

**MSP
#10****OFFICE EXAMINATION: The IRS Does Not Know Whether Its Office Examination Program Increases Voluntary Compliance or Educates the Audited Taxpayers About How to Comply in the Future****RESPONSIBLE OFFICIAL**

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TAXPAYER RIGHTS IMPACTED¹

- *The Right to Be Informed*
- *The Right to Quality Service*
- *The Right to Pay No More Than the Correct Amount of Tax*
- *The Right to Challenge the IRS's Position and Be Heard*
- *The Right to a Fair and Just Tax System*

DEFINITION OF PROBLEM

Under Internal Revenue Code (IRC) § 7602(a) the IRS may conduct examinations to determine whether a tax return is correct, to create a return where the taxpayer has not filed, and to determine a taxpayer's tax liability. The IRS's Office Examinations Program (Office Exam), administered by the Small Business/Self-Employed Division (SB/SE), performs a small fraction of all IRS audits per year. In fiscal year (FY) 2017, the IRS audit coverage rate for all returns was 0.5 percent.² Of those audited, only 102,517 returns were audited through office exams (approximately ten percent).³ Office exams are generally performed in locations where the IRS has the appropriate examination personnel, Tax Compliance Officers (TCOs).⁴ SB/SE currently has 639 TCOs performing office exams, a 49 percent decrease compared with FY 2011, despite office exams having higher agreed-to rates than correspondence exams.⁵

IRS Policy Statement 4-21 states that the primary purpose in selecting tax returns for examination is to promote the highest degree of voluntary compliance.⁶ However, the IRS does not know if Office Exam

1 See Taxpayer Bill of Rights (TBOR), www.TaxpayerAdvocate.irs.gov/taxpayer-rights. The rights contained in the TBOR are also codified in the Internal Revenue Code (IRC). See IRC § 7803(a)(3).

2 IRS, *Data Book* 23 (2017). The audit coverage rate is computed from the 1,059,934 returns audited in fiscal year (FY) 2017 across its examination programs divided by the 195,614,161 returns filed in calendar year 2016.

3 IRS response to TAS information request (Oct. 15, 2018).

4 Internal Revenue Manual (IRM) 4.10.2.9.2 (2), *Place and Time of Examination* (Feb. 11, 2016).

5 IRS response to TAS information request (Oct. 15, 2018). IRS, Compliance Data Warehouse (CDW), Automated Information Management System (AIMS) FYs 2011 to 2018 (Dec. 2018).

6 IRM 1.2.13.1.10, *Policy Statement 4-21* (June 1, 1974).

achieves this purpose. The National Taxpayer Advocate's concerns about the overall effectiveness of office exams are two-fold:⁷

- The measures the IRS uses to determine the effectiveness of the exam selection process do not capture data needed to determine the program's impact on increasing voluntary compliance; and
- The scope of the office exam program may limit its impact and introduce bias into the selection process, rendering the program available only to taxpayers who are geographically proximate, have specific issues, or where the IRS has appropriate examination personnel.

In-person face-to-face exams have the potential to provide a real opportunity for the IRS to educate taxpayers on filing compliance for the future and to increase voluntary compliance. Limiting office exams to a small portion of the taxpayer pool, closing the exams cursorily, and failing to approach the exam as an educational experience cannot serve to genuinely further the goal of increasing voluntary compliance and fails to capitalize on the opportunity to put a human face on the IRS.

BACKGROUND

The IRS uses several workstreams to identify returns that may merit additional scrutiny, including assigning all returns a discriminant function (DIF) score, implementing special projects, and receiving referrals.⁸ IRS employees review the pool of returns to determine if the return should be audited and the appropriate audit process. Returns may then be assigned to employees for audit.

Office Exams Offer Advantages to Taxpayers Versus Correspondence Exams

The IRS employee has an opportunity to educate the taxpayer in-person and ensure the taxpayer understands the law going forward. The face-to-face experience benefits both the taxpayer and the IRS—the taxpayer can, in real time, ask questions and explain his or her position to the IRS, and the IRS employee can immediately see if the taxpayer understands the current examination, next steps to be taken, and how to comply in the future. Compare this with the correspondence examination process where a taxpayer with limited understanding of the law may never speak to an IRS employee during the entire process.

When a return is selected for office examination, the TCO may send the taxpayer a letter with the date, time, and location of the exam.⁹ Research shows that an opt-out system (where a person is sent a letter with a firm date and time for an appointment) versus an opt-in (where a person is sent a letter requesting he or she call and schedule an appointment) may be more effective in ensuring the person shows up for

⁷ For an in-depth discussion of the National Taxpayer Advocate's concerns about other types of examinations, see Most Serious Problem: *Correspondence Examination: The IRS's Correspondence Examination Procedures Burden Taxpayers and are Not Effective in Educating the Taxpayer and Promoting Future Voluntary Compliance*, *supra*; Most Serious Problem: *Field Examination: The IRS's Field Examination Program Burdens Taxpayers and Yields High No Change Rates, Which Waste IRS Resources and May Discourage Voluntary Compliance*, *supra*.

⁸ For a discussion of the exam selection process, see *Introduction to the Examination Process: Promoting Voluntary Compliance and Minimizing Taxpayer Burden in the Selection and Conduct of Audits*, *supra*.

⁹ IRM 4.10.2.8.1.1 (Nov. 4, 2016). One letter option is IRS, Letter 2202, *Initial Contact Letter – Firm Set Appointment Letter* (Feb. 2017). This letter sets an appointment date and time for the taxpayer. Two other possible letters request that the taxpayer call the IRS to schedule the appointment. IRS Letter 3572 (Dec. 2016); IRS Letter 3572-A (Dec. 2016).

Office exams offer a unique opportunity to educate a taxpayer in person and to help the taxpayer understand his or her filing obligations going forward. With higher agreed-to rates and lower non-response rates than correspondence exam, the process results in a better outcome for taxpayers and the IRS.

the appointment.¹⁰ Correspondence exams (and the two office exam letters requesting the taxpayer call the IRS for an appointment) require the taxpayer to proactively respond to a letter, the functional equivalent to an opt-in system, and may be less effective in eliciting a response from the taxpayer, resulting in higher non-response rates. A mixed approach, where the letter sets a date for the exam, but permits the taxpayer to call to reschedule would allow for flexibility for the taxpayer, but also prompt the taxpayer to act due to the scheduled appointment.

Office exams offer a unique opportunity to educate a taxpayer in person and to help the taxpayer understand his or her filing obligations going forward. With higher agreed-to rates and lower non-response rates than correspondence exam, the process results in a better outcome for taxpayers and the IRS.¹¹ Many of the same benefits may be available from exams conducted in a virtual face-to-face environment, provided the IRS has the appropriate technology; however, virtual audits would not be an entire substitute for in-person audits due to the limitations of internet and technology access among taxpayers.¹²

The IRS Does Not Know if the Office Exam Program Effectively Promotes Voluntary Compliance

IRS Policy Statement 4-21 clearly articulates the IRS's stated purpose in selecting returns for examination:

The primary objective in selecting returns for examination is *to promote the highest degree of voluntary compliance* on the part of taxpayers. This requires the exercise of professional judgment in selecting sufficient returns of all classes of returns in order to assure all taxpayers of equitable consideration, in utilizing available experience and statistics indicating the probability of substantial error, and in making the most efficient use of examination staffing and other resources.¹³

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- 10 Studies have shown that an opt-out system for flu vaccinations results in higher rates of vaccination for those who receive a notice with a prescheduled appointment compared to those who receive an opt-in notice requesting they make an appointment. See, e.g., Gretchen Chapman, Meng Li, Howard Leventhal, Elaine Leventhal, *Default Clinic Appointments Promote Influenza Vaccination Uptake Without a Displacement Effect*, BEHAVIORAL SCIENCE & POLICY, Vol. 2 Issue 2 2016, at 41-50.
- 11 IRS, CDW, AIMS FY 2011 to 2018 (Dec. 2018). Combined, SB/SE and Wage and Investment (W&I) correspondence exams for FY 2018 had a non-response rate of over 40 percent, compared to 14 percent for office exam.
- 12 National Taxpayer Advocate 2017 Annual Report to Congress, vol. 2 61-146 (Research Study: *A Further Exploration of Taxpayers' Varying Abilities and Attitudes Toward IRS Options for Fulfilling Common Taxpayer Service Needs*) (95 percent confidence level). Taxpayers indicated that about 28 percent did not have broadband, which translates to over 41 million taxpayers without this type of access. This is more prevalent within the vulnerable population groups including low income taxpayers (at or below 250 percent of poverty level based on household size, income, and location), seniors (age 65 and older), and taxpayers with disabilities (long term condition self-reported in the survey).
- 13 IRM 1.2.13.1.10, *Policy Statement 4-21* (June 1, 1974).

Although this statement is decades old, the concept of promoting voluntary compliance is one that should underlie all IRS programs and procedures, including the selection of returns for examination.

As described in a research study in Volume 2 of this report, the type of audit can be important relative to the attitudes and behavior of taxpayers who have been audited. In the sample of taxpayers in the report, only 64 percent of taxpayers remember being audited, with stark differences from those who underwent correspondence audits versus field or office examinations.¹⁴ Eighty percent of those subject to office audit recall being audited, compared to less than 40 percent of those who experienced correspondence exam.

Overall, taxpayers in the study who experienced audits reported higher levels of fear, anger, threat and caution when thinking about the IRS and feel less protected by the IRS.¹⁵ Taxpayers who experienced field or office exams reported higher levels of perceived justice compared to those who underwent correspondence exam.¹⁶ Further, the study results suggest that taxpayers who undergo correspondence exam have a high erosion of trust of the IRS compared to those who experience field or office exam.¹⁷ Surprisingly, the study found that taxpayers who experienced an audit which resulted in a refund of tax perceived the IRS with less trust after the conclusion of the audit, suggesting that perhaps the taxpayers may have been frustrated to be selected for audit when they had overpaid their tax or felt that the IRS was unfair its selection of their returns.¹⁸

The IRS Gets What It Measures

If the IRS's goal is to promote voluntary compliance through the examination process, it needs to measure how taxpayers who undergo audits comply in future years. Currently the IRS relies on typical measures of cycle time, closure rates, quality scores, and employee satisfaction in evaluating the examination process.¹⁹ None of these measures address the impact of audits on voluntary compliance, whether the taxpayer understood why his or her tax was adjusted, or whether the examination concluded in the right result for the taxpayer—*i.e.*, what happens when a taxpayer appeals the results of the exam?²⁰

While the IRS measures field examination customer satisfaction, it does not separately survey office exam customer satisfaction. Further, while the field examination customer satisfaction survey may also capture taxpayers who underwent office examination, a customer satisfaction survey is not effective in achieving a broad picture of taxpayer satisfaction with the field examination process as the response rate is too low to extrapolate to the entire population.²¹ The IRS should not combine field and office exam taxpayer satisfaction into one survey; instead, it should break out taxpayer satisfaction by type of

14 See Brian Erard, Matthias Kasper, Erich Kirchler, and Jerome Olsen, Research Study: *What Influence do IRS Audits Have on Taxpayer Attitudes and Perceptions? Evidence from a National Survey*, *infra*.

15 *Id.*

16 *Id.*

17 *Id.*

18 *Id.*

19 SB/SE, *2nd Quarter 2018 Business Performance Review* 13. IRM Exhibit 4.2.8-1, *Quality Attributes Rated by Field and Office Exam National Quality Reviewers* (Mar. 5, 2018).

20 IRS response to TAS information request (Oct. 15, 2018). TAS understands that SB/SE Research will be working with the Campus Correspondence Audit function determining to what extent it is feasible to assess the impact they have on voluntary compliance. SB/SE intends to look at recent audit projects by industry and geographic region, including the extent to which the addition of outreach or education could magnify any impact of those examinations on voluntary compliance—assuming that outreach or education information is available in a timely manner to meet deliverable timeframes. TAS looks forward to the results of this project. IRS response to TAS fact check (Dec. 13, 2018).

21 IRS, *SB/SE Field Exam Mail Customer Satisfaction Report Survey Year 2017* (Aug. 2018). SB/SE did not receive enough responses to this survey to extrapolate the results to the larger population.

The IRS gets what it measures. If it does not measure how the exam process impacts future compliance, and it does not measure the quality of an exam to at a minimum include educating the taxpayer, it cannot hope to achieve these outcomes.

exam to allow the IRS to use the data it obtains to improve and refine the office examination program. However, the IRS also combines office and field exam into one category when it reports on the results of examination in the IRS Data Book.²²

The IRS could benefit from studying the future compliance of taxpayers subject to audit. Tracking future compliance, with an emphasis on type of audit performed, core issues examined, taxpayer type, and other characteristics, including the number and nature of interactions between the IRS auditor and the taxpayer, would help the IRS refine its audit strategy and use its audit resources more effectively to promote future compliance.

The mission of SB/SE Examination is to “provide Small Business and Self-Employed (SB/SE) taxpayers top quality service by helping them understand and meet tax responsibilities and by applying the tax law with integrity and fairness.”²³ Underlying this mission statement is a key element that states the goal of “educating and informing taxpayers so they understand what they must do to comply with the law.” Educating and informing taxpayers about how to achieve compliance and remain compliant in the future should be a primary goal of face-to-face interactions with taxpayers. However, nowhere in the quality review attributes of office exams does the IRS measure whether the employee educated the taxpayer and provided the taxpayer with information the taxpayer needs to be compliant in the future.²⁴

Further, the SB/SE office examination program does not track the results of appealed exams.²⁵ Failing to do so misses an opportunity to understand if the exam process could be improved so that fewer taxpayers feel the need to appeal the results of the initial exam or to offer training if similar issues are consistently being conceded or settled on appeal.

Again, the IRS gets what it measures.²⁶ If it does not measure, as discussed above, how the exam process impacts future compliance, and it does not measure the quality of an exam to at least include educating the taxpayer, it cannot hope to achieve these outcomes.

22 IRS, *2017 Data Book* (Mar. 2018).

23 IRM 1.1.16.3 (Nov. 16, 2018).

24 IRM 4.2.8 Exhibit 4.2.8-1, *Quality Attributes Rated by Field and Office Exam National Quality Reviewers* (Mar. 5, 2018). See also IRM 21.20.1-5, *EQRS/NQRS Attributes* (Oct. 22, 2018).

25 IRS response to TAS information request (Oct. 15, 2018).

26 National Taxpayer Advocate 2017 Annual Report to Congress 93-106.

The Scope of the Office Exam Program May Limit Its Impact and Introduce Bias Into the Selection Process

Office Exams Are Geographically Limited

Office exams are generally scheduled at the office closest to the taxpayer's residence, if the office has the appropriate examination personnel on site.²⁷ This constraint immediately limits which taxpayers may ever be selected for office exam. Currently, taxpayers in Alaska, Delaware, Montana, North Dakota, South Dakota, or Wyoming, where there are no TCOs conducting office exams, will never be audited via office exam.²⁸ Whereas taxpayers who live in Virginia (2 TCOs), North Carolina (7 TCOs), or Michigan (8 TCOs) may have a much lower chance of being audited via office exam versus taxpayers who live in Texas (59 TCOs), New York (62 TCOs), or Florida (50 TCOs).²⁹ Further, within the states that do have TCOs conducting office exams, the number of office exam locations have decreased from 241 to 175 (a 27 percent decrease) between 2011 and 2018.³⁰

27 IRM 4.10.2.9.2(2) (Feb. 11, 2016).

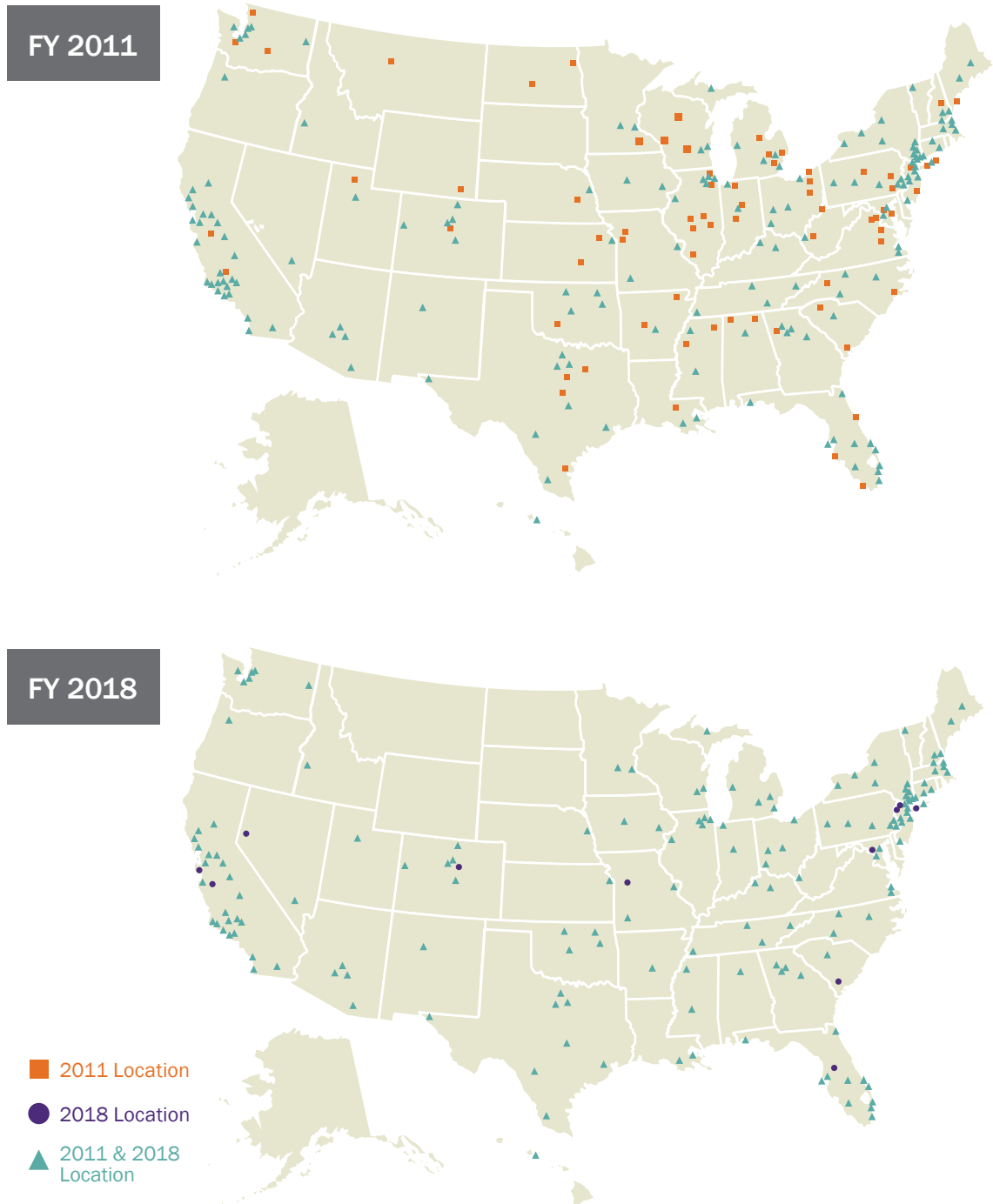
28 IRS response to TAS information request (Oct. 15, 2018).

29 *Id.*

30 *Id.*

FIGURE 1.10.1³¹

**Small Business/Self-Employed Tax Compliance Officer Locations
Fiscal Years 2011 and 2018**



31 IRS response to TAS information request (Oct. 15, 2018).

Selecting taxpayers for office exam based on where TCOs are located introduces selection bias into the office exam process and impacts the *right to quality service* and the *right to a fair and just tax system*. Such a process will also necessarily impact the type of businesses that are selected for office exam due to lack of TCOs in certain areas or make it more likely that businesses located in an area with a concentration of TCOs will be subject to office exam. Selecting in this manner also cuts the other way—an office exam gives the taxpayer an opportunity to interact in person with the IRS, and office exams have generally better outcomes for taxpayers than correspondence exams, such as lower default rates and higher agreed-to rates, so taxpayers selected for other types of exams due to the lack of nearby TCOs may be worse off than other taxpayers.³²

Office Exams Are Limited by Topic

SB/SE audits business tax returns. Classifiers sort potential returns for audit between Revenue Agents (RAs) (for field exam) and TCOs. The time planned for an audit by TCOs is substantially less than for an RA, so TCOs address less complicated issues.³³ The Internal Revenue Manual lists examples of issues for office exam:

Dependency exemptions; income from tips, pensions, annuities, rents, fellowships, scholarships, royalties, and income not subject to withholding; deductions for business related expenses; deductions for bad debts; determinations of basis of property; deductions for education expenses; capital gain versus ordinary income determinations; complex miscellaneous itemized deductions such as casualty and theft losses where determinations of fair market value are required; Schedule E basis and passive activity issues for flow-through losses; and deductions for employee business expenses such as travel and entertainment.³⁴

However, the IRS notes that is only an illustrative list, provides a checklist guide of additional items to consider, and leaves the classification of the exam up to the judgment of the classifier.³⁵

Since office exams have a higher agreed-to rate than correspondence exams, they can serve as a more effective means to get to the right answer for the taxpayer, as well as educating him or her about future compliance. The IRS could test-pilot programs for office exams in areas, such as charitable contributions, and track customer satisfaction, exam results, and future compliance of those taxpayers compared to taxpayers audited via correspondence exams to determine if office exam is more effective.

32 IRS, CDW, AIMS FY 2011 to 2018 (Dec. 2018). For a discussion of the National Taxpayer Advocate's concerns regarding other types of exams see Most Serious Problem: *Correspondence Examination: The IRS's Correspondence Examination Procedures Burden Taxpayers and are not Effective in Educating the Taxpayer and Promoting Future Voluntary Compliance*, *supra*; Most Serious Problem: *Field Examination: The IRS's Field Examination Program Burdens Taxpayers and Yields High No-Change Rates, Which Waste IRS Resources and May Discourage Voluntary Compliance*, *supra*.

33 IRM 4.1.5.3.2.6 (Oct. 20, 2017).

34 *Id.*

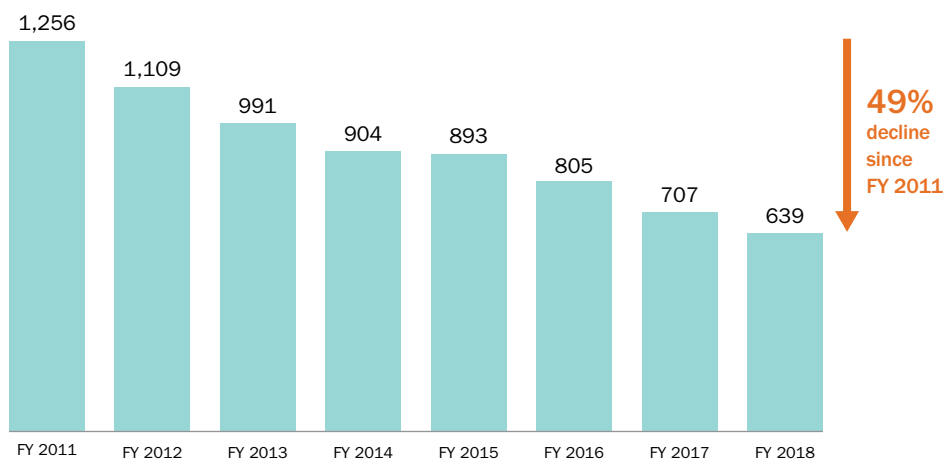
35 *Id.* Further indicated in the provided table for consideration are that Forms 1120s with assets under \$250,000 with no balance sheet issues, no priority issues, no acquisitions, mergers, reorganizations, no recapitalizations, liquidations, no stock redemptions, no IRC 351 stock transfer, and no final returns can be assigned to TCOs; Forms 1040s with Schedule C/F gross receipts and/or costs of goods sold between \$200,000 and \$750,000 if the return has multiple Schedule C/Fs and other indicators or less than \$200,000 if other indicators are not present; individuals receiving wages from closely held C corporations and claiming employee business expenses/Schedule C expenses; gross receipts as a classified issue less than \$200,000; Schedule C/F with only non-gross receipts issues classified and total gross receipts less than \$500,000.

Office Exams Are Limited by Number of TCOs

The employees who conduct office exams have declined precipitously. In FY 2011, the IRS had 1,256 employees conducting office exams and, in FY 2018, only 639, a decrease of 49 percent in only seven years.³⁶

FIGURE 1.10.2, Number of Tax Compliance Auditors Conducting Office Audits, FY 2011 to FY 2018³⁷

Tax Compliance Auditors Conducting Office Audits, Fiscal Years 2011-2018



As discussed above, office exams are already limited geographically by employee location, an issue further exacerbated by the staggering decline in IRS employees conducting office exams. Of the remaining 175 locations across the country where TCOs conduct office exams, 32 percent of the offices have only one TCO.³⁸ In FY 2018, the IRS closed about 79,000 office exams, or 124 exams per examiner.³⁹

³⁶ IRS response to TAS research request (Oct. 15, 2018).

³⁷ *Id.*

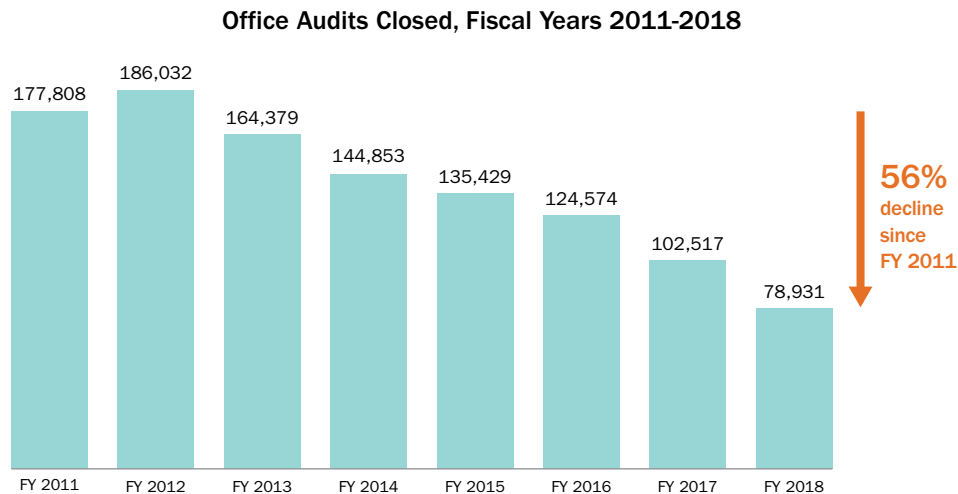
³⁸ *Id.* IRS response to TAS fact check (Dec. 13, 2018).

³⁹ *Id.*

Office Exams Have Significantly Declined

The number of office exams conducted by the IRS has declined since FY 2011 (with the exception of FY 2012). In FY 2011, the IRS closed almost 178,000 office exams, compared to about 79,000 in FY 2018, a nearly 56 percent decrease.⁴⁰

FIGURE 1.10.3, Number of Office Audits Closed, FY 2011 to FY 2018⁴¹



At the same time, dollars assessed from the office exam program have decreased only 28 percent from FY 2011 to FY 2018, suggesting that the IRS is doing a better job selecting returns for office exam.⁴² Dollars per return has actually increased, from \$6,666 in FY 2011 to \$10,815 in FY 2018, an increase of approximately 62 percent, further suggesting the IRS is selecting better returns for examination.⁴³

The constraints on office exam limit the likelihood of selection for an office exam based on many factors. This may impact the *right to a fair and just tax system*. Taxpayers who are not geographically proximate to an IRS office with office exam personnel are unlikely to ever be selected for an office exam versus those taxpayers who live nearby.

⁴⁰ IRS response to TAS information request (Oct. 15, 2018). IRS response to TAS fact check (Dec. 13, 2018).

⁴¹ *Id.*

⁴² *Id.*

⁴³ *Id.*

CONCLUSION

Promoting voluntary compliance is an important goal. However, the current IRS office exam program cannot show its progress toward this goal because of the way the program is designed and by SB/SE's failure to determine an actual impact on future voluntary compliance. Not only does the IRS not measure future compliance of taxpayers who undergo an audit, it neglects to track the results of its own audits that are appealed. Operating an examination program without significant analysis of the results of the program beyond closure rates and closure results is a missed opportunity for the IRS to improve the process and promote future voluntary compliance.

RECOMMENDATIONS

The National Taxpayer Advocate recommends that the IRS:

1. Develop measures to track the downstream compliance of audited taxpayers by type of exam.
2. Track results of audits that are appealed by the taxpayer by type of exam.
3. Add educating the taxpayer on future compliance to the quality attributes of an exam for field and office exam.
4. Increase the number of TCOs and put them in more locations throughout the United States.
5. Expand the issues covered by office exam, develop pilot programs for office exams for issues such as charitable contributions, and track the customer satisfaction for these pilots versus taxpayers audited via correspondence exam for the same issues.