



March 2017

IRS RETURN SELECTION

Improved Planning,
Internal Controls, and
Data Would Enhance
Large Business
Division Efforts to
Implement New
Compliance Approach

GAO Highlights

Highlights of [GAO-17-324](#), a report to congressional requesters

Why GAO Did This Study

LB&I audits large partnerships and corporations with \$10 million or more in assets and high wealth individuals. These entities pose compliance challenges. For example, IRS reported that the gross underreported income tax of large corporations alone averaged an estimated \$28 billion annually between 2008 and 2010, the most recent data. It is important for LB&I to have adequate controls for its audit procedures and to properly plan and implement its new approach to address noncompliance.

GAO was asked to evaluate how IRS selects returns and is implementing its new compliance approach. Among other objectives, this report (1) assesses the extent that LB&I's documented procedures and policies for its audit selection methods generally reflected relevant internal control principles, (2) assesses the extent that LB&I has a standard process to monitor audit selection decisions, and (3) assesses the extent that LB&I has planned and implemented its new approach to address compliance.

GAO reviewed LB&I procedures and policies for eight selection methods that involved the use of discretion and its plans for implementing a new compliance approach. Given the status of LB&I's plans for and implementation of its new approach, GAO did not assess LB&I's decision to create the approach. GAO held focus groups with LB&I staff responsible for selecting audits, and interviewed IRS officials.

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Improved Planning, Internal Controls, and Data Would Enhance Large Business Division Efforts to Implement New Compliance Approach

What GAO Found

The Internal Revenue Service's (IRS) Large Business and International division (LB&I) uses a variety of methods, such as computer models and staff reviews of returns, to identify tax returns for audit consideration. From the returns identified, managers and auditors in LB&I field offices select the returns to be audited. For the eight methods LB&I uses for identifying and selecting tax returns for audit (selection methods) that GAO analyzed, LB&I documentation on its procedures and policies generally reflected 4 of the 10 internal control principles GAO reviewed. For example:

- Related to the internal control principle of demonstrating commitment to integrity and ethical values, LB&I auditors who identify tax returns for audit consideration are prohibited from auditing those returns themselves or assigning them to specific individuals for audit. In addition, all LB&I staff completed a required training on ethics and impartiality in 2015, the latest available data.
- Related to the internal control principle of demonstrating a commitment to competence, LB&I's procedures and manuals generally documented its training to help assure the competence of staff involved in audit selection. This training included courses on basic skills as well as instruction on more specific topics.

However, for the other 6 internal control principles GAO reviewed, there were gaps in documentation that limit LB&I's assurance that its selection methods are being implemented as designed and are supporting its objectives. For example:

- Related to the internal control principle of identifying, analyzing, and responding to risk, LB&I documentation did not specify procedures or a process for how to respond to changing circumstances, such as a change in the law, in selecting returns for audit.
- Related to the internal control principle of reporting on issues and remediating related deficiencies, LB&I documentation indicated that problems identified with selection methods were discussed in meetings, but not that corrective action was taken to address them.

GAO also found that LB&I has monitoring directives, but it does not have a standard process for monitoring field staff's audit selection decisions. Without such a process, LB&I lacks reasonable assurance that decisions are made consistently.

LB&I is in the process of implementing a new approach for addressing taxpayer compliance, including how it identifies tax returns for audit. LB&I plans to implement what officials call "campaigns," which are projects focused on a specific compliance-related issue, such as partnerships underreporting certain income, rather than projects focused on the characteristics of whole tax returns. According to LB&I officials, campaigns could include conducting audits as well as other efforts, such as reaching out to taxpayers and tax professionals, issuing guidance, and participating in industry events. LB&I officials said certain audit selection methods that existed prior to the development of campaigns will operate while LB&I implements its campaign approach, and campaigns may subsume some of those methods.

What GAO Recommends

GAO recommends that IRS address documentation gaps in its selection method procedures and policies related to six internal control principles, develop a standard process to monitor field staff's audit selection decisions, and take seven actions to fully address planning principles in its efforts to implement its new compliance approach. In commenting a draft of this report, IRS agreed with all of the recommendations.

GAO found that LB&I made some progress in implementing its new compliance approach, such as by involving stakeholders in plans and implementing the process for submitting proposals for campaigns. However, LB&I has not fully met five project planning principles set forth in prior GAO work (see table below). Until it fully meets these principles, LB&I management lacks reasonable assurance that its new compliance approach will succeed in accomplishing its overall objectives of encouraging voluntary compliance and fair treatment of taxpayers.

Large Business and International (LB&I) Division's Plans for New Compliance Approach Assessed against Project Planning Principles as of December 2016

Project Planning Principles	LB&I Actions not yet taken to address the principle
Develop project plan with measurable goals, schedules, and resources.	<ul style="list-style-type: none"> Specific schedule is not set for adopting new campaign projects or establishing criteria for choosing projects. Compliance goals and resource needs are not stated in ways conducive to measurement.
Evaluate human resources by assessing how needed staff will be acquired and retained.	<ul style="list-style-type: none"> Means to evaluate measures of staff time devoted to working on plan is still being developed. Assessment of human resources is not documented.
Leverage stakeholder input and incorporate lessons learned by evaluating past performance.	<ul style="list-style-type: none"> Documentation is incomplete on how stakeholder input has been used. Evaluation of past performance did not document lessons learned on selection methods.
Monitor progress by collecting data to determine effectiveness in achieving the stated goals.	<ul style="list-style-type: none"> Monitoring plans focus on individual projects but not across selection methods overall. Data collection did not include data necessary to assess effectiveness of selection methods.
Analyze and mitigate risks by evaluating, prioritizing, and documenting risks as well as options for mitigating risks.	<ul style="list-style-type: none"> Plans for analyzing and mitigating the documented risks are not yet implemented.

Source: GAO analysis of IRS information. | GAO-17-324

View [GAO-17-324](#). For more information, contact James R. McTigue Jr. at (202) 512-9110 or mctiguej@gao.gov.

Contents

Letter		1
	Background	5
	LB&I Documentation on Audit Selection Methods We Reviewed Generally Reflected Some, but Not All, Internal Control Principles	10
	LB&I Does Not Have a Standard Process for Monitoring Audit Selection Decisions	14
	Audit Starts and Closures Declined Overall from Fiscal Years 2011 through 2015, but Data on Audit Results in Terms of Dollars Cannot Be Clearly Aligned with All Selection Methods	17
	LB&I Efforts to Plan and Implement New Compliance Approach to Audits Remain Incomplete	24
	Conclusions	32
	Recommendations for Executive Action	32
	Agency Comments and Our Evaluation	34
Appendix I	Objectives Scope and Methodology	36
Appendix II	Description of Large Business and International (LB&I) Selection Methods and Other Methods	42
	Selection Methods	42
	Other Methods	44
Appendix III	Statistical Summary of Large Business and International (LB&I) Audit Selection Method Performance Indicators	45
Appendix IV	List of Announced Campaign Compliance Projects	46
Appendix V	Comments from the Internal Revenue Service	49
Appendix VI	GAO Contact and Staff Acknowledgments	51

Tables

Table 1: Internal Control Principles for Audit Selection Methods Reviewed That LB&I Documentation Did Not Generally Reflect as of November 2016	13
Table 2: Number of Large Business and International (LB&I) Audit Starts and Closures Resulting from Referrals, Fiscal Years 2011 through 2015	21
Table 3: Project Planning Principles for Evaluating Program Start Ups	40
Table 4: Overall Audit Starts and Closures for Internal Revenue Service (IRS) Large Business and International Division (LB&I) by Selection Methods, Fiscal Years 2011 through 2015	45

Figures

Figure 1: Organization Chart of Large Business and International Division Audit Offices and Internal Revenue Service Executive Management	6
Figure 2: Conceptual Overview of How the Large Business and International (LB&I) Division Selects Tax Returns for Audit	8
Figure 3: Overall Number of Internal Revenue Service (IRS) Large Business and International Division Audit Starts and Closures, Fiscal Years 2011 through 2015	18
Figure 4: Percentage of Large Business and International (LB&I) Audit Starts and Closures by Selection Methods GAO Analyzed, Fiscal Years 2011 through 2015	20
Figure 5: Large Business and International (LB&I) Division's Plans for New Compliance Approach Assessed against Project Planning Principles as of December 2016	26
Figure 6: Large Business and International (LB&I) Division's Conceptual Plan for Choosing and Evaluating New Selection Methods	29

List of Abbreviations

BPR	Business Performance Review
CCM	Completed Contract Method
CIC	Coordinated Industry Case
CIP	Compliance Initiative Projects
the Council	Compliance Integration Council
CWD	Compliance and Workload Delivery
DOE	Department of Energy
DAS	Discriminant Analysis System
FPP	Foreign Payment Practice
GHW	Global High Wealth
IBMIS	Issue Based Management Information System
IC	Industry Case
IIC	Offshore International Individual compliance
IMS	Issue Management System
IRAP	International Risk Assessment Program
IRM	Internal Revenue Manual
IRC	Internal Revenue Code
IRS	Internal Revenue Service
LB&I	Large Business and International Division
LQMS	LB&I Quality Measurement System
LUQ	Large, Unusual or Questionable
MVPD	Multi-Channel Video Program Distributors
NRP	National Research Program
NOL	Net operating losses
OTSA	Office of Tax Shelter Analysis
OVDP	Offshore Voluntary Disclosure Program
PSP	Planning and Special Programs
SB/SE	Small Business/Self-Employed Division
TEFRA	Tax Equity and Fiscal Responsibility Act of 1982
TIGTA	Treasury Inspector General for Tax Administration
UTP	Uncertain Tax Position

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March 28, 2017

The Honorable Kevin Brady
Chairman
Committee on Ways and Means
House of Representatives

The Honorable Vern Buchanan
Chairman
Subcommittee on Oversight
Committee on Ways and Means
House of Representatives

The Honorable Peter Roskam
Chairman
Subcommittee on Tax Policy
Committee on Ways and Means
House of Representatives

The Internal Revenue Service’s (IRS) Large Business and International Division (LB&I) serves large partnerships and large corporations with \$10 million or more in assets, which filed about 353,000 tax returns in fiscal year 2015. As we previously have reported, large corporations and large partnerships may pose significant compliance challenges.¹ For example, underreported taxable income from large corporations alone accounted for \$28 billion of the \$458 billion estimated average annual gross tax gap—the difference between taxes owed and those paid voluntarily and on time—for tax years 2008 to 2010, the most recent years that IRS has measured. The \$28 billion represented 6 percent of the overall gross tax gap. LB&I also serves individuals with high wealth and international interests, both of which IRS considers to be high risk.

LB&I’s enforcement responsibilities include auditing tax returns to detect when taxpayers misreport tax obligations.² Audits can help reduce the tax

¹GAO, *Corporate Tax Compliance: IRS Should Determine Whether Its Streamlined Corporate Audit Process Is Meeting Its Goals*, [GAO-13-662](#) (Washington, D.C.: Aug. 22, 2013).

²An IRS audit (also called “examination”) is a review of a taxpayer’s books and records to determine whether information such as income, expenses, and credits are being reported accurately. The Internal Revenue Code gives the Secretary of the Department of the Treasury, IRS’s parent agency, the authority to conduct audits. 26 U.S.C. 7602.

gap by identifying noncompliance in reporting and by enhancing voluntary compliance. If taxpayers perceive that IRS unfairly selects returns for audit, their confidence in IRS could be undermined and voluntary compliance could be undercut. The mission of IRS, as well as LB&I, calls for ensuring compliance and fairly applying the tax law when selecting which tax returns merit an audit.³ LB&I is in the process of changing the way it addresses compliance including how it identifies tax returns for audit and is moving toward implementing issue-based projects it calls campaigns.⁴

Noncompliance associated with large partnerships and corporations as well as the sheer volume of tax revenue at stake speak to the importance of IRS maintaining appropriate internal controls over its audit selection methods. An effective internal control system can help federal agencies achieve their missions and objectives and improve accountability. As set forth in *Standards for Internal Control in the Federal Government*, also known as the Green Book, internal controls comprise the plans, methods, and procedures used to meet an entity's mission, goals, and objectives, which support performance-based management.⁵ The Green Book lists 17 internal control principles to help agency program managers achieve desired results. The principles also provide reasonable assurance that program objectives are being achieved through, among other things, effective and efficient use of resources. Internal control is not one event, but rather a series of actions and activities that occur throughout an entity's operations and on an ongoing basis. Two examples of internal control standards are establishing clearly defined objectives and a commitment to documenting significant events.

³Internal Revenue Manual (IRM) Part 1, Chapter 1, Sec. 1.1.24.1 (<http://www.irs.gov/irm/>) states LB&I's mission.

⁴A "campaign" is IRS's term for a compliance project focused on a specific compliance issue, such as partnerships underreporting income, rather than using characteristics of the whole tax return for audit consideration.

⁵GAO, *Standards for Internal Control in the Federal Government*, [GAO-14-704G](#) (Washington, D.C.: September 2014). These controls were applicable starting in fiscal year 2016.

To better understand how LB&I selects tax returns for audit, you asked us to review LB&I audit selection standards and internal controls.⁶ This report (1) assesses the extent to which LB&I's documented procedures and policies on audit selection methods generally reflect relevant internal control principles; (2) assesses the extent to which LB&I has a standard process to monitor audit selection decisions; (3) describes statistical information on audit starts and closures for LB&I's selection methods, including LB&I's use of audit referrals, and assesses how IRS evaluates its audit results from its selection methods; and (4) assesses to what extent LB&I has planned and implemented its new approach to address compliance.

To assess the extent to which LB&I documented procedures and policies generally reflect relevant internal control principles, we reviewed LB&I documentation and interviewed relevant officials to understand the processes and procedures that LB&I uses to determine which tax returns to audit. Based on LB&I officials' input and our review of relevant documentation, we narrowed our review to a subset of eight of LB&I's selection methods that required its staff to use discretion in selecting tax returns to audit and that continued to operate at the conclusion of our work.⁷ We assessed whether these processes and procedures generally

⁶This report is part of a larger body of our work on audit and collection case selection across IRS. See GAO, *Tax Debt Collection: IRS Needs to Define Field Program Objectives and Assess Risks in Case Selection*, [GAO-16-787](#) (Washington, D.C.: Sept. 13, 2016); *IRS Return Selection: Wage and Investment Division Should Define Audit Objectives and Refine Other Internal Controls*, [GAO-16-102](#) (Washington, D.C.: Dec. 17, 2015); *IRS Return Selection: Certain Internal Controls for Audits in the Small Business and Self-Employed Division Should Be Strengthened*, [GAO-16-103](#) (Washington, D.C.: Dec. 16, 2015); *IRS Case Selection: Automated Collection System Lacks Key Internal Controls Needed to Ensure the Program Fulfills Its Mission*, [GAO-15-744](#) (Washington, D.C.: Sept. 10, 2015); *IRS Case Selection: Collection Process Is Largely Automated, but Lacks Adequate Internal Controls*, [GAO-15-647](#) (Washington, D.C.: July 29, 2015); and *IRS Examination Selection: Internal Controls for Exempt Organization Selection Should Be Strengthened*, [GAO-15-514](#) (Washington, D.C.: July 13, 2015).

⁷As discussed later, selection methods we reviewed include the following 8 methods: the Discriminant Analysis System (DAS), a computerized scoring system; tax shelter analysis (reviews of Form 8886 *Reportable Transaction Disclosure Statement* and Form 8918 *Material Advisor Disclosure Statement*); computerized issue filtering; coordinated issue cases (CIC) selection; global high wealth (GHW), which reviews taxpayers within a certain threshold of asset wealth; offshore international individual compliance (IIC), which reviews individuals with certain international tax issues; miscellaneous returns, another international tax issue program; and compliance initiative projects (CIP), which are directed at specific tax issues or types of taxpayers. We relied on documentation provided by LB&I to check whether the internal control principles for the selection methods reviewed were met; we did not test whether the standards were systemically applied.

reflected 10 internal control principles, such as defining objectives to identify risk and define risk tolerances and demonstrating commitment to integrity and ethical values, which we determined were relevant to our review.

To assess the extent to which LB&I has a standard process to monitor its audit selection decisions, we reviewed IRS documentation on procedures that auditors and audit managers were to follow in selecting cases and assessed whether LB&I's quality assurance program addressed monitoring of selection decisions, using criteria from federal standards on internal controls on monitoring. We also conducted non-generalizable focus groups with randomly selected auditors and audit managers on audit selection issues.

To describe LB&I audit statistics as well as assess how IRS evaluates audit results by selection methods, we acquired a copy of LB&I's audit operations database, called A-CIS, and calculated statistics on audit starts and closures and use of referrals for fiscal years 2011 through 2015. To assess the reliability of the A-CIS data, we reviewed the data dictionary and related documentation, interviewed IRS officials knowledgeable about the data, and performed electronic tests. Based on these steps, we determined the data we generated on starts and closures were sufficiently reliable for the purposes of our reporting objective. For the assessment, we compared documentation on LB&I reports on selection method performance with federal internal control standards.

To assess LB&I's planning and implementation of its new approach for addressing compliance, we reviewed LB&I's plans for implementing this approach for selecting tax returns by issue and assessed those plans against five project planning principles we used in our prior work.⁸ Given the status of LB&I's plans for and implementation of its new approach, we did not assess LB&I's decision to create the approach.

We conducted this performance audit from January 2016 to March 2017 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that

⁸For more detail on the source of the project planning principles, other details about our scope and methodology—including information about how we choose the internal controls we used—and selection methods we reviewed, see appendix 1.

the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Background

LB&I is responsible for the tax compliance of partnerships and S and C corporations with assets of \$10 million or more, as well as individuals with high wealth or international tax implications.⁹ LB&I reports that its taxpayers typically employ large numbers of workers, deal with complicated issues involving tax law and accounting principles, and conduct their operations in an expanding global environment. According to IRS, these LB&I taxpayers filed 352,264 corporate and partnership tax returns in fiscal year 2015.

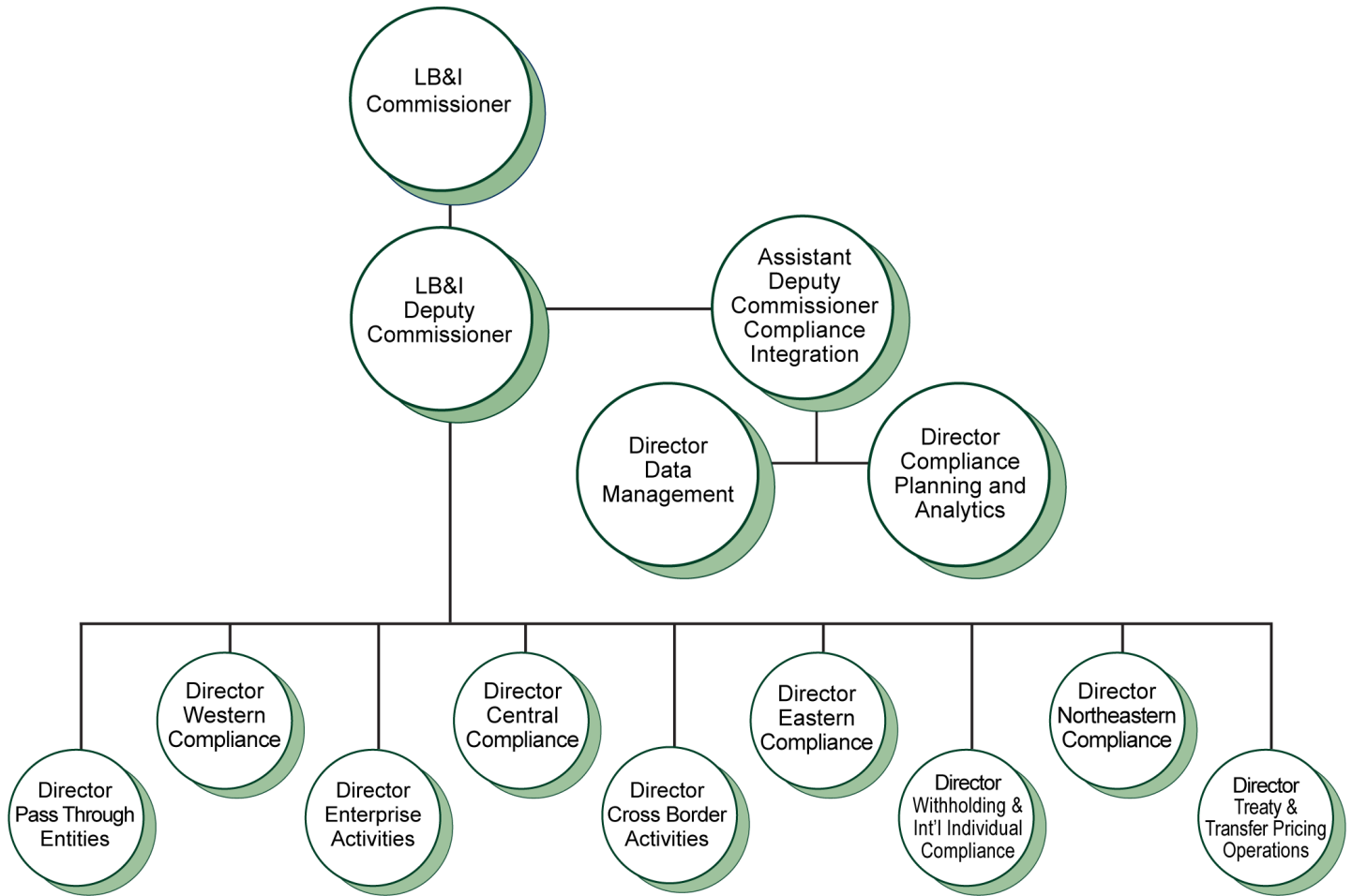
LB&I's stated mission is to provide taxpayers "quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all."¹⁰ In supporting that mission, LB&I audits tax returns to determine whether taxpayers correctly report information such as income, expenses, and credits. During an audit, LB&I staff review a taxpayer's books and records. The objective of audits, in turn, is to promote the highest degree of voluntary taxpayer compliance. In 2015, IRS reported that LB&I completed audits on more than 11 percent of large corporations—those with assets in excess of \$10 million. By comparison, the rate was 0.9 percent for all other corporations and 0.8 percent for individual returns.

LB&I has nine audit components focusing on five practice areas and four geographical areas. Figure 1 shows LB&I's organizational structure for audit activities. Each practice area has Planning and Special Programs (PSP) staff, who are responsible for controlling, monitoring, and assigning audit inventory to field groups.

⁹S Corporations are corporations that elect to pass corporate income, losses, deductions, and credits through to their shareholders for federal tax purposes. Shareholders of S corporations are to report the flow-through of income and losses on their personal tax returns and are to be assessed tax at their individual income tax rates. For federal income tax purposes, a C corporation is recognized as a separate taxpaying entity. A partnership is the relationship between two or more persons who join to carry on a trade or business and also are to pass through its taxable transactions to its partners. Because they do not pay taxes directly, S Corporations and partnerships are referred to as pass-through entities.

¹⁰Internal Revenue Manual, Sec. 1.1.24.1.

Figure 1: Organization Chart of Large Business and International Division Audit Offices and Internal Revenue Service Executive Management



Source: GAO analysis of IRS information. | GAO-17-324

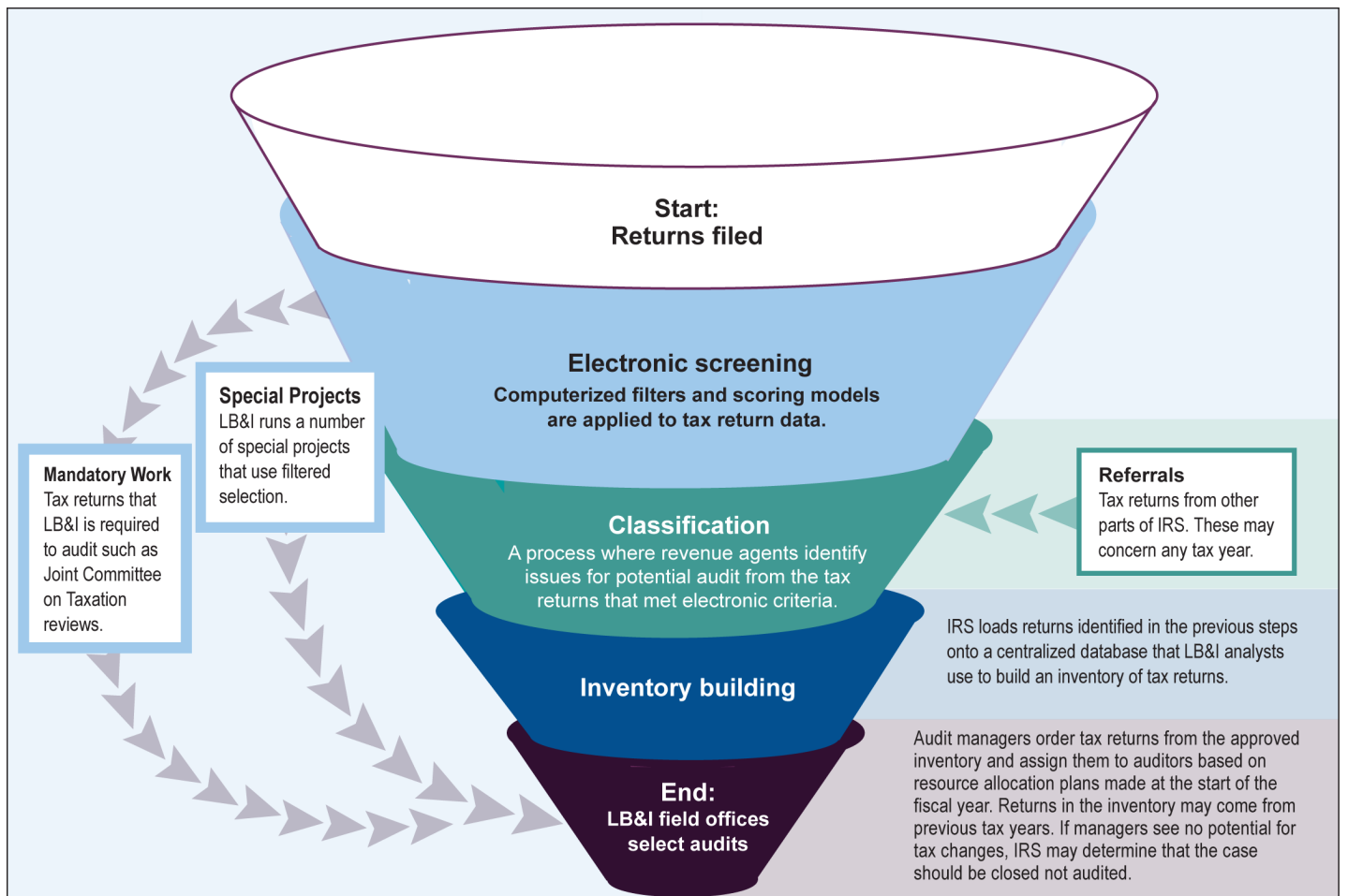
The term “selection methods” refers to all of the programs that LB&I uses to identify and review tax returns to include in the pool of possible audits, as well as the decisions made to audit tax returns by auditors and audit managers in LB&I field offices. LB&I uses a variety of methods to select returns for audit. Appendix 2 contains more detail on the selection methods that LB&I officials provided to us, including the methods that we focus on in this report.

Figure 2 provides a conceptual overview, based on our analysis of LB&I documentation and interviews with relevant officials, of how LB&I narrows

the pool of tax returns for audit consideration, including how LB&I uses its audit selection methods. After a tax return is filed with IRS, selection methods that involve computerized scoring models and filters identify tax returns that are likely to have compliance issues. According to LB&I officials, the higher the score, the greater the likelihood that a tax change will result from an audit. Computerized selection methods also may identify tax returns with specific compliance concerns, such as a particular value or combination of values reported on certain tax return lines. According to IRS documentation, LB&I picks returns with specific issues for compliance initiative projects (CIP) or returns that are mandated for audit, such as refund returns that are subject to Joint Committee on Taxation review.¹¹ IRS also has a program, in which LB&I participates, to identify tax returns with known abusive tax schemes. LB&I officials said that they give additional scrutiny to individual tax returns with certain international tax issues. After returns are scored by computers or pulled for special projects and mandatory work, LB&I conducts another review called classification, in which LB&I staff identify whether the return merits an audit as well as specific issues for audit consideration. This portion of the process is focused on identifying potential audit issues on returns that are already considered at risk for noncompliance.

¹¹The Joint Committee on Taxation, a congressional committee, is required to review any proposed refund or credit of income or estate and gift taxes or certain other taxes in excess of \$2 million (\$5 million in the case of a C corporation). 26 U.S.C. § 6405.

Figure 2: Conceptual Overview of How the Large Business and International (LB&I) Division Selects Tax Returns for Audit



Source: GAO analysis of IRS information. | GAO-17-324

After the identified returns have been classified or otherwise reviewed for specific tax issues, they are listed in a queue for audit managers to assign to auditors, as shown in the bottom of the funnel in figure 2. Auditors in the field assess whether the queued returns have large, unusual or questionable (LUQ) features. According to LB&I officials, other factors that guide which returns from the queue are selected include targets set in LB&I’s annual audit plan, which prioritizes tax return types and tax issues as well as resources and auditor’s skills and experience. Even if a return is ultimately selected for audit, auditors or their managers may decide upon closer examination not to proceed with the audit, a process called surveying. In addition to the process shown in figure 2, LB&I may

initiate an audit based on taxpayers' requests to amend their own returns, a special type of audit LB&I calls a claim. LB&I also may begin an audit based on facts from an ongoing audit, called a related pick up.

Once selected, LB&I audits fall into two categories, Coordinated Industry Cases (CIC) or Industry Cases (IC). According to LB&I officials, the CIC program puts large enterprises under continual audits. LB&I categorizes tax returns as CIC based on factors that include assets, gross receipts, and operating entities. CIC taxpayers are audited by a team of LB&I staff while IC returns usually are audited by a single auditor. Generally, LB&I officials said they use their most experienced and highest graded auditors to review the tax return of LB&I taxpayers to address issues that are often complex, involving multiple years and potentially ambiguous laws, regulations, or related guidance in determining the correct tax treatment. Auditors may be assisted by specialists to help review technical issues, such as transactions that are international in scope and raise valuation issues.

LB&I is in the process of changing the way it addresses compliance including how it identifies tax returns for audit and is moving toward implementing issue-based projects it calls "campaigns." According to LB&I, a campaign is a compliance project focused on a specific compliance issue, such as partnerships underreporting income, rather than on using characteristics of the whole tax return for audit consideration. According to LB&I officials, campaigns could consist of an audit, or a less burdensome treatment, such as letters asking taxpayers to consider changing how they report the issue or additional guidance to help taxpayers accurately report the issue on their returns. LB&I first released its plan for adopting campaigns in late 2014 and announced the initial 13 issues for campaigns in January 2017.¹² According to its plan, LB&I developed the campaign approach because of an increasingly difficult tax environment in which its budget and resources are shrinking and tax laws are growing more complex.

While LB&I implements campaigns, officials said the existing selection methods it uses will continue to operate until LB&I decides whether to replace them. LB&I officials also said that existing selection methods may be repurposed to operate within campaigns, as well. For example, they said that a computer filtering effort previously conducted as a standalone

¹²For a list of announced campaigns, see appendix IV.

project could be used to identify tax returns for audit under a specific campaign. LB&I officials said they have no set date for terminating the selection methods and starting the campaign process because developing the campaign process is iterative.

LB&I Documentation on Audit Selection Methods We Reviewed Generally Reflected Some, but Not All, Internal Control Principles

In reviewing LB&I's methods for identifying and selecting tax returns for audit, we determined that LB&I's related documentation generally reflected 4 of the 10 internal control principles we reviewed but was incomplete for the remaining 6 principles.¹³ Without complete documentation, LB&I lacks reasonable assurance that selection methods are being implemented as designed and therefore whether its return selection processes and procedures are supporting its objectives.

Documentation Generally Reflected Internal Control Principles on Ethics, Organizational Structure, Commitment to Competence, and Implementation of Control Activities for Selection Methods Reviewed

¹³Appendix II describes the selection methods we reviewed in greater detail. We relied on documentation provided by LB&I to make this determination; we did not test whether the standards were systemically applied.

Internal Control Principles that LB&I Documentation Generally Reflected in Audit Selection Methods Reviewed

- Principle 1: Demonstrate commitment to integrity and ethical values
- Principle 3: Establish structure, assign responsibility, and delegate authority to achieve objectives
- Principle 4: Demonstrate commitment to competence through recruiting, development, and retention
- Principle 12: Implement control activities through policies and reviews

Source: GAO analysis of [GAO-14-704G](#) | GAO-17-324.

LB&I has documented a commitment to promoting ethical behavior among staff, which provides some high-level assurance that the way it selects returns for audit may contribute to its strategic goal of treating taxpayers with integrity and fairness. For example, classifiers who identify whether a tax return should be considered for audit and which items on the return merit audit attention are prohibited from auditing those returns and from assigning them to specific auditors. Also, IRS's ethics training and an annual certification of that training help to assure that IRS staff members are aware of the need to act ethically and impartially. All LB&I staff were certified as successfully completing the training in 2015, the latest available data.

In addition, LB&I provided documentation to indicate that all of the selection methods we reviewed have a defined structure, and designated persons have the necessary responsibility and delegated authority to do their jobs in meeting the selection objectives. The documentation for all of the reviewed selection methods showed which LB&I staff members have been assigned responsibility for selecting returns for audit and have been delegated authority by management to oversee the process, including identifying and reviewing the potential returns and then selecting returns for audit. For example, once the Global High Wealth (GHW) unit identifies an individual taxpayer for possible audit, the related returns, such as partnership and S corporation returns, are linked together, and a classifier is responsible for assessing the compliance risk on the return. A manager is tasked with overseeing this work before it is sent to the field for audit.

LB&I documented its commitment to competence for staff members involved with audit selection. Congress enacted and the President signed a statute in 2004 that gives federal agencies additional flexibility to help recruit new staff and retain employees with needed skills by providing

enhanced recruitment and retention bonus authority.¹⁴ With many LB&I employees close to retirement age or considering moving on and hiring limited by budget constraints, LB&I officials said these provisions provide them with additional tools to help meet its human capital needs and assure the necessary skills are retained by its selection workforce.

In terms of training, LB&I's procedures and manuals generally documented its training to help assure the competence of staff involved in audit selection. IRS has courses to teach key staff about needed basic skills. For example, revenue agents—among the highest graded IRS auditors—are taught to look for returns with LUQ items that may merit an audit. In addition, the documentation showed training to instruct these auditors and other staff about specific knowledge to consider when reviewing returns for potential audit.

Finally, LB&I generally has documented the goals of and responsibilities related to the selection methods we reviewed to assure that the objectives and related risks are addressed. The documentation across the selection methods generally identified who is responsible for reviewing procedures to assure that the goals of the selection method are met.¹⁵ For example, the filtering selection method has detailed documentation describing the use of filters to identify the returns with the highest compliance risk, and the role of managers in reviewing the returns that have been selected.

LB&I Documentation for Selected Methods We Reviewed Did Not Generally Reflect Six Other Internal Control Principles We Reviewed

Table 1 shows gaps in the documentation related to 6 of the internal control principles for all of the audit selection methods we reviewed. For all six principles we reviewed, the documentation showed some support for adherence for most of the selection methods.

¹⁴Federal Workforce Flexibility Act of 2004, Pub. L. No. 108-411, 118 Stat. 2305 (Oct. 30, 2004).

¹⁵Although LB&I provided evidence for goals and responsibilities for the selection methods, it did not fully document the specific responsibilities for reviewing selected returns under the whistleblower program for the miscellaneous selection method. However, LB&I officials said that whistleblower cases make up a tiny portion of LB&I's audit workload, which our data analysis confirmed.

Table 1: Internal Control Principles for Audit Selection Methods Reviewed That LB&I Documentation Did Not Generally Reflect as of November 2016

Internal Control Principle	Gaps in the Documentation Related to the Internal Control Principles for Reviewed Selection Methods
Principle 6: Define Objectives to Identify Risk and Define Risk Tolerances	Documentation did not clearly state the specific objectives for reviewing returns for audit consideration or the risk tolerances to be considered for audit selection across the selection methods. For example, LB&I has not provided evidence that it tracks the outcome of returns selected and sets risk tolerances in the miscellaneous method to assure that the selection method is working given the risks identified. This is important because written objectives and clear risk tolerances articulate desired outcomes and clarify the boundaries for addressing risks, which would help reduce any appearance of subjectivity as well as help make decisions on which returns have the highest compliance risk.
Principle 7: Identify, Analyze, and Respond to Risks to Achieving the Objectives	Documentation did not clearly state how LB&I would respond to changing circumstances that could affect its ability to select returns with the highest compliance risks. For example, documentation for the coordinated issue selection method did not demonstrate that steps were taken to minimize selection risk in light of changing circumstances. Without a clearly stated process to regularly review changes that affect risks, LB&I may have difficulty adjusting its selection practices and procedures to help ensure it is fulfilling its responsibility to apply the tax law with integrity and fairness to all.
Principle 10: Design Control Activities to Achieve Objectives and Respond to Risks	Documentation did not clearly state how LB&I determines if the selection method is working in responding to risks. For example, no evidence was provided that the results from auditing returns selected due to offshore issues are monitored or that the results are provided to management to assure that the selection method is working given the related risks. This is important to determine if selection practices address compliance risk and apply the tax law with integrity and fairness.
Principle 13: Use Quality Information to Achieve Objectives	Documentation did not demonstrate that management regularly receives reports developed from relevant, reliable, and timely information about whether a selection method was working well. For example, no documentation was provided to show that quality data were being used to assure that the offshore selection method is achieving key objectives and addressing risks. Obtaining relevant data from reliable sources in a timely manner is important if LB&I is to be positioned to make the best choices in achieving its audit selection objectives.
Principle 14: Communicate Internally the Necessary Quality Information about the Objectives	Documentation did not clearly show that management receives quality information about selection process deficiencies through internal communication channels. For example, LB&I has not documented that the Discriminant Analysis System (DAS) selection method has internal communication channels to report any problems that were identified. This is important because effectively communicating information about problems with the audit selection processes can better enable management to make adjustments to achieve the selection objectives and address potential risks.
Principle 17: Reporting and Evaluating Internal Control Issues and Remediating Related Deficiencies	Documentation did not clearly show that LB&I management promptly evaluated any identified deficiencies and took appropriate corrective action. For example, documentation on the tax shelter selection method provided evidence that in team meetings officials discussed identified problems but not that LB&I took corrective actions on the problems identified. We found similar shortcomings with the Compliance Initiative Project, Global High Wealth, and international methods. Without a clear control for evaluating and implementing corrective actions, LB&I lacks assurance that problems will be corrected.

Source: GAO analysis of IRS information | GAO-17-324.

In summary, LB&I provided documentation showing that the reviewed selection methods generally reflected the six specified internal control principles to some extent. The evidence provided, however, did not completely document adherence to all parts of each principle. The gaps in documentation on these six principles leave LB&I vulnerable to inconsistently selecting tax returns for audit, or the perception of it. Throughout our work, LB&I officials sought clarification on what kind of documentation would generally reflect the internal controls principles and acknowledged that they would look to add additional documentation. Without complete documentation, LB&I cannot be assured that its existing audit selection methods are being used consistently.

LB&I Does Not Have a Standard Process for Monitoring Audit Selection Decisions

LB&I does not have a process to monitor the final decisions about which tax returns will be audited. In general, field managers and their auditors make the ultimate audit selection decisions about the tax returns, which generally have been reviewed by other IRS staff for audit consideration.¹⁶ Although our discussions with LB&I staff indicated that some of these audit selection decisions may be reviewed at the discretion of the managers, LB&I's procedures do not document a systematic, standard process to regularly monitor field audit decisions. In addition, LB&I does not have standardized criteria to explain the reasons for selecting a return for audit, which would be necessary to regularly monitor audit selection decisions.¹⁷

Lacking a standard monitoring process for audit selection decisions is not consistent with internal control standards for monitoring. Under internal control principle 16, management should establish and operate activities to monitor the internal control system and evaluate the results. Such

¹⁶After ordering tax returns from inventory, a field manager can decide whether to (1) assign a return to an auditor, (2) not audit a return (i.e., "survey") before assigning it or after assignment based on the auditor's input, or (3) retain the return in unassigned inventory. Managers may also decide to audit related returns based on an ongoing audit. Our focus groups with audit managers noted that they make decisions on returns to select for audit after those returns have been identified and reviewed by computer programs and other staff as being potentially noncompliant, except for certain returns such as those that are mandatory audits or that are audited because the taxpayer initiated a claim (e.g., refund claims on filed tax returns).

¹⁷Beyond the documentation that IRS auditors use to explain why a return was surveyed after being slated for audit, audit managers and auditors in our focus group said that they may generate memos or emails to explain their decisions but that those documents are entered into each case file for an audit rather than in a central system that allows regular and consistent monitoring to occur.

monitoring may be built into the operations and activities and done continually which could assist LB&I respond to change and help ensure that the controls align with changing objectives, laws, and risks. It assesses the quality of performance and points to corrective actions necessary to achieve the objectives.¹⁸

LB&I uses an audit monitoring system, but its review procedures and steps do not cover audit selection decisions. The LB&I Quality Measurement System (LQMS) is used to routinely monitor the examinations and adherence to technical audit standards. LB&I reviewers analyze a sample of tax returns that were audited and rate the quality of those audits. The technical standards include actions taken after a return has been assigned to an auditor, including planning the audit steps, implementing those steps to collect evidence, and developing audit findings. However, these monitoring activities and standards do not assess the quality of audit selection decisions or whether the decision processes have deficiencies that need to be addressed.¹⁹ According to officials responsible for the LQMS program, LB&I previously included a sample of surveyed returns in its annual review; however this was discontinued several years ago and officials could not recollect why this decision was made.

LQMS does not cover the selection decisions because the system was designed to measure the quality of the actual audit activities. The results of LQMS reviews are a part of the Balanced Measurement System, which measures customer satisfaction, employee engagement, and business results, including performance goals related to audits such as their quality.

LB&I also has reviews that cover field operations, but these reviews do not require monitoring audit selection decisions. For example, managers in each IRS territory are required to conduct one operational review each year of field audit managers to facilitate discussion and feedback on routine group operations. Each territory review is developed at the discretion of the manager and is non-standardized. One LB&I executive we interviewed indicated that when he did these territory reviews, he

¹⁸[GAO-14-704G](#).

¹⁹Effective October 1, 2015, LB&I updated its LQMS reviewer guidance by consolidating its four technical standard areas into three. However, LB&I officials said the update does not include evaluation of audit selection decisions.

sometimes asked about how selection decisions were made. However he acknowledged that he chose to ask those questions and that other territory managers may do their reviews differently. LB&I staff members also conduct Process and Issue Assessments that focus on providing management a better understanding of the processes and procedures being used and the issues being developed in audit, but these reviews do not cover audit selection decisions.

During our focus groups, we discussed who reviews and approves the audit selection decisions as well as gives feedback on the quality of the decisions. A number of managers in our focus groups concurred that, they have the authority to make most final selection decisions.²⁰ Our focus groups with auditors did not indicate that auditors regularly receive feedback on their recommendations to managers on selecting or surveying specific tax returns, although auditors who participated in the groups commented that they sometimes received such feedback.

By not monitoring the processes used in the field offices to select specific tax returns for audit, LB&I management risks relying on processes that may lead to inconsistent selection decisions. The lack of routine monitoring of selection decisions also can hinder LB&I management from identifying deficiencies in these processes and evaluating them for remediation. Furthermore, there is a risk that selection decisions may be perceived as not supporting the mission to apply the tax law with integrity and fairness to all taxpayers.

²⁰A number of audit managers in our focus groups agreed that they did not have a standardized way to analyze returns in making the selection decision. They generally said that they review each return for LUQ items as well as use their judgement based on their experience.

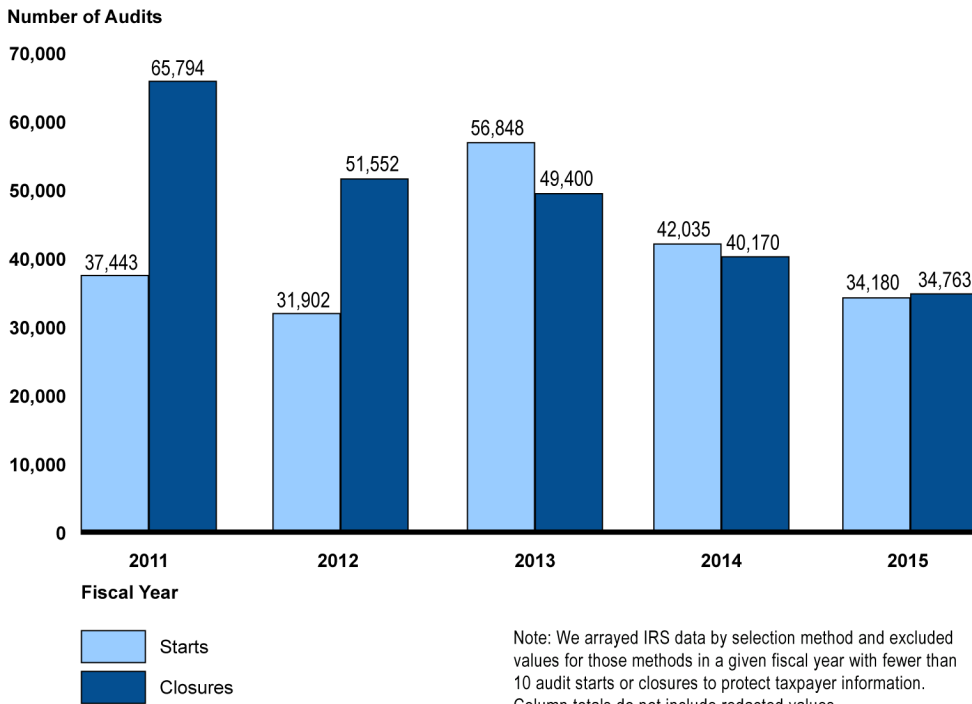
Audit Starts and Closures Declined Overall from Fiscal Years 2011 through 2015, but Data on Audit Results in Terms of Dollars Cannot Be Clearly Aligned with All Selection Methods

Audit Starts and Closures Declined Overall and Referrals Accounted for Small Portion of Starts and Closures

Based on our analysis of IRS data, LB&I audit starts and closures across all selection methods generally declined between fiscal years 2011 and 2015, from 37,443 audit starts in 2011 to 34,180 in 2015 and 65,794 closures in 2011 to 34,763 in 2015 (see figure 3). IRS officials told us that reductions in staffing over the 5-year period contributed to the overall downward trend in starts and closures. Despite the overall downward trend, audit starts increased between fiscal years 2012 and 2013. IRS officials explained that the increase in audit starts in fiscal year 2013 was caused by an influx of returns in the 2011 and 2012 offshore voluntary disclosure programs.²¹

²¹IRS's offshore voluntary disclosure programs offered incentives for taxpayers to voluntarily disclose their offshore accounts and pay delinquent taxes, interest, and penalties. Since 2003, IRS has carried out four programs, including the 2011 initiative and the 2012 program, which remains open. We previously reported on the 2009 offshore program in GAO, *Offshore Tax Evasion: IRS Has Collected Billions of Dollars, but May be Missing Continued Evasion*, [GAO-13-318](#) (Washington, D.C.: Mar. 27, 2013).

Figure 3: Overall Number of Internal Revenue Service (IRS) Large Business and International Division Audit Starts and Closures, Fiscal Years 2011 through 2015



Source: GAO analysis of IRS data. | GAO-17-324

As previously discussed, LB&I uses various selection methods to identify returns for audit. Figure 4 shows that the 7 methods on which our analysis focused accounted for more than half of all LB&I audit starts and closures between fiscal years 2011 and 2015 while the remaining audit starts and closures come from many other selection methods.²² Compared to the seven methods, these other methods do not require the same level of professional judgment by LB&I staff when selecting returns

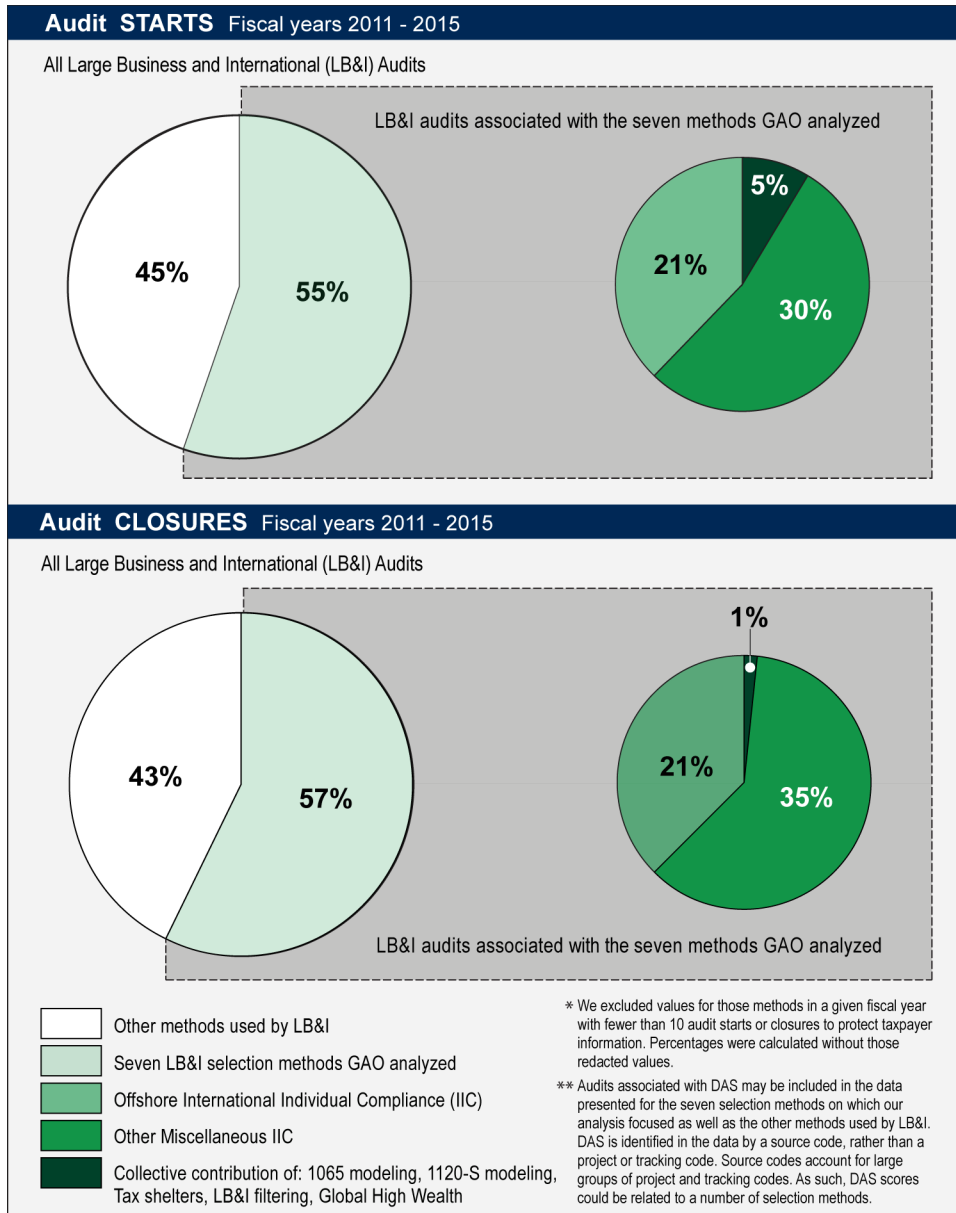
²²Due to limitations with LB&I's data, we are not able to directly compare DAS, which IRS officials told us is the main selection method for corporate tax returns, to other selection methods. The database identifies DAS by a selection source code, not a project or tracking code. A variety of selection methods could be associated with audits with DAS scores as the source code. Because we are not able to separate them out, DAS related returns may be included in the data for the seven selection methods we analyzed as well as the other methods. We discuss this and further limitations with IRS' data later in this section.

for audit.²³ For example, the audits can arise from taxpayer claims (such as when a taxpayer requests to be audited for a refund); mandatory work (such as audits to be reviewed by the Joint Committee on Taxation); or related pick-ups (when an auditor begins auditing another tax return based on what is observed in a different audit). Specifically, two selection methods in our analysis collectively accounted for the bulk of LB&I starts and closures. The Other Miscellaneous International Individual Compliance (IIC) method accounted for 30 percent of audit starts and 35 percent of audit closures, while the Offshore IIC method accounted for 21 percent of starts and of closures.²⁴ The remaining 5 selection methods in our analysis together accounted for only about 1 percent of closures and 5 percent of audit starts. For a statistical summary of LB&I audit starts and closures by selection method, see appendix III.

²³The 7 selection methods on which our analysis focused include: 1065 Modeling, 1120-S Modeling, Tax Shelters, LB&I Filtering, GHW, Offshore Individual International Compliance (IIC), and Other Miscellaneous IIC. LB&I initially identified 14 selection methods that it used. Appendix II describes why our analysis focused on 7 methods and excluded DAS, international risk assessment program, compliance and workload delivery, foreign payment practice, CIC, and CIP methods. We also combined 2—8886 Disclosures and Form 8918 Material Advisor Disclosures—into a Tax Shelters category. Other Methods includes all other audits excluded from the seven methods we analyzed (for examples, also see app. II).

²⁴Although the percentages of audit starts and audit closures for both methods are approximately the same across the 5-year period, the annual number of starts and closures for each method tended to differ. In some years, audit starts may exceed closures while closures may exceed starts in other years due to audit work that extends beyond a given fiscal year. Appendix III shows these annual differences in starts and closures by method.

Figure 4: Percentage of Large Business and International (LB&I) Audit Starts and Closures by Selection Methods GAO Analyzed, Fiscal Years 2011 through 2015



Source: GAO analysis of IRS data. | GAO-17-324

As illustrated in table 2, the number of audit starts and closures associated with internal and external referrals generally increased over the 5-year period from fiscal year 2011 to 2015, but referrals accounted for a very small portion of LB&I's starts and closures overall.²⁵ For example, in fiscal year 2015, LB&I had just under 35,000 audit closures, of which 40 closures—or less than one percent of LB&I audit closures—resulted from referrals.

Table 2: Number of Large Business and International (LB&I) Audit Starts and Closures Resulting from Referrals, Fiscal Years 2011 through 2015^a

Fiscal Year	Starts				Closures			
	Internal referrals	External referrals	Total referrals	Percent of all starts	Internal Referrals	External referrals	Total Referrals	Percent of all closures
2011	11	20	31	0.08	*	15	15	0.02
2012	15	16	31	0.10	*	15	15	0.03
2013	21	21	42	0.07	*	*	*	*
2014	26	47	73	0.17	17	*	17	0.04
2015	14	43	57	0.17	14	26	40	0.12

Source: GAO analysis of IRS data. | GAO-17-324

Note: In LB&I data, internal referrals come from other operating divisions in IRS. External referrals come from the Department of Justice or state auditing agencies.

^aThe * denotes values that are redacted to protect taxpayer information. Table totals do not include these values.

²⁵In LB&I data, internal referrals come from other operating divisions in IRS. External referrals come from the Department of Justice or state auditing agencies.

LB&I Tracks Results for Some of Its Selection Methods but Does Not Clearly Identify All Audit Selection Methods and Align Selection Methods with Audit Results

Federal Internal Control Standards state that quality information is vital to achieving agency objectives. These standards further define quality information as being appropriate, current, complete, accurate, and accessible. Management should use quality information to make informed decisions and evaluate performance in achieving key objectives.²⁶

Unlike our analyses of the data on audit starts and closures, when we tried to analyze LB&I's audit results data by each selection method, we encountered difficulties that prevented us from easily analyzing the results. An initial difficulty was that LB&I's selection methods were not clearly defined or documented. LB&I officials originally identified 14 methods that they used to select returns for audit; however, we found a large portion of the division's full audit inventory could not be categorized within those 14 methods.

We worked closely with IRS data managers to identify the correct project and tracking codes and categorize the data by selection method; these steps enabled us to generate reliable data on audit starts and closures. However, other difficulties unrelated to our ability to sort the data by selection method prevented us from analyzing and comparing data on audit results, such as additional tax dollars recommended, for the selection methods. For example:

- LB&I does not have project or tracking codes for DAS. DAS can only be identified in the data by a source code, while the selection methods can only be identified with project and tracking codes, causing overlap between DAS and other selection methods in the data and prevent direct comparison between DAS and the other LB&I selection methods in terms of the related audit results.
- The data cannot link a selection method used for entities such as partnerships and S corporations that pass through their tax liabilities to their partners and shareholders. As such, analyzing the results of the selection method's effect on changes to tax liability cannot easily be done.
- The data do not account for net operating losses (NOL), which makes the results of the audit difficult to assess.

²⁶[GAO-14-704G](#).

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- Linkages between the cost of an audit—such as auditors’ compensation and contractor fees—and audit results were not readily available. This information would be needed to calculate cost-benefit information to compare selection methods.

LB&I does periodically track data on results for its selection methods, but we could not rely on that data to support our analysis. For example, LB&I produces a monthly report to track data and performance measures for 9 of the 14 selection methods it originally identified as using.²⁷ According to LB&I officials, this report is used to analyze the performance of certain selection methods against a baseline of audit results for Industry Case (IC) returns and determine whether a particular method is achieving its objectives. Examples of the measures that LB&I tracks in its monthly report include:²⁸

- number of audits closed;
- additional tax dollars recommended overall and per audit hour;
- agreed recommended dollars (dollar amounts in additional tax recommended that taxpayers agreed with);
- no-change rate (percentage of audits closed without changing the amount of taxes currently owed); and
- audit cycle time (the time that returns are under audit).

While an IRS official told us that the monthly report helps inform decisions on which selection methods to use, several limitations prevent it from being used to compare how LB&I’s selection methods perform. Such comparisons would help inform decisions on whether one method is achieving better audit results in terms of adjustments made and hours invested than another method, if given more resources. Such limitations with the report include:

²⁷The 5 selection methods excluded from the monthly report include: DAS, IRAP, CWD, Offshore IIC, and Other Miscellaneous IIC. Appendix II lists the methods LB&I originally identified. In addition to the 9 selection methods in the report, an LB&I official told us that the report also contains discontinued selection methods.

²⁸Our June 2014 report on correspondence audits noted that any one of these measures would not be sufficient to assess audit performance. For example, no measure is a complete indicator of compliance; nor do the measures track dollars actually collected from each audit as additional tax dollars recommended can be abated or otherwise overturned, or not collected at all. See GAO, *IRS Correspondence Audits: Better Management Could Improve Tax Compliance and Reduce Taxpayer Burden*, [GAO-14-479](#) (Washington, D.C.: June 5, 2014).

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- The data for certain selection methods are not mutually exclusive, meaning comparing methods could be made more complicated by duplication. For example, IRS officials told us that data in the report for the Form 1065 and 1120-S modeling programs overlap, as well as data on GHW selection results.
 - The report excludes key selection methods. Specifically, the two methods that account for the bulk of LB&I's audit work—Offshore IIC and Other Miscellaneous IIC—for fiscal years 2011 through 2015 are excluded. It also excluded the Compliance and Workload Delivery method, which was included in the initial list of methods that LB&I said it uses.
 - While LB&I staff review the report informally, it has no documented guidance or criteria for how to assess the performance of its workload selection methods in order to make decisions or take actions.
 - The audit results are not arrayed to easily review other potentially important considerations, such as ratios of direct revenue yield per dollar of cost across LB&I selection methods.

Without data that aligns the selection methods to the audit results, LB&I has less assurance that it is allocating its limited resources most effectively as it selects more returns to audit. LB&I officials acknowledged that being able to more easily identify selection methods within the audit inventory would enhance IRS' ability to assess audit results by selection method, an assessment that could be used to inform decision making, as discussed later in the report.

LB&I Efforts to Plan and Implement New Compliance Approach to Audits Remain Incomplete

LB&I plans to conduct issue-based projects it calls "campaigns" to address taxpayer compliance. Campaigns may involve audits of tax returns or other types of compliance efforts, such as taxpayer outreach or tax form changes. According to LB&I, ideas for campaigns come from staff members who submit proposals, a process which started during our work. As part of this submission, staff must identify campaign goals, metrics, training, and resource needs. A governing board called the Compliance Integration Council (the Council) is to decide which campaigns are initiated and monitor campaign results. If the campaign includes audits, LB&I may use the same or similar audit selection methods, as discussed previously in this report. The concept for campaigns was established in a plan released in 2014; however, as discussed below, LB&I has not fully implemented that plan as of March 2017 and had not started work on any of the 13 campaigns announced in January 2017.

Using our prior work, we identified 5 key principles for effectively planning new projects and initiatives like LB&I's new compliance approach involving campaigns, as shown in the first column of figure 5.²⁹ Although LB&I has made progress in meeting all 5 principles, Figure 5 shows which parts of each of the five principles that LB&I plans did not meet as of December 2016.

Generally, LB&I officials said that planning and implementing campaigns was an iterative process without a baseline for how long the process would take, and, consequently, they adapted as they worked toward fulfilling the five principles. However, by not fully meeting all of the principles, LB&I lacks reasonable assurance that its new compliance approach will succeed in accomplishing LB&I's overall audit objective of encouraging voluntary compliance and fair treatment of taxpayers.

²⁹We have applied these principles in other reviews about designing and implementing new projects—for example, GAO, *Large Partnerships: With Growing Number of Partnerships, IRS Needs to Improve Audit Efficiency*, [GAO-14-732](#) (Washington, D.C; Sept. 18, 2014). See appendix I for detail on our selection of these principles and for more detail on additional sources for the criteria.

Figure 5: Large Business and International (LB&I) Division’s Plans for New Compliance Approach Assessed against Project Planning Principles as of December 2016

Project Planning Principles	LB&I Actions not yet taken to address the principle
Develop project plan with measurable goals, schedules, and resources.	<ul style="list-style-type: none"> ▪ Did not document a clear timetable with deadlines for carrying out its plan on the new compliance approach. ▪ Has not established metrics for measuring progress toward overall goals of the new compliance approach.
Evaluate human resources by assessing how needed staff will be acquired and retained.	<ul style="list-style-type: none"> ▪ Did not initially evaluate human resource needs for implementing its new compliance approach, and lacks a documented plan for such an analysis moving forward.
Leverage stakeholder input and incorporate lessons learned by evaluating past performance.	<ul style="list-style-type: none"> ▪ Did not document how stakeholder input was used and lessons learned through evaluating past performance.
Monitor progress by collecting data to determine effectiveness in achieving the stated goals.	<ul style="list-style-type: none"> ▪ Monitoring plans focus on individual campaigns but not across the new compliance approach overall. ▪ Data are not sufficient to assess effectiveness of selection methods. ▪ Did not develop criteria to choose the most effective audit selection methods for campaigns.
Analyze and mitigate risks by evaluating, prioritizing, and documenting risks as well as options for mitigating risks.	<ul style="list-style-type: none"> ▪ Plans for analyzing and mitigating the documented risks lack a specific timetable and metrics.

Source: GAO analysis of IRS information. | GAO-17-324

LB&I Did Not Document a Clear Timetable with Deadlines for Carrying Out Its Plan or Establish Metrics for Measuring Progress toward Its Overall Goals

LB&I’s plan contains a conceptual roadmap for standing up the operation of its new compliance approach involving campaigns and includes elements such as compliance risk identification and resource allocation. An LB&I executive said that some of LB&I’s plans have been completed already, such as restructuring, implementing the campaign submission process, and revising audit position descriptions. As noted earlier, LB&I announced an initial list of 13 campaigns in January 2017, and LB&I officials said they will continue to consider new campaigns in the future.

The plan does not, however, contain specific dates for implementing the new compliance approach. The absence of specific dates is not consistent with the project planning principles that call for having a plan with a schedule. Elements of the plan that have no specific timetable include establishing criteria for choosing upcoming campaigns or eliminating existing selection methods that campaigns are meant to

replace. The plan also has no specific timetable for approving proposed campaigns. LB&I officials said this was because they are transitioning from the traditional selection methods to the campaign approach. The officials said implementing the new campaign approach is iterative in order to make adjustments as they gain experience with campaigns. In March 2017 LB&I officials said they were working on a timeline they believe will be consistent with the project planning principles. Without specific timetables however, LB&I is less assured that it will stay on track in executing its plan.

IRS officials told us that the overall goal for campaigns is preventing noncompliance. LB&I's guiding principles also specifically say that LB&I will maintain a flexible well-trained workforce, select better work, use an effective mix of compliance techniques (such as audits), and employ a robust feedback loop. However, LB&I's plan has not established metrics for measuring progress toward those overall goals, although individual campaign projects are to include measurable goals. Without metrics to track progress across campaigns, LB&I is limited in its ability to determine whether its new approach is meeting its stated goals.

LB&I Did Not Initially Evaluate Human Resource Needs for Implementing Its New Compliance Approach, and Lacks a Documented Plan for Such Analysis Moving Forward

LB&I's plan discusses the need to assess human resources in three ways: skill assessment (ensuring that staff have the proper skills); workforce visibility (ensuring that management understands staff capability and capacity), and issue finalization (the process of deciding which issues will be audited by staff). For example, the plan is intended to "provide a comprehensive, real-time understanding of workforce capability and capacity."

However, inconsistent with the planning principles, LB&I officials did not evaluate human resource needs to implement the campaign approach overall in its plan, in part because LB&I did not have the ability to measure the resource investment. Based on our discussion with LB&I officials on ways to track resource investments, LB&I approved in January 2017 repurposing an old database code to allow them to analyze staff time charged to preparing campaigns. According to LB&I officials, the data was not available as of March 2017 but they said they plan to use the data to conduct return on investment analysis, though no plan is documented. Developing and documenting a plan for analyzing how staff time is being used on campaign activities can better position LB&I to determine how it is using resources as it implements its new approach to compliance.

LB&I Did Not Document How Stakeholder Input Was Used or the Lessons Learned through Evaluating Past Performance

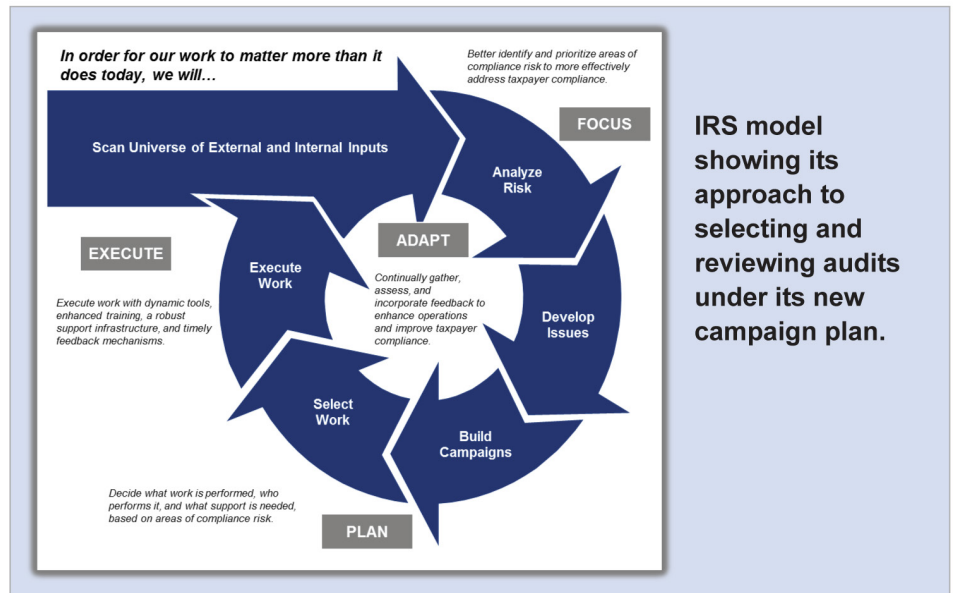
LB&I's plan cites a variety of IRS stakeholders involved in developing the campaign process, consistent with planning principles. For example, stakeholders included two commissioners, directors from the field, the General Counsel's office, and IRS's finance and technology offices, as well as executives for topical areas, such as the financial services industry, natural resources construction, and GHW. LB&I officials also said that these discussions covered past audit performance based on the available data that LB&I had been generating, including Business Performance Reviews (BPR), which list results by several measures for the division overall, and monthly reports that compare certain selection method results with results from audits selected primarily through DAS.

However, LB&I officials said the discussions with stakeholders to formulate the campaign approach were not meant to be formal, and the stakeholder input and any lessons learned from evaluating past performance were not specifically documented, as called for in internal control standards. Without the documentation of those discussions and evaluations, LB&I cannot demonstrate that it has leveraged lessons learned and contributions made by stakeholders and those evaluations for future reference.

LB&I Plans to Monitor Individual Campaign Performance but Its Plan Does Not Cover Monitoring Across Campaigns or Identify Criteria for Choosing Selection Methods for Particular Projects

According to its plans, LB&I intends to monitor how individual campaigns progress. If implemented, these division-level monitoring efforts would help align campaigns with LB&I audit goals. In particular, LB&I plans to make evaluating issue selection part of its performance feedback loop to refine key models and decision points to improve issue selection, as shown in the "adapt" portion of figure 6.

Figure 6: Large Business and International (LB&I) Division’s Conceptual Plan for Choosing and Evaluating New Selection Methods



IRS model showing its approach to selecting and reviewing audits under its new campaign plan.

Source: IRS information. | GAO-17-324

The system of analysis that LB&I plans partially satisfies the fourth project planning principle by setting up a monitoring process on the performance of *individual* campaigns. However, these plans do not address evaluating the performance of selection methods used across campaigns. Furthermore, the data analyses that LB&I has used to monitor the performance of its selection methods are not sufficient to compare results from campaigns using audits because of data problems discussed earlier. For example, the reports used to monitor selection methods had overlapping categories and the selection methods themselves were not always clearly identified in the data. LB&I officials said that the way LB&I captures audit data makes it challenging to compare audit results. Without analyzing and monitoring results by selection methods across campaigns, LB&I faces a greater risk of not using the most effective selection method within its campaigns.

LB&I’s plan also did not include measuring costs, such as auditor pay, travel expenses, and specialists that could be compared to the effectiveness of a selection method used in a specific campaign. Nor does the plan include an estimate for how much LB&I would spend on campaigns overall. According to LB&I officials, this level of detail was not deemed necessary when the plan was written. In 2012, we found that

IRS could more effectively target audit resources by measuring the marginal benefit and costs of auditing certain tax returns.³⁰ Research by IRS and other experts has found that although it may be complex, a marginal cost-benefit analysis could help IRS allocate resources to increase net revenues.³¹

LB&I faces several challenges in its efforts to monitor progress. First, the planned database for monitoring individual campaigns is the Issue Based Management Information System (IBMIS), which is populated with data from the Issue Management System (IMS), Audit Information Management System, and the Specialist Referral System. The Treasury Inspector General for Tax Administration (TIGTA) last year found reliability issues with IMS.³² In response to TIGTA, an LB&I compliance executive said the division had assembled a team to fix the IMS issues TIGTA identified and plans to improve the issue codes needed for evaluation, though those efforts were not complete as of January 2017. LB&I cannot be assured that it will draw appropriate conclusions about improving compliance through campaigns until the underlying data are in better order.

Furthermore, as previously discussed, LB&I officials said existing selection methods will continue to operate until LB&I decides whether to replace them or repurpose them to operate within campaigns. If LB&I chooses to discontinue any selection methods once campaigns are fully implemented, it would not make sense to compare them to other methods.³³ LB&I officials also said some selection methods should not be compared. For example, they said it may not be appropriate to compare selection methods used to choose an audit of a large corporation that

³⁰GAO, *Tax Gap: IRS Could Significantly Increase Revenues by Better Targeting Enforcement Resources*, [GAO-13-151](#) (Washington, D.C.: Dec. 5, 2012).

³¹Hodge, Ronald H.; Alan H. Plumley, Kyle Richison, and Getaneh Yismaw, Research, Analysis, and Statistics, IRS, and Nicole Misek, Matt Olson, and H. Sanith Wijesinghe, MITRE Corporation, *Estimating Marginal Revenue/Cost Curves for Correspondence Audits*, paper presented at the IRS Tax Policy Center Research Conference, June 18, 2015.

³²Treasury Inspector General for Tax Administration, *The Large Business and International Division's Strategic Shift to Issue-Focused Examinations Would Benefit From Reliable Information on Compliance Results*, 2016-30-089 (Washington, D.C.: Sept. 14, 2016).

³³For example, LB&I officials said that campaigns may replace CIPS, Global High Wealth, and Other Miscellaneous IIC-related methods.

may take years and require multiple staff members with the audit of a high wealth individual that takes less time and fewer resources. The range of taxpayers covered by methods also differs. For example, the tax shelters rely on disclosures from the public, making the possible universe of coverage small compared to DAS, which is applied to all Form 1120 submissions.

LB&I officials said they had received more than 700 campaign proposals by December 2016, but IRS has not developed criteria for choosing the most effective audit selection methods for campaigns with audits beyond the discretion of the Council, which IRS deemed sufficient. As of March 2017, LB&I said that they are developing such criteria. Without criteria to choose audit selection methods for campaigns using audits, LB&I lacks reasonable assurance the campaigns will meet LB&I's audit objectives.

LB&I Intends to Address Potential Risks but Plans Lack a Specific Timetable and Metrics for Risk Mitigation

LB&I officials said they held internal discussions about potential risks and have a plan stating LB&I intends to analyze risks as the campaigns are implemented. Areas of risk that LB&I has identified include an increasingly difficult environment in which its budget and resources are shrinking, tax laws are growing more complex, and taxpayers who are continuing to evolve. In addition, part of the Council's mission in overseeing and analyzing campaigns is to discuss and make decisions on risks.

While LB&I's plans to assess risk associated with campaigns show progress toward meeting the fifth project planning principle, LB&I officials did not provide us with documentation to support how the planned risks will be assessed and mitigated. Given the data limitations LB&I faced when it was developing the plan, officials would have been challenged to analyze the risks identified.

To mitigate specific risks, LB&I plans to identify and develop staff with needed skills, create a function to conduct environmental scans, and develop the ability to gather, manage, and analyze data. These plans for analyzing and mitigating risks, however, lack a set timetable, and do not include specific metrics for assessing whether progress is being made toward goals. Without these metrics and a timetable for developing them, LB&I will be less assured that it is addressing risks faced by audit-focused campaigns.

Conclusions

LB&I has documented policies and procedures that generally reflect 4 of the 10 internal control principles that we reviewed. However, gaps in documentation related to six of the principles leave LB&I without reasonable assurance that its selection methods are being implemented as designed and whether tax return selection supports the division's audit objectives. Ensuring that policies and procedures of audit selection methods are fully documented will continue to be important for LB&I as it implements its new campaign approach for selecting audits. Similarly, LB&I's lack of a standard process for monitoring field-level selection decisions, the most direct step in audit selection, may hinder management's ability to identify any inconsistencies across decisions and remediate any deficiencies in its audit processes.

LB&I's efforts to plan and implement its new compliance approach have partially met five key principles for effectively planning projects. However, opportunities exist to make improvements. In particular, LB&I has not fully established a specific timetable for implementing its new approach overall or completed plans to monitor those projects overall—only individual projects. LB&I also faces challenges in ensuring that data to conduct the monitoring is sufficient to assess any selection methods used in the new compliance approach moving forward. Without taking the steps to fully meet all five planning principles in implementing its new approach, LB&I management will lack reasonable assurance that its new compliance approach will succeed in accomplishing LB&I's overall audit objective of encouraging voluntary compliance and fair treatment of taxpayers.

Recommendations for Executive Action

As LB&I finishes implementing its new approach and decides which selection methods will be used with the campaigns, we recommend that the Commissioner of Internal Revenue ensure that the documentation gaps in policies and procedures are addressed for the following six internal control principles for the selection methods that will be used:

- define objectives to identify risk and define risk tolerances;
- identify, analyze, and respond to risks to achieving the objectives;
- design control activities to achieve objectives and respond to risks;
- use quality information to achieve objectives;
- communicate internally the necessary quality information about the objectives; and

-
- evaluate issues and remediate identified internal control deficiencies on a timely basis.

Also in accordance with federal internal control standards, we recommend that the Commissioner direct LB&I to adopt a standard process for monitoring audit selection decisions in the field, such as by modifying the existing quality control system.

To further ensure that the new campaigns under LB&I's new approach for addressing tax compliance are implemented successfully, we recommend that the Commissioner take these actions:

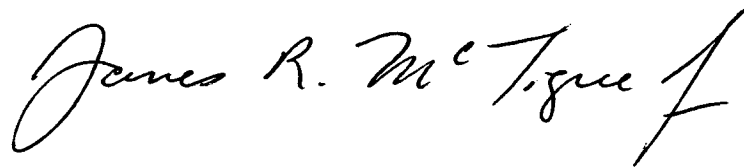
- create a timetable with specific dates for implementing its new compliance approach;
- establish metrics to help determine whether the campaign effort overall meets LB&I's goals;
- finalize and document plans to evaluate the human resources expended on campaign activities;
- document lessons learned from stakeholder input and past performance;
- monitor overall performance across future campaigns, not just individual compliance projects, and in doing so ensure that the data used for monitoring accounts for the costs beyond the auditor's time can clearly be linked with specific selection methods, including the Discriminant Analysis System (DAS) method, to the extent that the selection methods continue to operate;
- develop and document criteria to use in choosing selection methods for campaigns using audits; and
- set a timetable to analyze and mitigate risks and document specific metrics for assessing mitigation of identified risks.

Agency Comments and Our Evaluation

We provided a draft of this report to the Commissioner of Internal Revenue for review and comment. On March 9, 2017, the Deputy Commissioner for Services and Enforcement provided written comments stating that IRS agreed with all of the GAO's recommendations and is identifying the specific actions to be taken to effectively implement them. In the letter, which is reprinted in appendix V, the Deputy Commissioner said that the GAO report properly highlights the importance of addressing documentation, both in the traditional selection processes, as well as the new campaign process; developing a standard process to monitor audit selection systems; and fully addressing project planning principles in implementing the campaign approach. The Deputy Commissioner also said that LB&I has begun taking steps to improve its documentation and monitoring processes and that GAO's findings, along with the implementation of its recommendations, will improve this process. Lastly, the Deputy Commissioner said that IRS will provide a more detailed description of its actions, responsible officials, and implementation timelines in its response to the final report. At that time, we will review these details in determining IRS's progress in implementing our recommendations.

As agreed with your offices, unless you publicly announce the contents of this report earlier, we plan no further distribution until 30 days from the report date. At that time, we will send copies to the Chairmen and Ranking Members of other Senate and House committees and subcommittees that have appropriation, authorization, and oversight responsibilities for IRS. We will also send copies of the report to the Secretary of the Treasury, Commissioner of Internal Revenue, and other interested parties. In addition, this report is available at no charge on the GAO website at <http://www.gao.gov>.

If you or your staff have any questions or wish to discuss the material in this report further, please contact me at (202) 512-9110 or mctiguej@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Key contributors to this report are listed in appendix VI.

A handwritten signature in black ink that reads "James R. McTigue, Jr." with a stylized flourish at the end.

James R. McTigue, Jr.
Director, Tax Issues
Strategic Issues

Appendix I: Objectives Scope and Methodology

This report (1) assesses the extent to which the Large Business and International (LB&I) division's documented procedures and policies on audit selection methods generally reflect relevant internal control principles; (2) assesses the extent to which LB&I has a standard process to monitor audit selection decisions; (3) describes statistical information on audit starts and closures for LB&I's selection methods, including LB&I's use of audit referrals, and assesses how the Internal Revenue Service (IRS) evaluates its audit results from its selection methods; and (4) assesses to what extent LB&I has planned and implemented its new approach to address compliance.

To assess the extent to which LB&I documented procedures and policies generally reflect relevant internal control principles, we reviewed the various LB&I's selection methods and related internal controls that are intended to help LB&I achieve its stated goal for audits to promote voluntary compliance. We also reviewed IRS's *Strategic Plan FY2014-2017*, Internal Revenue Manual (IRM) sections related to LB&I's mission statement and statement for audits, LB&I's fiscal year 2016 Business Performance Review, and other IRS documentation related to LB&I's audit selection process.

At the start of our work, LB&I provided a list of its 14 audit selection methods which are listed in appendix II. Based on LB&I officials' input and our review of relevant documentation, we decided to focus our analysis on whether eight of these selection methods meet the relevant internal controls standards. Our decisions, to which LB&I officials agreed, include the following.

- Our analysis excluded three selection methods that were shut down during our work. LB&I has ceased operating the 1065 and 1120-S modeling program selection methods and merged the international risk assessment program (IRAP) with filtering. LB&I officials said they made these decisions based on experience with the programs and on the expected nature of new selection methods that LB&I is developing.
- We also excluded the compliance and workload delivery (CWD) and foreign payment program (FPP) selection methods because neither method involves decisions about whether to select tax returns for audit. Rather, their workload consists of referrals from other parts of IRS, or returns that are mandatory to audit.
- We combined the Form 8886 disclosures and Form 8918 material advisor disclosures into one return selection method because they are

handled by the same office—the Office of Tax Shelter Analysis (OTSA).

For the remaining 8 selection methods, we compared relevant LB&I procedures with 10 internal control principles from *Standards for Internal Control in the Federal Government (Standards)*.¹ We assessed whether documentation on LB&I's selection methods generally reflected the 10 internal control principles by reviewing documentation and interviewing LB&I officials familiar with the return selection methods. The internal control principles we used for our evaluation are noted below.

- Principle 1: Demonstrate commitment to integrity and ethical values
- Principle 3: Establish structure, assign, responsibility, and delegate authority to achieve objectives.
- Principle 4: Demonstrate commitment to competence through recruiting, training and development, and retention.
- Principle 6: Define objectives to identify risk and define risk tolerances.
- Principle 7: Identify, analyze, and respond to risks to achieving the objectives.
- Principle 10: Design control activities to achieve objectives and respond to risks.
- Principle 12: Implement control activities through policies and reviews.
- Principle 13: Use quality information to achieve objectives.
- Principle 14: Communicate internally the necessary quality information about objectives.
- Principle 17: Evaluate issues and remediate deficiencies.

We selected these 10 principles based on our previous work on IRS audit selection and our review of Green Book internal controls.² We consulted with GAO stakeholders with knowledge about the principles and evaluation methodology. We shared our identification of the relevant principles with LB&I officials, who agreed with the criteria. We also discussed the type of documentation we were seeking to support the internal controls with LB&I. We had three GAO analysts independently

¹[GAO-14-704G](#).

²[GAO-16-103](#), [GAO-16-102](#) and [GAO-15-514](#).

review LB&I's documentation and reach consensus on whether the documented policies and procedures generally reflect the principles.

To assess the extent to which LB&I had a standard process to monitor audit selection decisions, we reviewed documentation on the standards for audit selection from the IRM, as well as documentation on the LB&I Quality Measurement System, which LB&I officials told us was the primary method to assess how well auditors follow IRS standards. We also interviewed relevant LB&I officials on practices in selecting audits in the field. Additionally, we held seven focus groups—three with field audit managers and four with field auditors—to collect examples of field staff's experiences following audit standards. We acquired complete lists of field auditors and managers and randomly selected focus group participants from those lists. The selected participants are a nonprobability sample, and their views cannot be generalized to their respective populations. The focus groups were conducted by telephone and were facilitated by a GAO methodologist. We compiled the comments made during the focus group and identified common themes. For our assessment, we compared the documentation we reviewed and the information we collected from interviews and focus groups with the Green Book internal control on monitoring.

To describe statistical information on audit starts and closures from LB&I's audit selection methods, we acquired the complete dataset from A-CIS, an IRS system used to track LB&I audit activity, for fiscal years 2011 through 2015, the most recent complete data available during our analysis. We identified the codes corresponding to the 14 selection methods that LB&I officials told us they use to help select tax returns for audit, with the exception of IRAP for which LB&I did not have any codes.³ We worked with IRS data managers and identified 35 other selection methods within LB&I's audit inventory, which we determined to be outside of the scope of this review and refer to as "Other Methods" for comparative purposes in this report (see Appendix II for examples of other selection methods). We made other scoping decisions to ultimately arrive at the seven selection methods on which we focused our data analysis.

- We removed the Discriminant Analysis System (DAS) because it is identified in the data using source codes, which are not comparable

³As noted previously, we already removed IRAP from our internal controls analyses because it was terminated.

with the project and tracking codes used for the other selection methods.

- For consistency with our internal controls analysis, we combined the codes for Form 8886 disclosures and Form 8918 material advisor disclosures and presented those results as one return selection method, Tax Shelters.
- We did not include the CWD and FPP programs as we determined they do not require the professional judgment of LB&I staff in making audit selection decisions.
- Lastly, the results we present do not include the Compliance Initiative Projects (CIP) and Coordinated Industry Cases (CIC) as selection methods because the majority of the audit results were too small to report without revealing taxpayer information.

We used the codes to measure the annual number of starts and closures for these 7 remaining selection methods: 1065 Modeling, 1120-S Modeling, Tax Shelters, LB&I Filtering, Global High Wealth (GHW), Offshore IIC, and Other Miscellaneous IIC. In addition, to describe LB&I's use of audit referrals, IRS identified the coding for two groups of audit referrals that LB&I receives—internal and external—and we used these codes to count the number of audits that listed these referrals by source codes. We assessed the reliability of the data by reviewing existing information, including the A-CIS data dictionary and related documentation and conducted interviews with LB&I officials knowledgeable about the data. In addition, we compared our results to selected system control totals provided by IRS, and had our code and results confirmed by relevant IRS data experts. We also ran summary statistics for each selection method. Based on these steps, we determined that the data we generated were sufficiently reliable for calculating statistics on audit starts and closures.

To assess how IRS evaluates its audit results from its selection methods, we reviewed a monthly tracking report on LB&I's individual selection methods that LB&I officials told us they used to monitor selection methods. We also interviewed relevant LB&I officials. We compared LB&I's report with the Green Book internal control Principle 13: Use Quality Information.

To assess the extent to which LB&I planned and implemented its new approach for addressing compliance, we reviewed our prior work on

projects similar to what LB&I had designed with campaigns.⁴ Based on our review of those reports, we determined the project planning principles listed in table 3 below were appropriate for our analysis because of their applicability to planning new approaches or projects. IRS agreed with these principles during April 2016. We reviewed LB&I's plans to stand up campaigns and interviewed relevant officials then compared the information to the principles outlined in table 3. Given the status of LB&I's plans, we did not assess LB&I's decision to create the approach.

Table 3: Project Planning Principles for Evaluating Program Start Ups

Develop a project plan with clear and measurable goals, schedules, and resources.
Evaluate human resources by assessing how needed resources will be acquired and retained.
Leverage stakeholder input and incorporate lessons learned by evaluating past performance.
Monitor progress by collecting data to determine effectiveness in achieving the stated goals.
Analyze and mitigate risks by evaluating, prioritizing, and documenting risks as well as options for mitigating risks.

Source: GAO analysis of project management literature | GAO-17-324

To determine whether LB&I met the principles, two analysts independently compared the evidence with the criteria and recorded their assessments. A third analyst also reviewed the evidence and acted as a tie-breaker, if needed. The statements that analysts could make based on the evidence are “meets” or “does not meet.”

⁴GAO, *Large Partnerships: With Growing Number of Partnerships, IRS Needs to Improve Audit Efficiency*, [GAO-14-732](#) (Washington, D.C.: Sept. 18, 2014) and *2020 Census: Additional Steps Are Needed to Build on Early Planning*, [GAO-12-626](#) (Washington, D.C.: May 17, 2012).

To keep our conclusions as clear as possible, our definitions of the two assessments are as follows.

- Meets: The documented evidence supports all aspects of the criterion.
- Did not meet: The evidence did not support all aspects of the criterion, including cases in which some aspect of the criterion is met, but we did not have enough evidence to conclude that all aspects were met.

We conducted this performance audit from January 2016 to March 2017 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Appendix II: Description of Large Business and International (LB&I) Selection Methods and Other Methods

Selection Methods

LB&I officials initially identified fourteen selection methods that LB&I uses to help select tax returns for audit. The list of those selection methods, including definitions, follows:

Discriminant Analysis System (DAS): DAS is a mathematical system that LB&I uses to identify corporate (Form 1120) returns that may merit selection for audit. DAS prioritizes returns based on their probability of being profitable to audit. DAS computes a score that allows LB&I to rank the returns.

1065 Modeling: The partnership (Form 1065) computer model combines results from mathematical formulas and business rules to identify partnership returns for audit consideration.

1120-S Modeling: As with the 1065 model, the S corporation (Form 1120 S) computer model combines results from mathematical formulas and business rule to identify S corporation returns for audit consideration.

Form 8886 Disclosures: The Office of Tax Shelter Analysis (OTSA) in LB&I reviews this disclosure form for potentially abusive tax avoidance; taxpayers are to disclose particular transactions that may indicate such abuse.

Form 8918 Material Advisor Disclosures: OTSA in LB&I reviews this disclosure form, which is to be filed by those who promote tax shelters, for inappropriate shelter schemes to lower tax liability.

LB&I Filtering: Computer programs that LB&I staff develop to identify particular issues that have a tendency towards noncompliance on tax returns for audit consideration.

International Risk Assessment Program (IRAP): IRAP is a program to identify particular international tax planning strategies that may pose a compliance risk.

Coordinated Industry Case classification process: LB&I staff assign points to certain characteristics on a tax return to identify whether certain large corporate taxpayers should be under continuous audit.

Global High Wealth (GHW): LB&I teams use computerized models to identify high wealth individuals with audit potential because of various ownership and investment interests.

Compliance and Workload Delivery: This is a process that identifies and classifies returns for potential audit based on issues that LB&I lists in its annual letter on audit priorities due to a compliance risk.

Offshore International Individual Compliance: LB&I identifies individual tax returns with potential international compliance issues based on information received from third party information, such as banks complying with Internal Revenue Service (IRS) issued summonses for customer records

Other Miscellaneous: Tax returns that are referred by the Whistleblower program for possible audit on the basis of information received from a whistleblower.

Compliance Initiative Projects: LB&I staff identifies returns filed by specific types of taxpayers such as those engaging in certain activities to collect data about potential areas of noncompliance.

Foreign Payment Program: A program responsible for coordinating all foreign payment functions such as income tax withholding and information reporting by third parties on payments made to taxpayers.

Since the start of our engagement, LB&I has ceased operating the 1065 and 1120-S modeling programs and merged IRAP with filtering. According to LB&I officials, they made these decisions based on their experience with the programs and on the expected nature of new selection methods that LB&I is developing. We have excluded these three methods from our analyses of documented policies and procedures and calculations of audit starts and closures. We also excluded the compliance and workload delivery and foreign payment programs because we confirmed with IRS officials that neither of these programs include returns that require the discretion of LB&I officials in making an audit selection decision. Rather, their workload consists of referrals from other IRS divisions, or returns that are mandatory to audit. We also combined the Form 8886 disclosures and Form 8918 material advisor disclosures into one return selection method because they are handled by the same office—OTSA.

Other Methods

In addition to the 14 selection methods initially identified by LB&I, our work with IRS data analysts revealed 35 other selection methods in LB&I's inventory which we decided not to include in our analyses of documented policies and procedures. Similar to the compliance workload delivery and foreign payment practice programs, these other methods do not require the same level of professional judgement by LB&I staff to select returns for audit compared to the eight methods we focused on in our internal control analyses. For our analyses of the audit start and closure data, we included them in the aggregate and refer to them as "other methods" for context. Examples of these methods include:

- Joint Committee on Taxation review
- Training
- Uncertain Tax Position
- National Research Program
- Tax Equity and Fiscal Responsibility Act of 1982
- Employment Tax
- Non-Filer

Appendix III: Statistical Summary of Large Business and International (LB&I) Audit Selection Method Performance Indicators

Table 4: Overall Audit Starts and Closures for Internal Revenue Service (IRS) Large Business and International Division (LB&I) by Selection Methods, Fiscal Years 2011 through 2015^a

Selection Method	2011		2012		2013		2014		2015	
	Starts	Closures	Starts	Closures	Starts	Closures	Starts	Closures	Starts	Closures
1065 Modeling	1,142	104	1,203	144	1,297	162	1,091	93	667	88
1120-S Modeling	*	*	*	*	*	*	200	*	673	21
Tax Shelters	71	214	35	118	41	109	38	19	36	51
LB&I Filtering	142	69	175	118	280	164	387	229	178	230
Global High Wealth	317	24	448	85	479	142	451	186	455	242
Offshore IIC	1,819	14,472	2,884	4,151	21,767	14,638	10,394	11,174	4,732	7,456
Other Miscellaneous IIC	12,455	24,740	11,670	23,038	18,669	18,688	15,945	16,428	1,791	1,355
Total- Selection Methods in GAO Analysis	15,946	39,623	16,415	27,654	42,533	33,903	28,506	28,129	8,532	9,443
Total - Other Methods	21,497	26,171	15,487	23,898	14,315	15,497	13,529	12,041	25,648	25,320
Total - All Methods	37,443	65,794	31,902	51,552	56,848	49,400	42,035	40,170	34,180	34,763

Source: GAO analysis of IRS data. | GAO-17-324

^aThe * denotes values that are redacted to protect taxpayer information. Column totals do not include redacted numbers.

Appendix IV: List of Announced Campaign Compliance Projects

In January 2017, the Large Business and International (LB&I) division announced the following 13 compliance projects or “campaigns” that it will conduct.

1. **Internal Revenue Code (IRC) 48C Energy Credit:** LB&I said that this campaign will help ensure that the credit is claimed only by those taxpayers whose advanced energy projects were approved by the Department of Energy (DOE), and who have been allocated a credit by IRS. These credits must be pre-approved through application to the DOE. LB&I said that the treatment stream for this campaign will be soft letters and issue-focused audits.
2. **Offshore Voluntary Disclosure Program (OVDP) Declines-Withdrawals:** OVDP allows U.S. taxpayers to voluntarily resolve past non-compliance related to unreported offshore income and failure to file foreign information returns, according to LB&I. In the campaign, LB&I said it will address OVDP applicants who applied for pre-clearance into the program but were either denied access to OVDP or withdrew from the program. LB&I said that IRS will address continued noncompliance through a variety of treatment streams, including audits.
3. **Domestic Production Activities Deduction, Multi-Channel Video Program Distributors (MVPD) and TV Broadcasters:** MVPDs and TV broadcasters have claimed that “groups” of channels or programs are a qualified film eligible for the IRC Section 199 deduction for income attributable to domestic production activities, according to LB&I. They are asserting that they are the producers of a qualified film when distributing channels and subscriptions packages that include third-party produced content. Additionally, LB&I said that MVPD taxpayers maintain that they provide online access to computer software for the customers’ direct use. LB&I said that it has developed a strategy to identify taxpayers affected by these issues and will develop training to aid auditors and that the campaign will include potential published guidance and issue-based audits
4. **Micro-Captive Insurance:** LB&I said that this campaign addresses transactions in which a taxpayer attempts to reduce aggregate taxable income by using a contract with a related company that the parties treat as an insurance contract with a captive insurance company (i.e., an insurance company organized primarily to provide insurance

protection to its owners or persons related to its owners).¹ LB&I said that it has developed a training strategy for this campaign and the treatment stream will be issue-based audits.

5. **Related Party Transactions:** LB&I said that this campaign focuses on transactions between commonly-controlled entities that provide a means to transfer funds from a corporation to related pass through entities or shareholders. LB&I said it is seeking to determine the level of compliance in related party transactions and that the treatment stream for this campaign is expected to be issue-based audits.
6. **Deferred Variable Annuity Reserves and Life Insurance Reserves Industry Issue Resolution (IIR):** The IRS and Chief Counsel will develop guidance to address uncertainties about reserves for deferred variable annuities and for life insurance and related tax issues, according to LB&I. The campaign's objective is to collaborate with industry stakeholders. Chief Counsel and the Department of the Treasury are to develop published guidance that provides certainty to taxpayers regarding these related issues.
7. **Basket Transactions:** This campaign addresses structured financial transactions in which a taxpayer attempts to defer and treat ordinary income and short-term capital gain as long-term capital gain, according to LB&I. LB&I said that it has developed a training strategy for this campaign. The treatment streams will be issue-based audits, soft letters, and outreach.
8. **Land Developers - Completed Contract Method (CCM):** Large land developers that construct in residential communities may be improperly using CCM accounting, according to LB&I. In some cases, developers are improperly deferring all gain until the entire development is completed. LB&I will provide training for auditors doing follow-up audits when warranted. The treatment stream also will include development of a practice unit and issuance of soft letters.
9. **The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) Linkage Plan Strategy:** As partnerships have become larger and

¹In general, insurance premiums are deductible as business expenses. 26 C.F.R. § 1.162-1(a). In order for an arrangement to constitute insurance for federal income tax purposes, both risk shifting and risk distribution must be present. *Helvering v. LeGierse*, 312 U.S. 531 (1941). Arrangements between parent corporations and captive insurance company subsidiaries may lack risk shifting and risk distribution, and, therefore, do not constitute insurance for federal income tax purposes. *Humana Inc. v. Commissioner*, 881 F.2d 247, 257 (6th Cir. 1989). See also, *Malone & Hyde, Inc. v. Commissioner*, 62 F.3d 835 (6th Cir. 1995); IRS Rev. Ruling 2002-90 (Dec. 30, 2002).

more complex, LB&I has revised processes to assess tax on investors, according to LB&I. With recent legal changes, LB&I plans to focus on developing new procedures and technology to work collaboratively with auditors conducting TEFRA partnership audits to identify, link, and assess tax to the investors that pose the most significant compliance risk.

10. **S Corporation Losses Claimed in Excess of Basis:** S corporation shareholders report income, losses and other items passed through their corporation, according to LB&I. While the law limits losses and deductions to their cost basis in the corporation, LB&I said that it has found that shareholders claim losses and deductions in excess of their basis. LB&I also said that it has developed technical content for this campaign that will aid auditors. According to LB&I, the treatment streams for this campaign will be issue-based audits, soft letters encouraging voluntary self-correction, stakeholder outreach, and a new form for shareholders to assist in properly computing their basis.
11. **Repatriation:** LB&I said that it is aware of different structures being used by taxpayers for purposes of tax free repatriation of funds into the United States. LB&I has determined that many of the taxpayers do not properly report repatriations as taxable events on their filed returns. LB&I said that it plans to improve issue selection filters for conducting audits on identified, high-risk repatriation issues, increasing taxpayer compliance.
12. **Form 1120-F Non-Filer:** Foreign companies doing business in the U.S. are often required to file Form 1120-F, according to LB&I, data suggest that many of these companies are not meeting their filing obligations. In this campaign, LB&I said that it will use various external data sources to identify these foreign companies and encourage them to file their required returns. The treatment stream will involve soft letter outreach, according to LB&I. If the companies do not take appropriate action, LB&I will conduct audits to determine the correct tax liability.
13. **Inbound Distributor:** According to LB&I, U.S. distributors of goods from foreign-related parties have incurred losses or understated profits in their U.S. tax return reporting; these amounts are not commensurate with the functions performed and risks assumed. In many cases, the U.S. taxpayer would be entitled to higher returns in arms-length transactions. LB&I said that it has developed a training strategy that will aid auditors as they examine this in issue-based audits.

Appendix V: Comments from the Internal Revenue Service



DEPUTY COMMISSIONER

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

March 7, 2017

Mr. James R. McTigue
Director, Tax Issues
Strategic Issues Team
U.S. Government Accountability Office
441 G Street, N.W.
Washington, DC 20548

Dear Mr. McTigue:

Thank you for the opportunity to review and comment on the draft report, *IRS Return Selection: Improved Planning, Internal Controls, and Data Would Enhance Large Business Division Efforts to Implement New Compliance Approach* (GAO-17-324). We appreciate the collaborative effort between the GAO Audit team and the IRS Large Business & International (LB&I) personnel to ensure proper reporting of the methods and processes utilized by LB&I to select returns for examination.

The vision of LB&I is that we are a world class organization responsive to the needs of our customers in a global environment while applying innovative approaches to customer service and compliance. We apply the tax laws with integrity and fairness through a highly skilled and engaged workforce, in an environment of inclusion where each employee can make a maximum contribution to the mission of the team.

We are very excited by the progress made in the campaign process. The GAO report properly highlights the importance of addressing documentation in our traditional selection processes, as well as the new campaign process, developing a standard process to monitor audit selection systems and fully addressing project planning principles in the implementation of our campaign approach.

We take great pride in the accomplishments made by LB&I in 2016. LB&I transitioned into a completely new structure supporting our shift in the way we do business – from traditional return selection processes to campaigns. LB&I's implementation of campaigns to respond to compliance risks are part of the IRS broader effort to focus upon specific areas of noncompliance. LB&I is currently transitioning to the campaign focus and your suggestions for planning and monitoring workload selection will guide our continuing efforts to understand risks and to deploy resources against specific issues with the objective of improving taxpayer compliance.

2

The campaign concept is a fundamental part of LB&I's Future State. The process is a thorough harnessing of the combined intellect of our team to make intentional decisions about the compliance risks we will respond to, how we will respond and how we will know success. Our decisions impact the most important resource we have – the investment of time by every LB&I employee. We're using the best data and analytics we have, combined with input from the people who know the work best, our experienced workforce and their leaders, to identify areas of compliance risk and design campaigns to respond to achieve stated objectives.

A key part of our campaign process is an "integrated feedback loop" where we can hear from front-line examiners and practitioners as we evaluate, modify or terminate campaigns. We've received hundreds of campaign suggestions and we're committed to evaluating each one of them for its merits and documenting our decisions.

LB&I, similar to the IRS as a whole, is challenged by uncertain funding, shrinking resources, and the inability to adequately exploit information due to a shortage of skilled professionals such as data scientists or data analysts, who could, over time, greatly improve our ability to detect specific risks. Improved risk detection better focuses resource deployment and reduces taxpayer burden.

LB&I recognizes that there are many challenges to implement campaigns and has begun taking steps to improve upon our documentation and monitoring processes. Your findings, and implementation of your recommendations, will improve this process and LB&I's governance by strengthening internal controls and documentation of decision points.

We agree with all of the GAO's recommendations, and we are in the process of identifying the specific IRS actions to be taken to effectively implement them. We will provide a more detailed description of our actions, responsible officials, and implementation timelines in our response to the final report. If you have any questions, please contact me or members of your staff may contact Tina Meaux, Assistant Deputy Commissioner Compliance Integration at (346) 227-6300.

Sincerely,


John M. Dalrymple
Deputy Commissioner for
Services and Enforcement

Appendix VI: GAO Contact and Staff Acknowledgments

GAO Contact

James R. McTigue, Jr. (202) 512-9110 or mctiguej@gao.gov.

Staff Acknowledgments

In addition to the contact named above, Tom Short (Assistant Director); Ann Czapiewski; Steven Flint; Robert Gebhart; Eric Gorman; George Guttman; John Hussey; Shirley Jones; Edward Nannenhorn; Ellen Rominger; Cynthia Saunders; Andrew J. Stephens; and Mackenzie Verniero made significant contributions to this review.

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