

**The Small Business/Self-Employed Division
Has Made Significant Changes to Enhance the
Automated Substitute for Return Program, but
Opportunities Exist for Further Improvement**

April 2005

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

April 28, 2005

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED
DIVISION

Pamela J. Gardiner

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report - The Small Business/Self-Employed Division
Has Made Significant Changes to Enhance the Automated
Substitute for Return Program, but Opportunities Exist for
Further Improvement (Audit # 200430003)

This report presents the results of our review to determine whether the Small Business/Self-Employed (SB/SE) Division Automated Substitute for Return (ASFR) Program is effectively administered to achieve the desired program results and promote taxpayer compliance with the tax laws.¹ The ASFR Program focuses on high-income taxpayers who have not filed individual income tax returns but appear to owe significant income tax liabilities based on available Information Reporting Program information.² Internal Revenue Code (I.R.C.) Section (§) 6020(b)³ provides the Internal Revenue Service (IRS) with the authority to make a return for a nonfiling taxpayer if the taxpayer appears to be liable for the return, the person required to file the return does not file it, and attempts to secure the return fail. For Tax Year 2001, the IRS estimated the portion of the tax gap attributable to the nonfiling of individual income tax returns was \$28.1 billion.⁴

¹ The SB/SE Division and Wage and Investment Division have administered separate ASFR Programs since 2001. The SB/SE Division's customer base includes fully or partially self-employed individuals.

² Employers, financial institutions, and other business entities are required to submit information returns to the Internal Revenue Service (IRS) reporting wages, interest, dividends, nonemployee compensation, and other types of income. The IRS uses these information documents in its computer-matching program to determine whether the income recipients filed returns and/or reported all of the income.

³ I.R.C. § 6020(b) (2004).

⁴ The nonfiling tax gap is the dollar amount of taxes not paid timely on delinquent and nonfiled returns.

In summary, the SB/SE Division ASFR Program is having an increasingly positive effect on closing a significant portion of the nonfiling tax gap. For example, from Fiscal Years (FY) 2002 through 2004, the number of ASFR Program returns with tax assessments increased by 216 percent. During the same period, the total net dollars assessed amount increased by 101 percent, and the number of 30-day letters issued⁵ increased by 337 percent.

While the IRS has taken or planned several important initiatives to increase the effectiveness of the SB/SE Division ASFR Program and to improve the efficiency of the ASFR Program work processes, we identified opportunities for further improvement. One, the SB/SE Division does not have in place for its ASFR Program an established measure that can be used to routinely compare productivity from period to period. Management information data showed the number of ASFR Program closures per Full-Time Equivalent (FTE)⁶ had declined by 36 percent from FYs 2002 to 2004.

Two, opportunities exist to address repeated filing noncompliance. Although the ASFR Program is designed to bring nonfilers back into compliance with the expectation they will file without IRS intervention in subsequent years, the subsequent voluntary filing compliance rates for individual taxpayers that are treated by the ASFR Program are not tracked and reported by the IRS. In addition, the limited use of backup withholding⁷ does not encourage future voluntary filing compliance for those nonfilers whose cases were unsuccessfully resolved by the ASFR Program.

Three, the National Quality Review System (NQRS)⁸ data for the ASFR Program was insufficient to provide management with reliable information for evaluating overall program quality, detecting error trends, or identifying possible systemic problems. In FY 2004, the ASFR Program was expected to close about 141,000 cases. Yet, because ASFR Program cases did not represent a separate product line and were included in the samples of completed work selected from various compliance programs, only about 11 ASFR Program cases per month were selected for quality review.

Finally, the inventory of ASFR Program reconsideration⁹ cases that were considered over-age ranged from 13 to 38 percent from March through September 2004. Reconsideration cases are considered over-age if they remain unresolved more than 45 days after they are received by the IRS. Many taxpayers contested ASFR Program

⁵ The 30-day letter is the ASFR Program's first contact with noncompliant taxpayers. It is a notice of proposed assessment.

⁶ An FTE is a measure of labor hours. One FTE is equal to 8 hours multiplied by the number of compensable days in a particular fiscal year. For FY 2004, 1 FTE was equal to 2,096 staff hours.

⁷ Tax laws provide the IRS with the authority to institute backup withholding for those taxpayers who have underreported interest or dividend income or who failed to file a tax return reporting such income when required.

⁸ Prior to October 1, 2004, the NQRS was called the Centralized Quality Review System.

⁹ Reconsideration is the process the IRS uses when a taxpayer contests an ASFR Program determination. The reconsideration cases result from defaulted assessments (e.g., a taxpayer did not respond to the 30-day letter or 90-day letter). The reconsideration cases usually occur when the unpaid accounts enter the enforced collection stage and the taxpayers are finally motivated to send the IRS completed tax returns or other information to reduce the ASFR Program assessments.

assessments by providing completed tax returns or other information to various IRS offices throughout the country. As a result, more than one-half of the 7,032 reconsideration cases received at the Brookhaven Campus¹⁰ from other IRS offices during the last 7 months of FY 2004 were already over-age.

We recommended the Commissioner, SB/SE Division, establish measures to routinely gauge the productivity and efficiency of ASFR Program operations; develop a tracking and reporting mechanism to measure the subsequent voluntary filing compliance rates of the individual taxpayers treated by the ASFR Program; conduct a study to determine the feasibility of expanding the use of backup withholding to encourage future voluntary filing compliance, and if necessary, coordinate with the Office of Chief Counsel to draft legislation to amend I.R.C. § 3406; separate the ASFR Program from other compliance programs for purposes of NQRS sampling to provide a better overall measure of program quality; provide guidance to all SB/SE Division collection offices that contribute to the over-age ASFR Program reconsideration inventory, establish service level agreements with the offices most responsible for routing delays to set guidelines for timely submission of ASFR reconsideration returns, and examine whether systemic solutions could be developed to reduce the percentage of over-age reconsideration inventory.

Management's Response: The Commissioner, SB/SE Division, concurred with the recommendations. The Commissioner, SB/SE Division, will review the current performance measures and determine the potential for establishing additional measures that gauge program productivity. The Commissioner, SB/SE Division, also agreed that changing taxpayer behavior is a key component and will take a subsequent look at voluntary compliance rates of individuals treated in the ASFR Program for the purpose of developing other strategies for dealing with nonfilers. In addition, the Commissioner, SB/SE Division, has established for FY 2005, separate workgroup codes, separate weighted reports, and a separate sample available for review. In FY 2007, the ASFR Program will be developed as a Specialized Product Review Group on the NQRS. The Commissioner, SB/SE Division, will also revisit the procedures and develop processes for monitoring and handling ASFR Program cases to reduce the percentage of over-age reconsideration inventory.

While the Commissioner, SB/SE Division, agreed to explore the feasibility of the revision/expansion of the backup withholding definition to include nonwage income, review the options, and proceed in the best interest of sound tax administration, the Commissioner disagreed with the outcome measure. The Commissioner, SB/SE Division, is uncertain whether the potential increase of \$45 million in revenue could be realized over 5 years from an increase in backup withholding, as revenue is already collected from backup withholding on cases meeting criteria. Further, the Commissioner, SB/SE Division, stated the intent of the ASFR Program is to encourage taxpayers to file outstanding returns or determine whether a tax liability exists, rather

¹⁰ The campuses are the data processing arm of the IRS. They process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.

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

Office of Audit Comment: While we are encouraged the Commissioner, SB/SE Division, will explore the feasibility of revising/expanding backup withholding treatment, we disagree that additional revenue could not be realized from an expanded application of backup withholding. The ASFR Program is a critical tool used to combat tax noncompliance, a top priority for the IRS. Applying backup withholding treatment to all nonwage income sources that form the basis for the nonfiling condition worked by the ASFR Program would increase revenue and deter noncompliance, allowing for earlier intervention and a reduction of subsequent enforcement actions.

Copies of this report are also being sent to the IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Philip Shropshire, Acting Assistant Inspector General for Audit (Small Business and Corporate Programs), at (215) 516-2341.

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Background

The United States tax system generally involves taxpayers self-reporting and paying their tax liabilities. In February 2004, the Internal Revenue Service (IRS) Commissioner estimated the United States Department of the Treasury loses one-quarter of a trillion dollars each year because taxpayers do not pay their taxes voluntarily or timely.¹ The three components of this tax gap (i.e., the difference between what taxpayers actually owe and what is timely collected by the IRS) are filing noncompliance, payment noncompliance, and reporting noncompliance. For Tax Year (TY) 2001, the IRS estimated the portion of the tax gap attributable to the nonfiling of individual income tax returns was \$28.1 billion.²

The individual nonfiling population has been growing at nearly twice the rate of the individual filing population. For example, between TYs 1994 and 2001, there was a 65 percent increase in the number of individual accounts with no return filed while the filing population increased only 33 percent. Because the IRS does not have the resources to address every identified case of potential taxpayer noncompliance, case creation criteria have been established to prioritize the universe of identified nonfilers and the type(s) of compliance action to be taken on each case. The IRS generally works those nonfiler cases that are judged to have the best potential to result in significant net taxes due.

Internal Revenue Code (I.R.C.) Section (§) 6020(b)³ provides the IRS with the authority to make a return for a nonfiling taxpayer if the taxpayer appears to be liable for the return, the person required to file the return does not file it, and attempts to secure the return fail. For nonfiled individual income tax returns, the IRS uses this authority in

¹ Prepared Testimony of IRS Commissioner Mark Everson Before the Permanent Subcommittee on Investigations, Senate Committee on Governmental Affairs, on Collecting Taxes From Defense Department Contractors, February 12, 2004.

² The nonfiling tax gap is the dollar amount of taxes not paid timely on delinquent and nonfiled returns.

³ I.R.C. § 6020(b) (2004).

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its Automated Substitute for Return (ASFR) Program.⁴ The ASFR Program focuses on high-income taxpayers who have not filed individual income tax returns but appear to owe significant income tax liabilities based on available Information Reporting Program (IRP) information.⁵

The ASFR Program is an automated deficiency assessment process which generates a notice of proposed assessment (30-day letter) based on the IRP data. Taxpayers may respond in one of several ways. First, a taxpayer could respond by filing a tax return. Second, a taxpayer could reply with an explanation about why he or she is not liable to file a tax return. Third, a taxpayer could agree to the assessment as proposed. Finally, a taxpayer could reply with information different from that used to compute the proposed assessment, based on changes to filing status, dependents, credits, and deductions. When a taxpayer does not satisfactorily respond to the 30-day letter, the IRS confirms that the taxpayer receives mail at the address of record and issues a Statutory Notice of Deficiency (90-day letter) as authorized by I.R.C. § 6212.⁶ The taxpayer may respond as above for the 30-day letter or file a petition in Tax Court to contest the proposed assessment. If the taxpayer does not satisfactorily respond and does not petition the Tax Court, the deficiency is assessed, and the taxpayer is billed.

The scope of this review was limited to the ASFR Program administered by the SB/SE Division. The review was performed during the period March through October 2004 at the SB/SE Division Headquarters office in New Carrollton, Maryland, and at the SB/SE Division consolidated ASFR Program site at the Brookhaven

⁴ The Small Business/Self-Employed (SB/SE) Division and Wage and Investment Division have administered separate ASFR Programs since 2001. The SB/SE Division's customer base includes fully or partially self-employed individuals.

⁵ Employers, financial institutions, and other business entities are required to submit information returns to the IRS reporting wages, interest, dividends, nonemployee compensation, and other types of income. The IRS uses these information documents in its computer-matching program to determine whether the income recipients filed returns and/or reported all of the income.

⁶ I.R.C. § 6212 (2004).

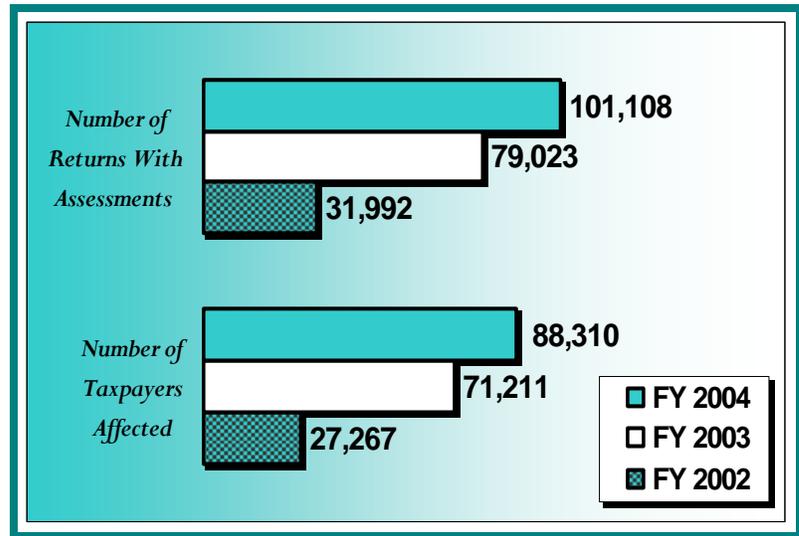
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Campus⁷ in Holtsville, New York. The audit was conducted in accordance with *Government Auditing Standards*. Some of the data used in this report came from various IRS reports. We did not verify the accuracy of the information from those sources. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

Program Effectiveness Measures Show Improvement

Several key performance effectiveness measures show the SB/SE Division ASFR Program is having an increasingly positive effect on closing a significant portion of the nonfiling tax gap. As shown in Figure 1, for example, the number of ASFR Program returns with tax assessments increased by 216 percent from Fiscal Years (FY) 2002 through 2004. During the same 3-year period, the number of noncompliant taxpayers who were affected by an ASFR Program enforcement action increased by 224 percent.

Figure 1: Selected ASFR Program Effectiveness Measures FYs 2002-2004, SB/SE Division



Source: SB/SE Division management information reports.

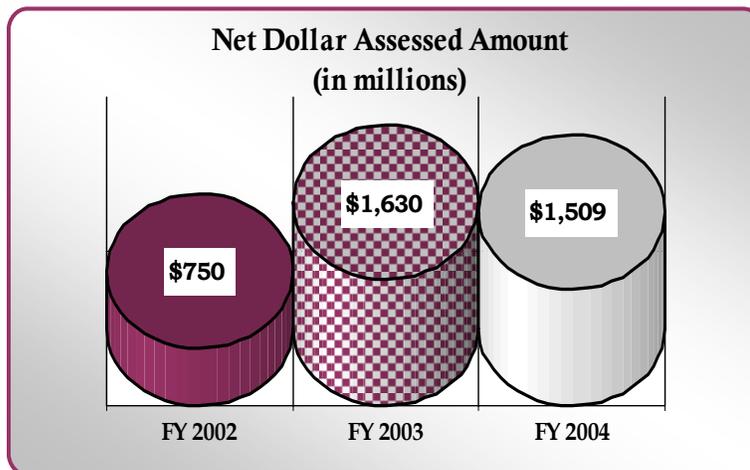
Figure 2 shows the total net dollars assessed amount, which considers assessments for taxes, penalties, interest, and any

⁷ The campuses are the data processing arm of the IRS. They process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.

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prepaid credits, increased by 101 percent from FYs 2002 to 2004.

**Figure 2: ASFR Program Monetary Performance Measure
FYs 2002-2004, SB/SE Division**



Source: SB/SE Division management information reports.

Various work activity measures for the SB/SE Division ASFR Program also show important increases from FYs 2002 through 2004. As shown in Figure 3, the number of 30-day letters issued, which is the ASFR Program's first contact with noncompliant taxpayers, increased by 337 percent, and the number of Full-Time Equivalents (FTE)⁸ applied to ASFR Program cases increased by 178 percent. In addition, Figure 3 shows the number of ASFR Program reconsideration⁹ case receipts, which involve taxpayer-initiated contact with the IRS after the ASFR Program case has been closed, declined by 13 percent. Reconsideration cases provide taxpayers with an opportunity to file a tax return after an ASFR Program default assessment has been made. To the extent the number of reconsideration cases can be reduced, resources are available to work additional ASFR Program cases. During this 3-year period, the number of FTEs applied by

⁸ An FTE is a measure of labor hours. One FTE is equal to 8 hours multiplied by the number of compensable days in a particular fiscal year. For FY 2004, 1 FTE was equal to 2,096 staff hours.

⁹ The process the IRS uses when the taxpayer contests an ASFR Program determination by filing an original delinquent return.

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the SB/SE Division to ASFR Program reconsideration cases decreased by 19 percent.

**Figure 3: Selected ASFR Program Work Activity Measures
FYs 2002-2004, SB/SE Division**

Activity	FY 2002	FY 2003	FY 2004
Number of 30-Day Letters Issued	74,446	161,548	325,276
FTEs Applied to ASFR Program Cases	53.9	104.2	149.6
ASFR Program Reconsideration Case Receipts ¹⁰	25,816	15,674	22,593
FTEs Applied to ASFR Program Reconsideration Cases	38.8	25.2	31.5

Source: SB/SE Division management information reports.

New initiatives have been implemented or planned to improve the ASFR Program

During the past 3 years, the IRS has taken or planned several important organizational and procedural initiatives to increase the effectiveness of the SB/SE Division ASFR Program and to improve the efficiency of the ASFR Program work processes.

¹⁰ An ASFR Program reconsideration case can occur months or years after the defaulted ASFR Program assessment is made; therefore, it is inappropriate to compare the percentage of reconsideration cases to the number of 30-day letters issued for each fiscal year.

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- **Schedule K-1¹¹ cases** – Taxpayers who received income from flow-through entities,¹² such as partnerships and Subchapter S corporations, were first included in the SB/SE Division’s nonfiler selection codes for TY 2001. If unresolved, these cases are designated for ASFR Program treatment. This was a significant expansion of the potential inventory for the SB/SE Division ASFR Program because, for TY 2001, there were over 2.1 million partnerships with a total of more than 14.2 million partners and almost 3 million Subchapter S corporations that had a total of nearly 5.4 million shareholders.
- **Nonemployee compensation¹³ cases** – Nonfiler cases involving self-employed individuals with nonemployee compensation were added to the ASFR Program in May 2003. This was another important expansion of the ASFR Program for the SB/SE Division because, historically, tax compliance among independent contractors who earn nonemployee compensation has been significantly lower than that of wage earners whose taxes are withheld by their employers.
- **Increased funding** – For FY 2004, the funding for the SB/SE Division’s ASFR Program was increased by 66 positions. For FY 2005, an additional 37 FTEs are planned, although the uncertainty of the IRS budget for FY 2005 could prevent this from occurring. For FY 2006, the IRS is planning for an additional 65 FTEs for the SB/SE Division ASFR Program.

¹¹ Partner’s Share of Income, Credits, Deductions, etc. (Schedule K-1) is used to show each partner’s share of the income from a partnership. Shareholder’s Share of Income, Credits, Deductions, etc. (Schedule K-1) is used to show each shareholder’s share of the income from a Subchapter S corporation.

¹² Certain businesses that are not subject to income tax, such as partnerships and small business corporations, are often referred to as “pass-through” or “flow-through” entities. In general, the profits or losses from these businesses pass through to the individual partners or shareholders who must report their shares of the profits or losses on their individual income tax returns.

¹³ Nonemployee compensation is reported to the IRS on statements for recipients of Miscellaneous Income (Forms 1099-MISC).

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- **Consolidation of the ASFR Program campus sites** – In January 2004, the ASFR Program work processes were consolidated at the Brookhaven Campus from the SB/SE Division’s four other campus locations. This consolidation was expected to improve the efficiency of the ASFR Program operations and improve customer satisfaction through easier and more personalized access.
- **Refund Hold Program cases** – In January 2004, refund hold cases were added to the ASFR Program and made the top work priority. Prior to that time, the Automated Collection System (ACS)¹⁴ function worked most Refund Hold Program cases; however, its effectiveness was limited because the ACS function did not have the authority to make Substitute for Return assessments. The Refund Hold Program delays issuing an income tax refund while the IRS investigates a return delinquency on another tax year. The primary reason for holding a refund is the IRS believes there will be a balance due on the delinquent return when filed and the refund will be applied to the liability. Internal controls are in place in the ASFR Program to assure refund credits are transferred to the nonfiled tax periods. Also, a systemic change is planned to automatically move the refund credits to the nonfiled tax periods at the time the 90-day letter is issued to the taxpayer.
- **Postal tracer checks** – Redundant postal tracer checks were eliminated from the ASFR Program work processes in March 2004. This action was designed to reduce ASFR Program case processing time and eliminate the number of erroneous “unable to locate” ASFR Program dispositions.
- **Power-of-Attorney (POA) checks** – A programming change was requested in May 2004 to systemically provide POA information prior to mailing the 30-day and 90-day letters. This programming change, which is

¹⁴ The ACS function attempts to resolve return delinquency cases on taxpayers that have not responded to the initial notices and/or do not meet the criteria for ASFR Program assignment. Attempts are made to contact the taxpayer by telephone and/or letter.

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expected to be operational by March 2005, will free the ASFR Program tax examiners from time-consuming manual research to locate the POAs authorized to receive copies of the 30-day and 90-day letters.

- **Delinquent account checks** – Another programming change was requested in May 2004 to check for the presence of a delinquent account for the same taxpayer. When identified, the potential ASFR Program case will be automatically transferred to the ACS function rather than being shown as a failed error condition on the ASFR Program's weekly error listing. This change is scheduled to be operational in March 2005.
- **Systemic ASFR Program closures** – A third programming change, requested in May 2004, will systemically close a case off of the ASFR Program system if the weekly update shows the ASFR Program Taxpayer Delinquency Investigation (TDI)¹⁵ was closed (e.g., the taxpayer filed the return) prior to issuance of the 30-day letter. This change is also expected to be operational in March 2005.
- **Predictive dialer** – The IRS plans to use a predictive dialer¹⁶ in working ASFR Program cases in 2005. This technology enhancement has the potential to substantially improve ASFR Program effectiveness and efficiency. The ASFR Program has traditionally communicated with taxpayers through written correspondence. During the last 2 quarters of FY 1998, the IRS tested¹⁷ the effectiveness of telephonically contacting taxpayers during the 30-day and 90-day letter process. The test data showed a 40 percent taxpayer response rate compared to 23 percent in FY 1997, 26 percent in FY 1996, and 31 percent in FY 1995 when telephone contact was not

¹⁵ A TDI involves a taxpayer who has not filed a required tax return by the return due date.

¹⁶ A predictive dialer is a telephone control system that automatically calls a list of telephone numbers in sequence and screens out no-answers, busy signals, answering machines, and disconnected numbers.

¹⁷ Telecomputer Test for the ASFR Program in the Austin Service Center, conducted in FY 1998.

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used. The test data also showed a 33 percent return-secured rate compared to 13 percent in FY 1997, 10 percent in FY 1996, and 5 percent in FY 1995.

Productivity and Efficiency Measures Are Needed

The existence of productivity and efficiency measures ensures compliance with the Government Accountability Office's *Standards for Internal Control in the Federal Government* that requires agencies to establish and monitor performance measures and indicators. The SB/SE Division does not have in place for its ASFR Program an established measure that can be used to compare productivity from period to period. While ad hoc studies can be made to determine the levels of productivity, IRS management advised us there was a reluctance to establish a permanent productivity measure because of the fear that these measures could be misused and possibly violate the IRS Restructuring and Reform Act of 1998.¹⁸

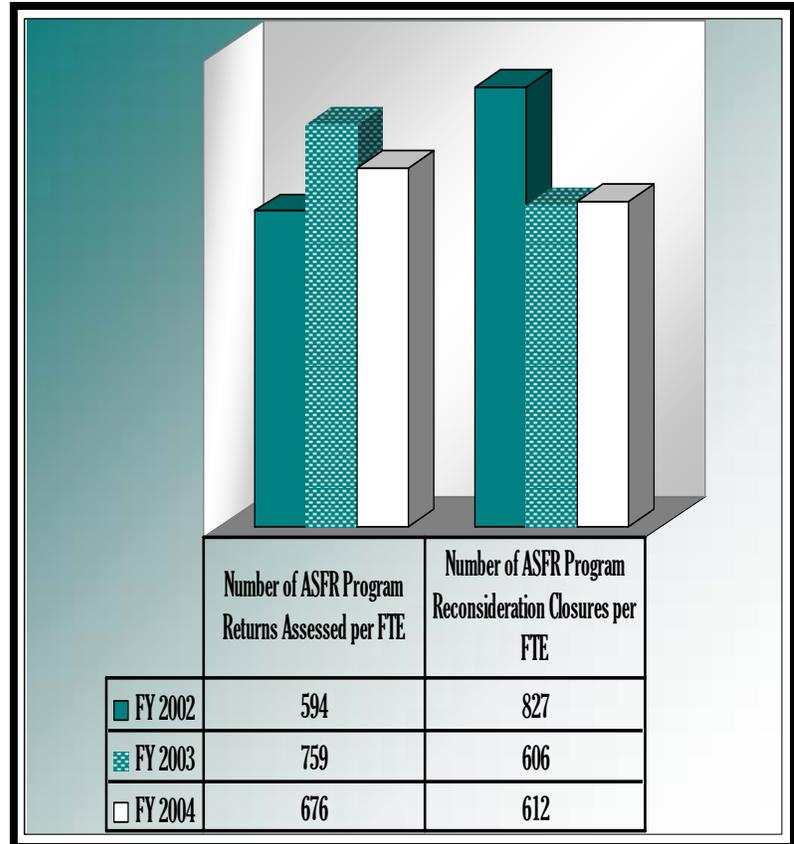
However, without sufficient measures to analyze business results, management does not have a clear picture of the effectiveness of the ASFR Program. Earlier in this report, we cited positive increases in the number of ASFR Program returns with assessments, number of taxpayers affected, net dollars assessed, etc. However, further analysis to evaluate ASFR Program productivity and effectiveness shows the improvements may not be quite so positive. For example, we analyzed the number of ASFR Program closures with assessments per FTE (i.e., the labor cost), the number of ASFR Program reconsideration closures per FTE, and the number of ASFR Program closures per FTE. While the number of ASFR Program returns assessed per FTE has increased, the other measures have declined from FYs 2002 to 2004.

Figure 4 shows the number of ASFR Program returns assessed per FTE in FY 2004 increased 14 percent in comparison to FY 2002, and the number of ASFR Program reconsiderations closed per FTE decreased by 26 percent.

¹⁸ Pub. L. No. 105-206, 112 Stat. 685 (codified as amended in scattered sections of 2 U.S.C., 5 U.S.C. app., 16 U.S.C., 19 U.S.C., 22 U.S.C., 23 U.S.C., 26 U.S.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.).

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**Figure 4: Selected ASFR Program Productivity Measures
FYs 2002-2004, SB/SE Division¹⁹**



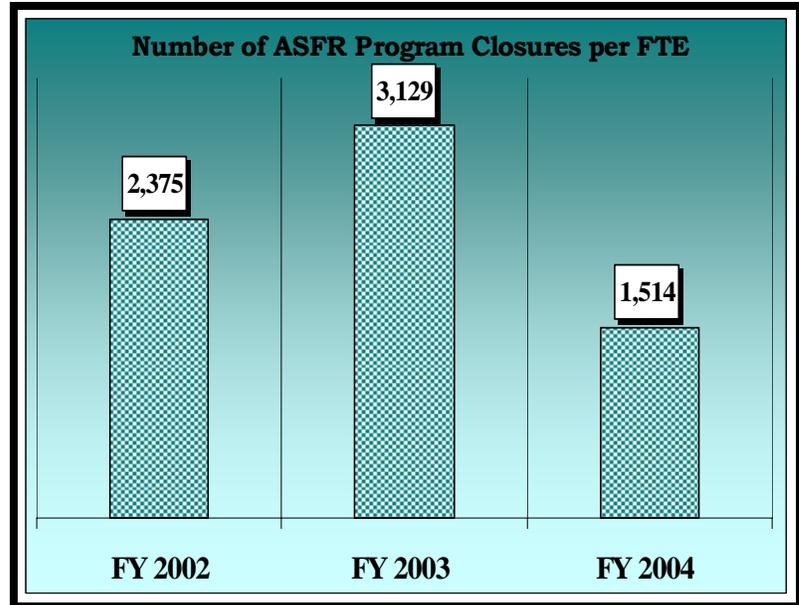
Source: SB/SE Division Service Center Collection Branch Delinquent Returns Activity Reports (Report Symbol NO-5000-139) and Work Planning and Control Reports.

Similarly, Figure 5 shows that the number of ASFR Program closures per FTE in FY 2004 declined by 36 percent from FY 2002 levels.

¹⁹ Calculation of Number of ASFR Program Returns Assessed per FTE: ASFR Program Returns Assessed divided by Total ASFR Program FTEs (direct FTEs plus overhead allocation). Calculation of ASFR Program Reconsideration Closures per FTE: Number of ASFR Program Reconsideration Closures divided by Total ASFR Program FTEs (direct FTEs plus overhead allocation).

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Figure 5: ASFR Program Closures per FTE
FYs 2002-2004, SB/SE Division²⁰



Source: ASFR 200 Reports²¹ and Work Planning and Control Reports.

According to IRS management, several factors contributed to the decline in productivity in FY 2004:

- In preparation for the ASFR Program consolidation in January 2004, the 4 campuses that discontinued ASFR Program processing ceased to mail 30-day letters to taxpayers after March 2003, to minimize taxpayer burden in responding to multiple IRS locations.
- The ASFR Program computer system was down from about December 9, 2003, until February 9, 2004, due to

²⁰ Calculation of Number of ASFR Program Closures per FTE: Number of ASFR Program Closures divided by Total ASFR Program FTEs (direct FTEs plus overhead allocation). Unlike prior years, in FY 2004 a programming problem resulted in a high volume of reassignments to other functions being counted as ASFR Program closures. The programming problem has been corrected and the excessive number of reassignments was subtracted from the count of ASFR Program FY 2004 closures.

²¹ An ASFR 200 Report is generated weekly, showing the ASFR Program's receipts, closings, and ending inventory.

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the Taxpayer Information File (TIF)²² consolidation and the consolidation of all of the SB/SE Division ASFR Program activities at the Brookhaven Campus.

- The consolidation of the ASFR Program at one site in January 2004 required significant time in training new employees.

Recommendation

The Commissioner, SB/SE Division, should:

1. Establish measures to provide management with the means to routinely gauge the productivity and efficiency of ASFR Program operations and to effectively assess the impact of changes to ASFR Program policy or work processes.

Management's Response: The Commissioner, SB/SE Division, will review the current performance measures and determine the potential for establishing additional measures that gauge program productivity.

Opportunities Exist to Address Repeated Filing Noncompliance

The success of the United States tax system is dependent on taxpayers' perception that others self-report their tax liability by filing a return. To assist the IRS in evaluating taxpayers' voluntary filing compliance, measures should be established to improve the IRS' ability to detect noncompliance. An IRS study²³ of individual nonfilers showed repeaters play a significant role in filing noncompliance but are inadequately flagged by the nonfiler identification system. For example, repeaters made up 51 percent of the 1998 Collection Compliance File,²⁴ accounted for 72 percent of all nonfiler leads during 1996 to 1998, and averaged 2.5 tax periods per individual. The

²² The TIF is the primary database for the Integrated Data Retrieval System, which enables IRS employees in service centers and Area Offices to have instantaneous visual access to certain taxpayer accounts.

²³ *Individual Master File Repeat Nonfilers*, by SB/SE Division Research function, dated September 2002.

²⁴ The Collection Compliance File is a database of leads for systemically identified potential nonfilers of individual income tax returns that are compiled by tax year using the Collection Compliance Nonfiler Identification Process.

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cumulative projected balance due for repeat nonfilers was \$63 billion for 1996 to 1998.

The ASFR Program lacks a measure of effectiveness in promoting subsequent voluntary compliance

The ASFR Program is designed to bring nonfilers back into compliance with the expectation that they will file without IRS intervention in subsequent years. However, the subsequent voluntary filing compliance rates for individuals that are treated by the ASFR Program, a key and essential measure of the long-term success of the ASFR Program, is not tracked and reported by the IRS. As a result, the IRS is unable to evaluate whether the ASFR Program goal to promote voluntary filing compliance is being achieved.

In 2003, the IRS completed a study²⁵ that showed the subsequent voluntary filing compliance by individuals treated by the ASFR Program for TYs 1996 and 1997 averaged 41 percent for the first year and 37 percent for the second year following the disposition of the ASFR Program case. The study concluded that, if an individual does file subsequent to ASFR Program treatment, it appears that he or she continues to file for multiple years. However, the voluntary filing rate does decline in the subsequent years.

For FY 2004, the SB/SE Division ASFR Program resulted in net tax assessments of more than \$1.509 billion.²⁶ If the same 41 percent subsequent year filing compliance rate identified by the IRS study continues to exist, the IRS can expect to voluntarily collect approximately \$619 million from the taxpayers that were treated by the SB/SE Division ASFR Program in FY 2004. This leaves approximately 59 percent, or \$890 million, that may not be voluntarily filed with and paid to the IRS.

²⁵ *Automated Substitute for Return Subsequent Fact of Filing*, by SB/SE Division Research function, dated May 2003.

²⁶ SB/SE Division Service Center Collection Branch Delinquent Returns Activity Report (Report Symbol NO-5000-139), dated September 29, 2004.

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Backup withholding could be expanded to reduce repeated filing noncompliance

The tax laws²⁷ provide for backup withholding in certain circumstances. Backup withholding may be imposed, for example, when taxpayers underreport their interest or dividend income or failed to file a tax return reporting such income when required. Once identified by the IRS as potential subjects to backup withholding, taxpayers who underreport their interest or dividend income are sent several notices asking that the problem be corrected. The final notice informs the taxpayers they are now subject to backup withholding and the IRS is notifying the payors to begin withholding (at a rate of 28 percent).

However, the issuance of the ASFR Program's initial contact letter requesting a filed return from the taxpayer suspends backup withholding treatment. Generally, backup withholding treatment remains suspended until an assessment with a significant dollar amount is made. When a taxpayer responds to ASFR Program contact by submitting a filed return, an assessment can be made using the information from the return. Often, though, the taxpayer does not respond to ASFR Program contacts and remains noncompliant. In such instances, a default assessment is made based on income information available from third parties.

In May 2004, the IRS transferred responsibility for its Backup Withholding Program from the Wage and Investment (W&I) Division to the SB/SE Division because of limited program results. At the time we completed our review, the SB/SE Division was researching the tax laws and regulations as a first step in evaluating the application of the backup withholding authority to the ASFR Program.

At present, backup withholding is primarily limited to interest or dividend income. This limitation prevents IRS from encouraging future voluntary filing compliance for those nonfilers whose cases were unsuccessfully resolved by the ASFR Program. If backup withholding treatment was expanded to cover all sources of nonwage income (e.g.,

²⁷ 26 U.S.C. § 3406 (2004).

The Small Business/Self-Employed Division Has Made Significant Changes to Enhance the Automated Substitute for Return Program, but Opportunities Exist for Further Improvement

pensions, annuities, etc.) that form the basis for the nonfiling condition, we estimate the IRS could expect to collect an additional \$9 million per year, or an additional \$45 million over the next 5 years. See Appendix IV for details.

Recommendations

To assist the IRS in its efforts to improve voluntary filing compliance, the Commissioner, SB/SE Division, who has the overall responsibility for the SB/SE Division compliance programs, should:

2. Develop a tracking and reporting mechanism to measure the subsequent voluntary filing compliance rates of the individual taxpayers treated by the ASFR Program.

Management's Response: The Commissioner, SB/SE Division, agreed that changing taxpayer behavior is a key component and will take a subsequent look at voluntary compliance rates of individuals treated in the ASFR Program for the purpose of developing other strategies for dealing with nonfilers.

3. Conduct a study to determine the feasibility of expanding backup withholding treatment to all nonwage income sources that form the basis for the nonfiling condition, and if necessary, coordinate with the Office of Chief Counsel to draft legislation to amend I.R.C. § 3406.²⁸ To ensure equal treatment of taxpayers in similar situations, consideration in implementing this recommendation should also take the W&I Division ASFR Program into account.

Management's Response: The Commissioner, SB/SE Division, stated nonfilers are considered for backup withholding under current Internal Revenue regulations; however, the Commissioner, SB/SE Division, will explore the feasibility of the revision/expansion of the backup withholding definition to include nonwage income, review the options, and proceed in the best interest of sound tax administration. The Commissioner, SB/SE Division,

²⁸ 26 U.S.C. § 3406 (2004).

The Small Business/Self-Employed Division Has Made Significant Changes to Enhance the Automated Substitute for Return Program, but Opportunities Exist for Further Improvement

disagrees with the potential increase of \$45 million in revenue over 5 years as revenue is already collected from backup withholding on cases meeting the criteria. Further, the Commissioner, SB/SE Division, stated the intent of the ASFR Program is to encourage taxpayers to file outstanding returns or determine whether a tax liability exists, rather than to raise revenue.

Office of Audit Comment: While we are encouraged the Commissioner, SB/SE Division, will explore the feasibility of revising/expanding backup withholding treatment, we disagree that additional revenue could not be realized from an expanded application of backup withholding. The ASFR Program is a critical tool used to combat tax noncompliance, a top priority for the IRS. Applying backup withholding treatment to all nonwage income sources that form the basis for the nonfiling condition worked by the ASFR Program would increase revenue and deter noncompliance, allowing for earlier intervention and a reduction of subsequent enforcement actions.

Limited Quality Assurance Data Are Available on Closed Case Work

The SB/SE Division FY 2003 and FY 2004 Compliance Operations Program Letters emphasized the IRS goal to provide top-quality service to each taxpayer in every interaction and to all taxpayers through fair and uniform application of the law. To determine the degree to which this goal is being achieved, management needs quality measurement systems in place that provide statistically valid results. Quality review data is also needed by management to provide a basis for measuring and improving program effectiveness.

The IRS uses the National Quality Review System (NQRS)²⁹ to measure the accuracy rates achieved by a multitude of compliance programs at its various campus locations. However, ASFR Program cases do not represent a separate product line and are included in the quality review samples selected from various other compliance programs.³⁰ Therefore, an extremely small number of ASFR

²⁹ Prior to October 1, 2004, the NQRS was called the Centralized Quality Review System.

³⁰ The other compliance programs include Taxpayer Delinquent Account (TDA) Balance Due, TDA Offer in Compromise, TDI, and Trust Fund Recovery Penalty.

The Small Business/Self-Employed Division Has Made Significant Changes to Enhance the Automated Substitute for Return Program, but Opportunities Exist for Further Improvement

Program cases is selected for quality review in any one time period.

The ASFR Program involves three distinct types of cases: proposed assessment cases, reconsideration cases, and refund hold cases. In FY 2004, the ASFR Program was expected to close about 141,000 cases. As of July 2004, only 109 ASFR Program cases, or an average of 11 cases per month, had been selected for NQRS sampling. These included 72 proposed assessment cases, 37 reconsideration cases, and zero refund hold cases. This limited sampling is insufficient to provide management with reliable information for evaluating overall ASFR Program quality, detecting error trends, or identifying possible systemic problems.

The NQRS results for the ASFR Program varied significantly from the quality review results determined by the ASFR Program managers in evaluating the individual performance of the ASFR Program tax examiners.³¹ As of July 2004, for example, the 2 measures for timeliness varied by 13 percent and the 2 measures for customer accuracy varied by 10 percent.³² The samples of cases selected for managerial reviews were significantly larger than the samples of ASFR Program cases selected for the NQRS.

Due to the consolidation of the ASFR Program at one site, management at the Brookhaven Campus has requested that the NQRS treat ASFR Program cases as a separate product line. At the time we completed our review, a final decision on this request had not been made.

Recommendation

The Commissioner, SB/SE Division, who is responsible for the overall ASFR Program, should:

³¹ Managerial reviews are performed to evaluate individual employee performance and are performed independently from national and local quality reviews.

³² The timeliness measure was 98 percent according to the managerial reviews and 85 percent according to the NQRS. Customer accuracy was 85 percent according to the managerial reviews and 75 percent according to the NQRS.

The Small Business/Self-Employed Division Has Made Significant Changes to Enhance the Automated Substitute for Return Program, but Opportunities Exist for Further Improvement

4. Separate the ASFR Program from other compliance programs for purposes of the NQRS sampling, as suggested by the Brookhaven Campus, to provide a statistically valid measure of program quality and to provide ASFR Program management with a sound basis for taking actions that affect policies, procedures, and operational practices.

Management's Response: The Commissioner, SB/SE Division, has established for FY 2005, separate workgroup codes, separate weighted reports, and a separate sample available for review. In FY 2007, the ASFR Program will be developed as a Specialized Product Review Group on the NQRS.

Over-age Reconsideration Case Inventory Has Been Reduced but Remains at a High Level

Reconsideration is the process the IRS uses when a taxpayer contests an ASFR Program assessment by filing an original delinquent return. The reconsideration cases result from defaulted assessments (e.g., a taxpayer did not respond to the 30-day letter or 90-day letter). The reconsideration cases usually occur when the unpaid accounts enter the enforced collection stage and the taxpayers are finally motivated to send the IRS a completed tax return or other information to reduce the ASFR Program assessment. This can happen months or up to 2 years after the defaulted ASFR Program assessment is made.

The untimely resolution of ASFR Program reconsideration cases could adversely affect taxpayer relations and result in additional taxpayer interest costs being incurred. Reconsideration cases are considered over-age if they remain unresolved more than 45 days after they are received by the IRS. The Brookhaven Campus has monitored over-age ASFR Program reconsideration cases on a weekly basis³³ since the week of March 3, 2004. From March to September 2004, the inventory of reconsideration cases ranged from 1,660 to 4,531 cases, and the percentage of over-age cases ranged from 13 to 38 percent.

Many taxpayers contested ASFR Program default assessments by providing completed tax returns or other

³³ This report is entitled ASFR Weekly Report and includes numerous case inventory data.

The Small Business/Self-Employed Division Has Made Significant Changes to Enhance the Automated Substitute for Return Program, but Opportunities Exist for Further Improvement

information to various IRS offices throughout the country. As a result, the ASFR Program reconsideration cases are frequently over-age by the time they are received at the Brookhaven Campus. To address this over-age problem, ASFR Program national policy staff initiated the generation of transcripts. One transcript is forwarded to the SB/SE Division's consolidated ASFR Program site, the Brookhaven Campus, alerting management that a taxpayer filed a return with the IRS. The other transcript goes to the IRS site where the taxpayer filed the return, informing the Files unit to pull the return and route it to the appropriate site.

Beginning in March 2004, the Brookhaven Campus began monitoring ASFR Program reconsideration cases received from other IRS offices. For the last 7 months of FY 2004, this monitoring showed that 3,903 (56 percent) of the 7,032 cases were already over-age at the time they were received at the Brookhaven Campus. The percentage of over-age reconsideration cases received from other IRS offices ranged from 25 to 79 percent.

To achieve the lowest over-age percentage possible, ASFR Program management at the Brookhaven Campus has been determining the specific sites that are delaying shipment of the reconsideration work. Brookhaven Campus ASFR Program management has coordinated with the sending sites and the Brookhaven policy staff to improve shipping timeliness and has revised operating procedures for identifying and mailing ASFR Program reconsideration cases. While the national/local initiatives have helped to reduce the ASFR Program reconsideration over-age inventory from 38 percent in June 2004 to 13 percent in September 2004, the over-age inventory remains at a high level.

Recommendation

To further reduce the percentage of ASFR Program reconsideration inventory that is over-age and thus improve IRS service to taxpayers by more timely resolving cases in which the taxpayers are making an attempt to become compliant, the Commissioner, SB/SE Division, should:

The Small Business/Self-Employed Division Has Made Significant Changes to Enhance the Automated Substitute for Return Program, but Opportunities Exist for Further Improvement

5. Provide guidance to all SB/SE Division collection offices that contribute to the over-age ASFR Program reconsideration inventory, establish service level agreements with the offices most responsible for the routing delays to set guidelines for timely submission of ASFR Program reconsideration returns, and examine whether systemic solutions could be developed to reduce the percentage of over-age reconsideration inventory.

Management's Response: The Commissioner, SB/SE Division, stated the ASFR Program was centralized in January 2004, but agreed there are additional actions which can be taken to clarify the processing for the ASFR Program reconsideration returns. The Commissioner, SB/SE Division, will revisit the procedures and develop processes for monitoring and handling ASFR Program cases to reduce the percentage of over-age reconsideration inventory.

The Small Business/Self-Employed Division Has Made Significant Changes to Enhance the Automated Substitute for Return Program, but Opportunities Exist for Further Improvement

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of the audit was to determine whether the Small Business/Self-Employed (SB/SE) Division Automated Substitute for Return (ASFR) Program is effectively administered to achieve the desired program results and promote taxpayer compliance with the tax laws. The audit objective was accomplished by interviewing Internal Revenue Service (IRS) managers and program analysts at the SB/SE Division Headquarters office and at the Brookhaven Campus,¹ conducting a walk-through of ASFR Program and ASFR Program reconsideration campus activities, and reviewing management information system reports and other documentation related to ASFR Program and ASFR Program reconsideration activities.

To accomplish our objective, we:

- I. Determined whether the ASFR Program is effectively designed and used to support the IRS strategies, plans, policies, and procedures for ensuring filing compliance and for achieving the desired program results.
 - A. Reviewed the SB/SE Division Fiscal Year (FY) 2004 – FY 2005 Strategy and Program Plan, SB/SE Division FY 2003 and FY 2004 Compliance Operations Program Letters, FY 2004 IRS Annual Performance Plan, SB/SE Division Compliance FY 2004 Business Plan, ASFR Consolidation Action Plan, SB/SE Research study *Automated Substitute for Return Subsequent Fact of Filing*, and IRS' Statistics of Income study *Nonfiler Profiles, Fiscal Year 1993: A Focus on Repeaters*.
 - B. Interviewed SB/SE Division Headquarters Compliance Policy's Return Delinquency analysts and Centralized Workload and Selection Development analysts and SB/SE Division Headquarters Compliance Services analyst.
 - C. Interviewed the SB/SE Division Headquarters Nonfiler analyst and ASFR Program analysts and the SB/SE Division Brookhaven Campus Compliance Services Campus Operations (CSCO) manager and ASFR Program department managers to evaluate the effectiveness of the case selection process for assigning cases to the ASFR Program.
 - D. Interviewed SB/SE Division Brookhaven Campus ASFR Program department managers, reviewed Internal Revenue Manual (IRM) section 5.18.1 *ASFR Program*, and analyzed the Brookhaven Campus ASFR Program weekly reports for the period February 25 to September 29, 2004,² to identify key processing stages of ASFR Program activities and to evaluate timeliness and quantity standards used for the ASFR Program.

¹ The campuses are the data processing arm of the IRS. They process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.

² Brookhaven Campus did not start maintaining data for these reports until February 25, 2004. Thus, the weekly reports available for FY 2004 were from February 25, 2004, to September 29, 2004.

The Small Business/Self-Employed Division Has Made Significant Changes to Enhance the Automated Substitute for Return Program, but Opportunities Exist for Further Improvement

- E. Interviewed the SB/SE Division Headquarters Strategy Research and Performance Management analyst and Brookhaven Campus SB/SE Division CSCO manager and Planning and Analysis manager/analysts and reviewed the October 2003 through July 2004 ASFR Program managerial and nonmanagerial quality reviews³ to determine whether the quality assurance data is sufficient to monitor the ASFR Program.
- II. Determined whether the management information reports the IRS uses to monitor and evaluate the SB/SE Division ASFR Program activities are sufficient.
- A. Obtained and reviewed FYs 2002, 2003, and 2004 ASFR Program management information reports used by SB/SE Division Headquarters to monitor ASFR Program and ASFR Program reconsideration activities.
 - B. Interviewed the SB/SE Division Headquarters ASFR Program analysts and Business Systems Planning manager/analysts, analyzed FYs 2002, 2003, and 2004 ASFR Program management information reports with corresponding Full-Time Equivalent (FTE)⁴ levels, and reviewed FYs 2002, 2003, and 2004 SB/SE Division Service Center Collection Branch (SCCB) Delinquent Returns Activity Reports (Report Symbol NO-5000-139) to determine the significant productivity, effectiveness, and efficiency measures for ASFR Program and ASFR Program reconsideration cases.
 - C. Analyzed the FYs 2002, 2003, and 2004 ASFR Program management information reports and the FYs 2002, 2003, and 2004 SB/SE Division SCCB Delinquent Returns Activity Reports (Report Symbol NO-5000-139) to determine whether the annual statistics for direct FTEs, number of cases selected and closed, returns secured, dollars assessed, dollars collected, and dollars refunded are gathered by SB/SE Division management.
 - D. Interviewed the SB/SE Division CSCO manager and ASFR Program department managers to determine how ASFR Program and ASFR Program reconsideration cases are scheduled, including the standards used, and the actual work performance levels.
- III. Determined whether the actions IRS management has taken to deal with high-income nonfilers has had the desired effect of reducing high-income filing noncompliance.
- A. Interviewed the SB/SE Division Workload Planning analyst and obtained the FYs 2002, 2003, and 2004 funding levels for the ASFR Program.
 - B. Reviewed the FYs 2002, 2003, and 2004 SB/SE Division SCCB Delinquent Return Activity Reports (Report Symbol NO-5000-139) to obtain the net assessments for ASFR Program cases.

³ We examined quality reviews for the current fiscal year, FY 2004. At the time of our visitation, the quality reviews available for FY 2004 began in October 2003, ending July 2004.

⁴ An FTE is a measure of labor hours. One FTE is equal to 8 hours multiplied by the number of compensable days in a particular fiscal year. For FY 2004, 1 FTE was equal to 2,096 staff hours.

The Small Business/Self-Employed Division Has Made Significant Changes to Enhance the Automated Substitute for Return Program, but Opportunities Exist for Further Improvement

- C. Obtained and analyzed the ASFR Program productivity levels and interviewed SB/SE Division Headquarters ASFR Program analysts and the SB/SE Division CSCO manager/analyst to determine the actions IRS management has taken or is taking to improve productivity levels.
- D. Interviewed IRS Modernization and Information Technology Services organization specialists and SB/SE Division Headquarters ASFR Program analysts, reviewed IRM section 5.19.3 *Liability Collection – Backup Withholding Program*, and examined the Internal Revenue Code (I.R.C.) Section (§) 3406⁵ to determine whether the IRS application of backup withholding could be expanded to encourage future voluntary filing compliance for nonfilers whose cases were unsuccessfully resolved by the ASFR Program.

⁵ I.R.C. § 3406 (2004).

The Small Business/Self-Employed Division Has Made Significant Changes to Enhance the Automated Substitute for Return Program, but Opportunities Exist for Further Improvement

Appendix II

Major Contributors to This Report

Philip Shropshire, Acting Assistant Inspector General for Audit (Small Business and Corporate Programs)

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E. John Thomas, Lead Auditor

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The Small Business/Self-Employed Division Has Made Significant Changes to Enhance the Automated Substitute for Return Program, but Opportunities Exist for Further Improvement

Appendix III

Report Distribution List

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Audit Liaison: Commissioner, Small Business/Self-Employed Division SE:S

The Small Business/Self-Employed Division Has Made Significant Changes to Enhance the Automated Substitute for Return Program, but Opportunities Exist for Further Improvement

Appendix IV

Outcome Measures

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

Type and Value of Outcome Measure:

- Increased Revenue – Potential; \$9 million for 1 year; \$45 million over 5 years (see page 12).

Methodology Used to Measure the Reported Benefit:

The following is a general summary of the methodology used to measure the reported benefit.

Increased Revenue: Backup withholding.

Our estimate of increased revenue is based on the belief that long-term return filing compliance by those taxpayers subject to Automated Substitute for Return (ASFR) Program compliance treatments could be improved by expanding the backup withholding compliance tool. For Fiscal Year (FY) 2004, the Small Business/Self-Employed (SB/SE) Division ASFR Program generated net tax assessments¹ of \$1.509 billion.² An Internal Revenue Service (IRS) study³ for Tax Years 1996 and 1997 showed that, in the year following the ASFR Program compliance treatment, 41 percent of taxpayers voluntarily filed their tax returns while the other 59 percent remained noncompliant. If these filing compliance percentages and the net ASFR Program assessments remain the same for FY 2005, the IRS can expect to voluntarily collect 41 percent of the ASFR Program assessments, or \$618,690,000 ($\$1,509,000,000 \times 41$ percent). This leaves the remaining 59 percent, or \$890,310,000 ($\$1,509,000,000 \times 59$ percent), that will require IRS intervention and/or IRS collection enforcement action. These estimates assume the taxpayers that voluntarily file their tax returns will also pay the amount due in full, which may be overly optimistic since these taxpayers have been noncompliant in the past.

Assuming 1 percent of the \$890,310,000 can be collected through expanded authority of backup withholding, the additional IRS collections would be \$8,903,100 ($\$890,310,000 \times 1$ percent) for 1 year, or \$44,515,500 ($\$8,903,100 \times 5$) over 5 years. The 5-year estimate may represent the low

¹ In an ASFR Program assessment, the Internal Revenue Service determines the taxpayer's liability using a filing status of single, the standard deduction, and income information available from third parties and notifies the taxpayer it will assess this amount unless the taxpayer responds by filing a correct return for a different amount, often a lesser amount than the ASFR assessment.

² SB/SE Division Service Center Collection Branch Delinquent Returns Activity Report (Report Symbol NO-5000-139), dated September 29, 2004.

³ *Automated Substitute for Return Subsequent Fact of Filing*, by SB/SE Division Research function, dated May 2003.

The Small Business/Self-Employed Division Has Made Significant Changes to Enhance the Automated Substitute for Return Program, but Opportunities Exist for Further Improvement

end for both the amounts collected and the amounts requiring an IRS intervention or collection enforcement action because the SB/SE Division ASFR Program production goals and Full-Time Equivalents (FTE)⁴ are expected to increase in FY 2005 and later years. For example, the FY 2004 production goal was 141,490 cases while the FY 2005 production goal is 396,392 cases, an increase of 180 percent. The SB/SE Division applied 181 FTEs to its ASFR Program in FY 2004, while the planned increase for FY 2005 is 37 FTEs, an increase of 20 percent. The planned increase for FY 2006 is an additional 65 FTEs, an increase of 58 percent over the FY 2004 level.

The 1 percent improvement factor we used to calculate the additional yearly revenues as a result of expanding the backup withholding compliance tool was arrived at by considering the improved filing compliance rate achieved during the IRS study⁵ of using a predictive dialer to call taxpayers to advise them of a pending ASFR Program action. This study resulted in a secured return rate of 33 percent. This represented a 20 percent increase over FY 1997, a 23 percent increase over FY 1996, and a 28 percent increase over FY 1995 when the predictive dialer was not used.

In our view, an expanded backup withholding compliance tool represents a stronger leverage action because withholding payments will be made to the IRS at the time of payor distributions for all nonwage income sources. Since the IRS will collect a portion or all of the taxes due, taxpayers should be more likely to timely file their tax returns. The 1 percent improvement factor may be a conservative estimate because the predictive dialer tests showed improvements significantly greater. Also, a private sector study⁶ of 327 entities that had undergone reengineering initiatives in 2002 showed that 54 percent of the participants expected improvements of over 30 percent. In addition, to address the principle of equal treatment of taxpayers in similar situations, consideration in evaluating the recommendation also needs to be given to the Wage and Investment Division ASFR Program, which had net ASFR Program assessments of \$2.505 billion in FY 2004.

⁴ An FTE is a measure of labor hours. One FTE is equal to 8 hours multiplied by the number of compensable days in a particular fiscal year. For FY 2004, 1 FTE was equal to 2,096 staff hours.

⁵ Telecomputer Test for the ASFR Program in the Austin Service Center, conducted in FY 1998.

⁶ *Prosci's 2002 Best Practices in Business Process Reengineering Report.*

The Small Business/Self-Employed Division Has Made Significant Changes to Enhance the Automated Substitute for Return Program, but Opportunities Exist for Further Improvement

Appendix V

Management's Response to the Draft Report

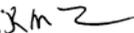


DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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APR -7 2005

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Kevin M. Brown 
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – The Small Business/Self-Employed Division Has Made Significant Changes to Enhance the Automated Substitute for Return Program, but Opportunities Exist for Further Improvement (Audit # 200430003)

We have reviewed your report and appreciate your recognition of our efforts to improve filing compliance. We have completed several initiatives to increase the efficiency and efficacy of the Automated Substitute for Return (ASFR) Program.

We agree that there are further opportunities for improvement in the program. We will review the process and determine the best and most efficient methods to increase program productivity and effectiveness.

Your report suggests that an additional \$45 million in revenue could be realized over five years from an increase in backup withholding. As we already are collecting backup withholding on cases meeting the criteria, we are uncertain about this estimate. In any event, the intent of the ASFR Program is to encourage taxpayers to file outstanding returns or determine whether a tax liability exists, rather than to raise revenue.

Our comments on your recommendations follow:

RECOMMENDATION 1

The Commissioner, Small Business/Self-Employed Division, should establish measures to provide management with the means to routinely gauge the productivity and efficiency of the ASFR Program operations and to effectively assess the impact of changes to ASFR Program policy or work processes.

CORRECTIVE ACTION

We will review the current performance measures and determine the potential for establishing additional measures that gauge program productivity.

The Small Business/Self-Employed Division Has Made Significant Changes to Enhance the Automated Substitute for Return Program, but Opportunities Exist for Further Improvement

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IMPLEMENTATION DATE

January 15, 2006

RESPONSIBLE OFFICIAL(S)

Director, Filing & Payment Compliance, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN

Program Manager, Filing Compliance, will advise the Director, Filing & Payment Compliance, of any delays.

RECOMMENDATION 2

The Commissioner, Small Business/Self-Employed Division, should develop a tracking and reporting mechanism to measure the subsequent voluntary filing compliance rates of the individual taxpayers treated by the ASFR Program.

CORRECTIVE ACTION

We agree that changing taxpayer behavior is a key component, and we will take a subsequent look at voluntary compliance rates of individuals treated in the program for the purpose of developing other strategies for dealing with non-filers.

IMPLEMENTATION DATE

January 15, 2006

RESPONSIBLE OFFICIAL(S)

Director, Filing & Payment Compliance, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN

Program Manager, Filing Compliance, will advise the Director, Filing & Payment Compliance, of any delays.

RECOMMENDATION 3

The Commissioner, Small Business/Self-Employed Division, should conduct a study to determine the feasibility of expanding backup withholding treatment to all non-wage income sources that form the basis for the non-filing condition, and if necessary amend the Internal Revenue Code, Section 3406. To ensure equal treatment of taxpayers in similar situations, consideration in implementing this recommendation should also take the W&I Division ASFR Program into account.

CORRECTIVE ACTION

Non-filers are considered for backup withholding under current Internal Revenue regulations. We will explore the feasibility of the revision/expansion of the backup withholding definition to include non-wage income, review the options, and proceed in the best interest of sound tax administration.

IMPLEMENTATION DATE

January 15, 2007

The Small Business/Self-Employed Division Has Made Significant Changes to Enhance the Automated Substitute for Return Program, but Opportunities Exist for Further Improvement

3

RESPONSIBLE OFFICIAL(S)

Director, Filing & Payment Compliance, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN

Program Manager, Filing Compliance, will advise the Director, Filing & Payment Compliance, of any delays.

RECOMMENDATION 4

The Commissioner, Small Business/Self-Employed Division, should separate the ASFR Program from other compliance programs for purposes of the NQRS sampling, as suggested by the Brookhaven campus, to provide a statistically valid measure of program quality and to provide ASFR Program management with a sound basis for taking actions that affect policies, procedures, and operational practices.

CORRECTIVE ACTION

For FY 05, we have established separate workgroup codes, separate weighted reports and a separate sample available for review. In FY07, ASFR will be developed as a Specialized Product Review Group (SPRG) on the National Quality Review System (NQRS).

IMPLEMENTATION DATE

January 15, 2007

RESPONSIBLE OFFICIAL(S)

Director, Filing & Payment Compliance, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN

The Program Manager, Filing Compliance, will advise the Director, Filing & Payment Compliance, of any delays.

RECOMMENDATION 5

The Commissioner, Small Business/Self-Employed Division, should provide guidance to all Small Business/Self-Employed Division collection offices that contribute to the overage ASFR Program reconsideration inventory, establish service level agreements with the offices most responsible for the routing delays to set guidelines for timely submission of ASFR reconsideration returns, and examine whether systemic solutions could be developed to reduce the percentage of overage reconsideration inventory.

CORRECTIVE ACTION

The ASFR Program was centralized in January 2004, but we agree there are additional actions we can take to clarify the processing for the ASFR reconsideration returns. We will revisit the procedures and develop processes for monitoring and handling ASFR cases in order to reduce the percentage of overage reconsideration inventory.

The Small Business/Self-Employed Division Has Made Significant Changes to Enhance the Automated Substitute for Return Program, but Opportunities Exist for Further Improvement

4

IMPLEMENTATION DATE

January 15, 2006

RESPONSIBLE OFFICIAL(S)

Director, Filing & Payment Compliance, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN

The Program Manager, Filing Compliance, will advise the Director, Filing & Payment Compliance, of any delays.

If you have any questions, please call me at (202) 622-0600 or Robert L. Hunt, Director, Campus Compliance Services, Small Business/Self-Employed Division, at (202) 283-2200.