

**The High Income Taxpayer Strategy Was
Effectively Implemented, Although Its
Success Still Needs to Be Determined**

November 2004

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INSPECTOR GENERAL
for TAX
ADMINISTRATION

November 16, 2004

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED
DIVISION

Gordon C. Milbourn III

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

SUBJECT: Final Audit Report - The High Income Taxpayer Strategy Was Effectively Implemented, Although Its Success Still Needs to Be Determined (Audit # 200430013)

This report presents the results of our review of the implementation of the High Income Taxpayer Strategy (HITS). The overall objective of this review was to determine whether the Small Business/Self-Employed (SB/SE) Division effectively implemented the HITS.

As of Tax Year 2000, the number of individual income tax returns containing Total Positive Income (TPI)¹ of \$100,000 or more had grown to approximately 10 percent of the individual filing population. The Internal Revenue Service (IRS) Commissioner was concerned that there were potentially high levels of noncompliance in this segment of the population and that these taxpayers had the resources to avail themselves of sophisticated methods of tax avoidance. Of most concern were taxpayers having TPI of greater than \$1 million on their tax returns.

In Fiscal Year (FY) 2003, after conducting various research studies, the SB/SE Division developed four unique models or filters in an attempt to identify noncompliant high income taxpayer returns to select for examination. In FY 2004, SB/SE Division management implemented the HITS based on research from the selection model and started testing the new return selection model approach. The SB/SE Division Examination function selected 1,503 returns for examination. As of August 21, 2004, data provided by SB/SE Division management for these 1,503 returns showed

¹ The TPI is calculated by using only positive income values from specific income fields on the tax return and treating losses as a zero.

employees had completed 85 examinations² resulting in \$1,392,743 of recommended assessments (an average of \$16,385 per return).

In summary, although the research and development of the HITS took over 3 years, the SB/SE Division conducted thorough initial research to identify indicators of noncompliance among high income taxpayers. To identify returns for examination from the return selection model, SB/SE Division management implemented effective classification and return selection procedures and delivered returns to Examination function field groups as inventory was needed.

However, the ultimate success of the HITS still needs to be measured. In our opinion, a method and specific baselines to measure the HITS' overall success through closed case results should have been determined earlier in the process. Original plans to monitor the success of the HITS called for a report in November 2004 showing measurement of selection rates³ and a report in December 2005 showing measurement of examination results, although baselines had not been established against which to measure the examination results. However, based on our discussions throughout the audit and other factors, SB/SE Division management now recognizes the need for more specificity in establishing the measures and baselines. In July 2004, SB/SE Division management identified the need for an interim assessment of the Strategy, involving operational field visits, before continuing to classify and select additional returns. Starting with August 2004 results, they are now monitoring closed examination results on a monthly basis. If these current monitoring plans continue as the HITS evolves, there should be an effective measurement process to determine if the HITS is addressing noncompliance and ensuring resources available in the SB/SE Division Examination function are effectively used.

We made no recommendations in this report. However, key IRS management officials reviewed it prior to issuance. Copies of this report are also being sent to the IRS managers affected by the report. Please contact me at (202) 622-6510 if you have questions or Richard J. Dagliolo, Acting Assistant Inspector General for Audit (Small Business and Corporate Programs), at (631) 654-6028.

² In addition to examined cases, there have been some nonexamined cases resulting from short statutes and excess inventories.

³ Selection rates refer to the percentage of returns selected for examination during classification compared to the number screened.

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Background

In Fiscal Year (FY) 2000, the Internal Revenue Service (IRS) Commissioner requested that the Small Business/Self-Employed (SB/SE) Division conduct an indepth study to determine whether taxpayers with large amounts of income are complying with Federal income tax laws. High income taxpayers were defined as those taxpayers with Total Positive Income (TPI)¹ of \$100,000 or more, with an emphasis on those with TPI greater than \$1 million. As of Tax Year 2000, the number of individual income tax returns containing TPI of \$100,000 or more had grown to approximately 10 percent of the individual filing population. The IRS Commissioner was concerned that a potentially high level of noncompliance exists in this segment of the population and that these taxpayers have the resources to avail themselves of sophisticated methods of tax avoidance.

Since that time, the SB/SE Division has researched ways to better identify returns of potentially noncompliant high income taxpayers to increase the number of tax returns examined for this taxpayer population. The SB/SE Division developed four unique models or filters in an attempt to identify noncompliant high income taxpayer returns to select for examination. One of the action items included in the FY 2004-2005 SB/SE Division Business Action Plan was to implement a High Income Taxpayer Strategy (HITS) based on the research from the selection model. In FY 2004, the SB/SE Division started testing the new return selection model approach.

This review was performed at the Brookhaven, New York, Campus² and Plantation, Florida, and Dallas, Texas, Planning and Special Programs (PSP)³ offices during the period February through September 2004. The audit was conducted in accordance with *Government Auditing Standards*. Detailed information on our audit objective,

¹ The TPI is calculated by using only positive income values from specific income fields on the tax return and treating losses as a zero.

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

³ The PSP function is responsible for monitoring the inventory of tax returns for the Examination function and assessing overall program effectiveness.

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The Small Business/ Self-Employed Division Effectively Implemented the High Income Taxpayer Strategy

scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

The goal of the HITS was to test the return selection model for identifying tax returns with indications of noncompliance and in need of examination. Our review showed that the SB/SE Division met this goal. SB/SE Division management:

- Conducted thorough initial research to identify a return selection model.
- Implemented effective classification and return selection procedures.
- Properly controlled and delivered returns to Examination function groups.

As a result of these efforts, SB/SE Division management appropriately selected returns with potentially noncompliant issues for examination and delivered them to Examination function groups.

SB/SE Division management conducted thorough initial research

Although the research and development of the HITS took over 3 years, the SB/SE Division performed a thorough and effective analysis to identify indicators of noncompliance among high income taxpayers. The SB/SE Division assembled sufficient resources and expertise to develop the new return selection model.

The SB/SE Division Research function performed various studies of high income taxpayers. In 2001, it performed market research and compliance analysis on taxpayers with TPI greater than \$1 million. It profiled this population and separated it into six strata based on the natural breaks in the TPI distribution. In 2003, it prepared a validation study report designed to test the stability of the compliance profile from year to year.

The Centralized Selection and Workload Delivery (CSWD) function also performed work related to high income taxpayers. In 2002, the CSWD function completed a task force study on high income taxpayers which identified noncompliance characteristics including the effects of

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flowthrough entities.⁴ That same year, the CSWD function received a Compliance Initiative Project to test three different approaches to selecting high income taxpayer returns. They included Chi-squared Automatic Interaction Detector (CHAID)⁵ node multivariate analysis, an outside vendor scoring model, and a set of Midwest Automated Compliance System (MACS) filters.⁶

In 2003, the SB/SE Division Research function initiated a research study on a “4-model approach for Examination.” This 4-model approach included the Discriminate Index Function (DIF)⁷ as a consideration. The 4-model approach became the basis for the HITS return selection and includes the following filters:

- *CHAID Node* identifies the most noncompliant nodes of each stratum once returns have been categorized into strata based on the TPI.
- *Adjusted Gross Income (AGI)⁸/TPI Ratio* compares the AGI with the TPI and selects those returns on which the AGI is significantly less.
- *Comparative Year Analysis* is used to find taxpayers who reduced their tax liability from an extraordinary one-time event.
- *DIF Score* identifies returns with greater than a specified score.

Using the above models, the most potentially noncompliant taxpayer returns would be those meeting the criteria for all four models. Those taxpayers meeting the criteria for three models would be the next potentially noncompliant taxpayer returns, and so on.

⁴ An example of a flowthrough entity can be a partnership which reports the share of income, losses, deductions, and credits that pass through to the partners to report on their individual tax returns.

⁵ The CHAID is a multivariate technique employed to determine which combination of variables is the best predictor of noncompliance.

⁶ The MACS is a menu-driven, automated database and data retrieval system that stores 3 years of tax return data.

⁷ The DIF is a mathematical technique used to score income tax returns for examination potential.

⁸ The AGI is the difference between the total income reported on the tax return and certain allowable deductions.

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SB/SE Division management implemented effective classification and return selection procedures

The population of high income taxpayers for the HITS initially consisted of those taxpayers with TPI greater than \$1 million during Tax Years 2000 and 2001. The SB/SE Division Research function identified a population of 213,262 taxpayers meeting the criteria and sampled 2,801 returns from that population. Our review of the sample design and process showed the process was logical and met proper sampling techniques.

Of the 2,801 returns sampled, employees classified 2,343 (458 of the returns from the sample of 2,801 were not available). From the returns classified, employees:

- Selected 1,503 for examination.
- Accepted 840 as filed; therefore, they did not require an examination.

As of August 21, 2004, data provided by SB/SE Division management showed employees had closed 85 examinations⁹ resulting in \$1,392,743 of recommended assessments (an average of \$16,385 per return).

Classification procedures were effective. The classifiers were experienced Examination function employees. They received instructional aids regarding HITS-type cases and issues. Case files included case-building items such as original income tax returns and MACS prints to assist the classifiers. In addition, there were subject matter experts who both classified returns and assisted others with technical questions.

We reviewed a judgmental sample of 30 returns selected for examination from 2 SB/SE Division field offices (15 from each office). The classifiers made appropriate decisions to select the 30 returns for examination. Classifiers identified issues that were complex and in line with the potentially noncompliant issues related to this taxpayer population and the overall HITS. For example, classifiers identified issues such as basis of property, capital gains and losses, and

⁹ In addition to examined cases, there have been some nonexamined cases resulting from short statutes and excess inventories.

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flowthrough income and losses. Also, we reviewed a nationwide judgmental sample of 30 returns that classifiers accepted as filed. Overall, we agree that the classifiers made appropriate decisions to accept the returns as filed and not select them for examination.

The same procedures are being used to classify another segment of high income taxpayers having TPI greater than \$250,000 but less than \$1 million. Although this phase of classification was not complete at the time of our review, classifiers had finished screening more than 50 percent of the returns.

SB/SE Division management properly controlled and delivered returns to Examination function groups

A review of the PSP functions in the two SB/SE Division field offices showed that the PSP function controlled the HITS cases on the Audit Information Management System (AIMS)¹⁰ and properly tracked cases to deliver the returns to Examination function groups. A further nationwide analysis of the inventory of all HITS cases showed that, once all classification details were complete, the PSP function properly controlled, updated the status of, and delivered returns to the Examination function field groups as inventory was needed. The July 2004 inventory listing of currently open HITS cases showed that 1,386 of 1,500¹¹ (92.4 percent) cases had been processed through the PSP function and sent to Examination function field groups, where they were either waiting assignment to a revenue agent (RA), already assigned, or closed.

Our review showed the inventory moved effectively from the PSP function to the Examination function field groups. The inventory levels overall decreased for those returns selected but not assigned and steadily increased for those returns on which examinations have been started. See Appendix IV for the details of inventory movement.

An analysis of the experience and grade levels of the RAs assigned HITS cases showed that HITS cases were properly

¹⁰ The AIMS is a computer system designed to provide information about the returns open in and charged to the Examination function.

¹¹ As of July 2004, 1,500 of the 1,503 cases selected for examination remained open.

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assigned to the higher graded, more experienced RAs. Table 1 shows that 76 percent of the RAs assigned HITS cases were at the Grade 12 and 13 levels. In addition, another 21 percent were at the Grade 11 journeyman level. This closely matched the assignment goals of the HITS. These RAs generally have had sufficient training and experience in examining more complex returns, including those for individuals, all types of corporations, partnerships, and trusts.

Table 1: RAs Assigned HITS Cases

RA Grade Level	Number of RAs	Percentage of RAs
5 and 9	11	3
11	73	21
12	154	43
13	117	33
Total	355	100

Source: Examination Return Control System (ERCS)¹² and Treasury Integrated Management Information System (TIMIS)¹³ (July 19, 2004).

In addition, the RAs assigned HITS cases were provided instructional aids that included HITS guidelines and expectations. There was also online assistance available through an SB/SE Division web site.

Plans Now Exist for Monitoring the Strategy's Progress

While the HITS was effectively implemented, the real success of the Strategy cannot be determined until a sufficient number of tax returns is examined. To evaluate the success of a new program or strategy, it is important to have established a feedback process. Part of this process is to establish specific measures and baselines to provide a reference point against which the results will be compared.

When we began our review, the HITS management team was planning to measure selection rates¹⁴ as one way to

¹² The ERCS is a national inventory system for controlling tax returns being examined.

¹³ The TIMIS is a computer system that supports payroll and personnel processing and reporting requirements for the IRS.

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determine the success of the HITS. The FY 2004 goal for the HITS was mainly directed at creating and testing a return selection model. The measure for success was whether the HITS 4-model approach was more productive than use of the DIF score in identifying productive cases for examination. A final report, due in November 2004, is going to cover these results.

Also, when we began our review, there were less specific plans for measuring the overall success of closed examinations. SB/SE Division management was planning to use the AIMS-Centralized Information System (A-CIS)¹⁵ to monitor the status of returns. However, they indicated it was too early in the process to establish the best method of measuring results of the actual examinations since at that point there were no closed cases. There are plans for a supplemental report to be prepared in December 2005 by the SB/SE Division Research function, which will include examination results of closed cases.

In July 2004, SB/SE Division management identified the need for an interim assessment of the Strategy before continuing to classify and select additional returns. This planned assessment includes operational visits to discuss open cases and address issues such as whether:

- The proper cases are getting to the field.
- Barriers exist to the HITS.
- RA skills are adequate.
- Case assignment practices are effective.

More recently, SB/SE Division management informed us they are now monitoring closed case examination results on a monthly basis using the A-CIS, starting with the August 2004 results. In addition to monitoring the A-CIS monthly, SB/SE Division management is considering selecting a date by which a sufficient number of cases has

¹⁴ Selection rates refer to the percentage of returns selected for examination during classification compared to the number screened.

¹⁵ The A-CIS is a database-monitoring tool that provides monthly AIMS data on both open and closed cases.

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been closed, so they can properly measure and evaluate the results.

In our opinion, a method and specific baselines to measure the HITS' overall success through closed case results should have been determined earlier in the process. However, based on our discussions throughout the audit and other factors, SB/SE Division management now recognizes the need for more specificity in establishing the measures and baselines. If these current monitoring plans continue as the HITS evolves, there should be an effective measurement process. It is important to determine as soon as possible whether the Strategy is effective in addressing noncompliance and ensuring resources available in the SB/SE Division Examination function are effectively used.

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Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this audit was to determine whether the Small Business/Self-Employed (SB/SE) Division effectively implemented the High Income Taxpayer Strategy (HITS). To accomplish this objective, we:

- I. Determined whether adequate research was conducted to identify the high income taxpayer level of compliance by reviewing the various research projects' documentation, data on high income taxpayers, and the selection model criteria.
- II. Determined whether the Strategy's classification and selection procedures were properly and effectively followed.
 - A. Reviewed the classification procedures and discussed procedures with managers and classifiers.
 - B. Reviewed a judgmental sample of 30 cases from the 1,503 cases that had been classified and selected for examination at the time of our review. We selected 15 unassigned cases from each of 2 SB/SE Division field offices. We used a judgmental sample because use of a statistical sample would have required extensive travel, as the cases sent to the Examination function field groups had been distributed nationwide.
 1. Determined whether sufficient case-building documentation was in the case files. We reviewed the case files to determine whether they included such items as the original tax returns, 3 years of Midwest Automated Compliance System (MACS)¹ prints, related return information, research material from public records information, currency transaction reports, Integrated Data Retrieval System (IDRS)² information, classification check sheets, and special instructions for the examiners.
 2. Identified the types of issues classified, number of issues classified, and remarks made by the classifiers regarding the issues identified.
 3. Determined whether the issues were consistent with the Strategy's goals and selection model criteria of having the most potential for adjustment.
 4. Determined whether the decision to select each case for examination was appropriate and if cases were classified consistently.

¹ The MACS is a menu-driven, automated database and data retrieval system that stores 3 years of tax return data.

² The IDRS is the Internal Revenue Service computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer's account records.

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- C. Reviewed a judgmental sample of 30 cases from the 840 cases that were classified and accepted as filed at the time of our review. We used judgmental sampling because we did not intend to project the results to the entire population.
 - 1. Determined whether the decision to accept the returns as filed was consistent with the Strategy's goals and selection model criteria.
 - 2. Compared accepted as filed cases to those that were selected for examination and determined whether there were inconsistencies.
 - D. Identified the classifiers' experience, grade levels, and training on examination issues related to the HITS.
- III. Determined whether HITS cases received consistent priority when assigned to the field offices.
- A. Determined whether the two SB/SE Division field offices visited properly controlled the cases on the Audit Information Management System (AIMS)³ and identified the status of the cases in these offices.
 - B. Determined whether HITS cases were properly assigned to examiners by analyzing the AIMS-Centralized Information System (A-CIS)⁴ December 2003 through July 2004 monthly reports. We determined the current status of each case and identified the priorities for case assignments.
 - C. Determined whether HITS cases were assigned to examiners with experience in examining complex returns by identifying the examiners' grade levels and extent of training.
- IV. Determined whether SB/SE Division management had adequate plans for monitoring and measuring the Strategy's progress and results.
- A. Determined how the success of the return selection model and the Strategy's overall success would be measured.
 - B. Determined when results would be evaluated, such as on an interim basis, at the end of classification, or at the end of the examinations. We also determined whether/when potential changes would be made based on interim results.

³ The AIMS is a computer system designed to provide information about the returns open in and charged to the Examination function.

⁴ The A-CIS is a database-monitoring tool that provides monthly AIMS data on both open and closed cases.

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Appendix II

Major Contributors to This Report

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Appendix III

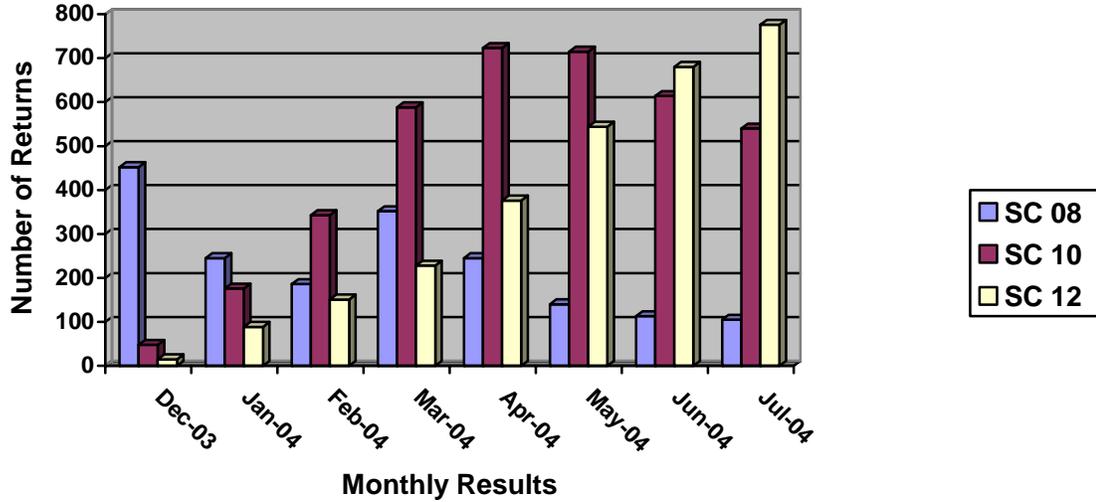
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Appendix IV

Open Case Monitoring by Status Code



Status Code (SC) and Description

- SC 08 Planning and Special Programs function – Selected Not Assigned
- SC 10 Field function – Assigned No Time Applied
- SC 12 Field function – Started

Source: Audit Information Management System (AIMS)-Centralized Information System (A-CIS)¹ – Examination function open data file (December 2003 – July 2004).

¹ The AIMS is a computer system designed to provide information about the returns open in and charged to the Examination function. The A-CIS is a database-monitoring tool that provides monthly AIMS data on both open and closed cases.