenges the IRS to ensure that for every audit, or similar examination process, no matter the dollar amount involved, the IRS should:

1. In light of the information available in the 21st century, review and reassess the audit processes deemed “not an examination” and instead use the audit process to protect taxpayer rights, increase compliance, and preserve IRS credibility.
2. Provide a clear, concise, and understandable initial contact letter that places taxpayers on notice as to whether they are under audit and explains the rights associated with the process.
3. Whenever possible, verbally discuss the audit process and appeal rights with the taxpayer during the first interview to ensure that the taxpayer understands the process, what he or she needs to do, and his or her appeal rights.
4. Train all examiners in the tax law, not just IRS publications, so they are capable of and comfortable with discussing issues and the basis for determinations with taxpayers and practitioners.
5. Revisit the definition of “computer-generated letter,” provide taxpayers with direct contact information for the assigned examiner, and permit taxpayers to contact and discuss the case with one examiner who will work that case to resolution.

Update the Correspondence Examination Program to meet taxpayer needs and preferences and in doing so maximize compliance.

To meet taxpayer needs and preferences, and in doing so maximize compliance, the IRS should consider the following recommendations:

1. Conduct a comprehensive review of the work of correspondence examination and its staffing needs, today and in the future — and determine how to best incorporate virtual service delivery and other technologies such as a remote office audit to facilitate better interaction and service to taxpayers.

2. Whenever reasonable, use the term “audit” in place of “examination.” Words like “review” or “exam” confuse taxpayers. “Audit” alerts the taxpayer to the importance of the IRS action.
3. Limit correspondence audits to returns with specific, clear-cut issues. Returns requiring income probes or issues that generally require voluminous records, such as employee business records, are best handled by Tax Compliance Officers in an office or field setting.
4. Include in all correspondence involving determinations the name, telephone number, and unique identifying number of the IRS employee making the determination as required by RRA 98.
5. Reinstate procedures under which, if they would benefit the taxpayer, one IRS employee is assigned to handle a case until it is resolved.
6. Test the ability to establish a telephone audit appointment, where an examiner can hold an initial interview, explain the examination process and appeal rights, discuss documentation, and define the next steps.
7. Redesign correspondence audit letters to increase comprehension, reduce redundant phone calls, and meet the requirements of the Plain Writing Act of 2010.
8. Improve training for Tax Examiners and provide them the technical guidance they need to be completely comfortable handling calls and inquiries.
9. Update the transfer request guidance to bring the regulation into conformity with the structure in place for more than a decade and describe situations where a request for a face-to-face audit is appropriate and will be considered.
10. Institute a technical review process to preserve the “presumption of correctness” of the Statutory Notice of Deficiency and resulting assessments. The review should focus on making sure the correct amount of tax is assessed against the correct taxpayer only after full consideration and discussion of any documentation submitted.