

**MSP
#4****AUDIT RATES: The IRS Is Conducting Significant Types and Amounts of Compliance Activities That It Does Not Deem to Be Traditional Audits, Thereby Underreporting the Extent of Its Compliance Activity and Return on Investment, and Circumventing Taxpayer Protections****RESPONSIBLE OFFICIALS**

Kirsten Wielobob, Deputy Commissioner, Services and Enforcement

Kenneth Corbin, Commissioner, Wage and Investment Division

Mary Beth Murphy, Commissioner, Small Business/Self-Employed Division

Doug O'Donnell, Commissioner, Large Business and International Division

Sunita Lough, Commissioner, Tax Exempt and Government Entities Division

TAXPAYER RIGHTS IMPACTED¹

- *The Right to Challenge the IRS's Position and Be Heard*
- *The Right to Appeal an IRS Decision in an Independent Forum*
- *The Right to Finality*
- *The Right to a Fair and Just Tax System*

¹ See Taxpayer Bill of Rights (TBOR), www.TaxpayerAdvocate.irs.gov/taxpayer-rights. The rights contained in the TBOR are now listed in the Internal Revenue Code (IRC). See Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, Div. Q, Title IV, § 401(a) (2015) (codified at IRC § 7803(a)(3)).

DEFINITION OF PROBLEM

The National Taxpayer Advocate has previously written about the issue of “real” vs “unreal” audits.² Under Internal Revenue Code (IRC) § 7602(a)(1), the IRS has the authority to examine any books, papers, records, or other data that may be relevant to ascertain the correctness of any return.³ This type of examination can be referred to as a traditional or “real” audit. However, the IRS interprets this IRC provision narrowly and takes the position that a host of taxpayer compliance contacts through programs and procedures such as math error corrections, Automated Underreporter (AUR), identity and wage verification, and Automated Substitute for Return (ASFR) are not classified as “real” audits.⁴ Yet these contacts, or “unreal” audits, where taxpayers must provide documentation or information to the IRS, comprise the majority of compliance contacts and eclipse “real” audit figures.⁵ And to taxpayers, these “unreal” audits may feel very much like a “real” examination, in particular a correspondence examination.⁶ This distinction between “real” and “unreal” audits has real-world consequences that impact taxpayer rights, including *the right to challenge the IRS’s position and be heard, the right to appeal an IRS decision in an independent forum, the right to finality, and the right to a fair and just tax system.*

2 See National Taxpayer Advocate 2016 Annual Report to Congress 27-29 (Special Focus: *IRS Future State: The National Taxpayer Advocate’s Vision for a Taxpayer-Centric 21st Century Tax Administration*); National Taxpayer Advocate 2011 Annual Report to Congress 24 (Introduction to Revenue Protection Issues: *As the IRS Relies More Heavily on Automation to Strengthen Enforcement, There is Increased Risk It Will Assume Taxpayers Are Cheating, Confuse Taxpayers About Their Rights, and Sidestep Longstanding Taxpayer Protections*); Nina Olson, *What’s an Audit, Anyway?*, NATIONAL TAXPAYER ADVOCATE BLOG (Jan. 25, 2012), <https://taxpayeradvocate.irs.gov/news/what’s-an-audit-anyway>. In its response to our standard request that the IRS verify the data cited in this discussion, the IRS objected to our use of the terms “real audits” and “unreal audits” and requested that we not use them. Its response stated:

An audit is defined per the Code as an examination of books and records, and is subject to limitations (*i.e.*, only one inspection of a taxpayer’s books shall be made each taxable year — unless there is evidence of fraud, malfeasance, etc. [See IRC §] 7605(b), Policy Statement P-4-3). Other contacts with a taxpayer (*e.g.*, to verify or adjust a discrepancy between the taxpayer’s return and third-party information returns) do not meet the definition of an inspection of the books and records within the meaning of [section] 7605(b) of the Code. Taxpayers may not always make such a distinction. However, the IRS must follow the law and properly distinguish an audit versus a contact. *The terms “real” and “unreal” are inaccurate, misleading and a mischaracterization of IRS’ interactions with taxpayers* [emphasis added].

The National Taxpayer Advocate disagrees and believes the use of the terms “real audits” and “unreal audits” are appropriate for purposes of this discussion. As the IRS notes, taxpayers generally do not make a distinction. Receipt of a notice stating that the IRS will increase the taxpayer’s liability unless the taxpayer responds and provides acceptable documentation to support his or her return position feels like an audit, regardless of whether it is technically an audit within the definition of IRC § 7605(b), a math-error adjustment, or a document-matching adjustment made by the IRS’s Automated Underreporter (AUR) program. Moreover, as this Most Serious Problem demonstrates, the National Taxpayer Advocate believes the IRS’s reporting of statistics, which focus heavily on the audit rate, understates the true level of IRS compliance activity, which includes “real” and “unreal” audits.

3 See Most Litigated Issue: *Summons Enforcement Under IRC §§ 7602, 7604, 7609, infra.*

4 See Rev. Proc. 2005-32, § 4.03, 2005-23 I.R.B. 1206.

5 See National Taxpayer Advocate 2016 Annual Report to Congress 27-28 (Special Focus: *IRS Future State: The National Taxpayer Advocate’s Vision for a Taxpayer-Centric 21st Century Tax Administration*). In addition to the “unreal” audits mentioned here, other IRS functions may conduct work that may be similar to an “unreal” audit. For example, in addition to “real” examinations, the Tax Exempt and Government Entities (TE/GE) Exempt Organizations function conducts compliance checks “to determine whether an organization (*i.e.*, taxpayer) is adhering to recordkeeping and information reporting requirements.” When TE/GE conducts a compliance check, the taxpayer is contacted and may be asked to submit information. Although the taxpayer is not required to respond to a compliance check, TE/GE may ultimately select the case (whether the taxpayer responds or not) for a “real” audit where appeal rights would be available. However, to the taxpayer, the pre-audit compliance contact may feel very similar to an audit in that the IRS is contacting them regarding information filed on a form or return. See IRS, *Tax Exempt and Government Entities FY 2018 Work Plan 8* (Sept. 28, 2017), https://www.irs.gov/pub/irs-tege/tege_fy2018_work_plan.pdf; IRS, *Tax Exempt and Government Entities Business Performance Review FY 2017: Second Quarter 17*; See also IRS Pub. 4386, *Compliance Checks: Examination, Audit or Compliance Check?* (Apr. 2006); Internal Revenue Manual (IRM) 4.75.9.2.2, *Compliance Check Workstreams* (Aug. 9, 2016).

6 See, *e.g.*, *Effectively Representing Your Client Before the IRS: A Practical Manual for the Tax Practitioner with Sample Correspondence and Forms 3-9* (Keith Fogg ed., 2015) (noting that “to millions of taxpayers, receipt of a notice from one of the Service’s information-matching return programs feels very much like an examination or investigation”). A description of the three different types of IRS examinations is provided below.

The IRS’s “Future State” Initiative calls for the increased use of these types of “unreal” audit programs, which will undoubtedly impact many more taxpayers.⁷ It is therefore crucial for the IRS to reevaluate and revise its current guidance about what constitutes an audit, through the lens of the Taxpayer Bill of Rights.

The National Taxpayer Advocate is concerned that the narrow definition of “real” audits:

- Causes the IRS to publicly report misleading information. For instance, the IRS only reports “real” audit statistics, which skews the audit rate and understates the IRS’s actual level of compliance contacts with taxpayers. It also causes the IRS to not completely and accurately report its return on investment (ROI) for compliance activities, as the IRS does not include all “unreal” audit programs in its ROI calculations;
- Limits a taxpayer’s ability to appeal to the IRS Office of Appeals (“Appeals”), as a taxpayer who disagrees with an “unreal” audit’s proposed assessment generally receives a statutory notice of deficiency, without the opportunity to seek an administrative review with Appeals to resolve the issue; and
- Circumvents statutory taxpayer protections from unnecessary audits as, under the IRS’s current position, taxpayers that are subjected to an “unreal” audit may face a “real” audit and other “unreal” audits at a later time.⁸

ANALYSIS OF PROBLEM

Background

Traditional or “Real” Audits

As noted above, under IRC § 7602(a)(1) the IRS has the authority to examine any books, papers, records, or other data that may be relevant to ascertain the correctness of any return.⁹ The IRS conducts three types of traditional examinations or “real” audits: correspondence, field, and office.¹⁰ A correspondence exam is conducted by mail for a single tax year and generally involves no more than a few issues that the IRS believes can be resolved by producing documents.¹¹ A field exam deals with more complex issues and involves a face-to-face meeting between the taxpayer and an IRS revenue agent, at the taxpayer’s home or place of business.¹² Finally, an office audit is conducted at a local IRS office

7 See, e.g., IRS, *Exploring the IRS Future State: Balancing Taxpayer Needs with IRS Budget and Resource Constraints*, adapted from ABA National Institute on Tax Controversy, Las Vegas, NV 16 (Dec. 9, 2016), https://www.irs.gov/pub/newsroom/future_state_aba.pdf (noting that one of the focus areas of Small Business/Self Employed (SB/SE) and Wage & Investment (W&I) is issue identification and filing resolution to “maximize prerefund automatic issue identification and self-correction”).

8 See IRC §7605(b). This section provides “no taxpayer shall be subjected to unnecessary examination or investigations, and only one inspection of a taxpayer’s books of account shall be made for each taxable year unless the taxpayer requests otherwise or unless the Secretary, after investigation, notifies the taxpayer in writing that an additional inspection is necessary.”

9 See Most Litigated Issue: *Summons Enforcement Under IRC §§ 7602, 7604, 7609, infra*.

10 Part 4 of the IRM discusses the IRS’s examination process. For a good discussion of the different types of IRS examinations, see *Effectively Representing Your Client Before the IRS: A Practical Manual for the Tax Practitioner with Sample Correspondence and Forms 3-9, 10* (Keith Fogg ed., 2015). See also National Taxpayer Advocate 2011 Annual Report to Congress vol. 2, 71 (discussing the differences between field and correspondence audits).

11 See National Taxpayer Advocate 2011 Annual Report to Congress vol. 2, 71 (discussing the differences between field and correspondence audits).

12 See IRM 4.10.3.3.2, *Where to Conduct Interviews* (Feb. 26, 2016).

and generally involves issues that are more complex than those found in correspondence exams but less complex than field ones.¹³

Typically, in the “real” audit context, before issuing a statutory notice of deficiency, which enables a taxpayer to petition the Tax Court, the IRS will issue a 30-day letter to the taxpayer offering the opportunity to request an administrative appeal with IRS Appeals.¹⁴ In addition, under IRC § 7605(b), taxpayers are protected from unnecessary examinations and the IRS is generally allowed to conduct only one inspection of a taxpayer’s books of account for each taxable year.¹⁵

Other Compliance Contacts or “Unreal” Audits

The IRS also conducts a host of other compliance contacts with taxpayers, which can be categorized as “unreal” audits, and often solely rely on matching third-party documentation against the taxpayer’s return.¹⁶ These contacts include:

- **Math or Clerical Error** – Congress has given the IRS authority to circumvent normal deficiency procedures in certain circumstances. IRC § 6213(b) authorizes the IRS to make a summary assessment of tax due where that addition is the result of a mathematical or clerical error on a return. To make this summary assessment, the IRS must explain the error to the taxpayer.¹⁷ The taxpayer has 60 days from the date of the notice to request that the IRS abate the tax.¹⁸ The IRS cannot begin to collect the tax due until the taxpayer has agreed to it or until the 60 days have passed.¹⁹ If the taxpayer requests the tax be abated, the IRS must first use the deficiency procedures under IRC § 6212 to increase the tax shown on the return.²⁰ It is also the only way for the taxpayer to preserve the right to challenge the adjustment in the Tax Court — the only prepayment judicial forum.²¹

13 See IRM 4.10.3.3.2, *Where to Conduct Interviews* (Feb. 26, 2016).

14 See IRS Publication 3498-A, *The Examination Process (Audits by Mail)* (Jan. 2014), available at <http://www.irs.gov/pub/irs-pdf/p3498a.pdf>. For times for requesting appeals conferences, see IRM 4.19.13.14.2, *Transfer to Appeals* (Jan. 1, 2016).

15 IRC § 7605(b) provides “no taxpayer shall be subjected to unnecessary examination or investigations, and only one inspection of a taxpayer’s books of account shall be made for each taxable year unless the taxpayer requests otherwise or unless the Secretary, after investigation, notifies the taxpayer in writing that an additional inspection is necessary.” See also Treas. Reg. § 601.105(j) (limiting the IRS’s ability to reopen a case closed after examination to situations such those where there is evidence of fraud).

16 In the case of an information return that turned out to be inaccurate, courts have held that “the Commissioner would not be able to choose to rely solely upon the naked assertion that the taxpayer received a certain amount of unreported income for the tax period in question.” See *Portillo v. Comm’r*, 932 F.2d 1128 (5th Cir. 1991).

17 IRC § 6213(b)(1).

18 IRC § 6213(b)(2)(A).

19 IRC § 6213(b)(2)(B).

20 IRC § 6213(b)(2)(A).

21 IRC § 6213(b)(1). For a discussion of the National Taxpayer Advocate’s concerns regarding the IRS’s math error authority, see National Taxpayer Advocate 2015 Annual Report to Congress 329-39 (Legislative Recommendation: *Math Error Authority: Authorize the IRS to Summarily Assess Math and “Correctable” Errors Only in Appropriate Circumstances*); National Taxpayer Advocate 2014 Annual Report to Congress, 163-71 (Most Serious Problem: *Math Error Notices: The IRS Does Not Clearly Explain Math Error Adjustments, Making It Difficult for Taxpayers to Understand and Exercise Their Rights*); National Taxpayer Advocate 2011 Annual Report to Congress vol. 2, 116-20 (*Math Errors Committed on Individual Tax Returns – A Review of Math Errors Issued on Claimed Dependents*). See also, Nina E. Olson, *Why Correctible Error Authority Raises Significant Taxpayer Rights Concerns – Part 1*, NATIONAL TAXPAYER ADVOCATE BLOG (Aug. 9, 2017), <https://taxpayeradvocate.irs.gov/news/why-correctible-authority-error-raises-significant-taxpayer-rights-concerns-part-1>; Nina Olson, *Correctible Error Authority Part 2: Why Correctible Error Authority Creates More Problems Than It Resolves*, NATIONAL TAXPAYER ADVOCATE BLOG (Aug. 16, 2017), <https://taxpayeradvocate.irs.gov/news/correctible-error-authority-part-2-why-correctible-error-authority-creates-more-problems-than-it-resolves>; Nathan J. Richman, *Expanding Math Error Authority Could Worsen Two Tax Systems Issues*, TAX NOTES TODAY (July 5, 2017).

- **Automated Underreporter (AUR)** – The IRS’s AUR program uses third party (*e.g.*, employers, banks, or brokers) documents submitted to the IRS. The IRS matches amounts reported on tax returns with the information returns.²² This computer matching begins after the original return due date and is not a real-time process. The IRS will send the taxpayer a notice either notifying them of this adjustment or requesting additional information. If the taxpayer does not respond to these notices, the IRS will issue a statutory notice of deficiency.²³
- **IRS Programs Used to Stop Identity Theft and Refund Fraud**²⁴ – The return integrity program, a process critical to the IRS’s strategy to address identity theft and detect and prevent improper fraudulent refunds, is complex and multifaceted.²⁵ The Return Integrity & Compliance Services (RICS) Return Integrity Operations (RIO) — a part of the Wage & Investment (W&I) Division — uses filters, rules, data mining models, and manual reviews to identify potentially false returns, usually through wages or withholding reported on the returns, to stop fraudulent refunds before the IRS issues them.²⁶ If one of these systems flags a return as potentially fraudulent, the return goes through the Taxpayer Protection Program (TPP), which verifies the identity of the taxpayer, and/or the Income Wage Verification (IWV) program, which verifies that the taxpayer’s wages and withholding are accurate, for further scrutiny.²⁷
- **Automated Substitute for Return (ASFR)** – ASFR is an IRS program for enforcing filing compliance by taxpayers who have not filed individual tax returns, but have incurred a “significant” tax liability.²⁸ The program estimates the liability by computing tax, penalties, and interest based upon information reported to the IRS by third parties.²⁹ When a taxpayer with reported income is delinquent in filing a return, the IRS attempts to secure the return through correspondence. If the attempt is unsuccessful, the IRS is authorized by IRC § 6020(b) to

22 Some of the third-party forms used to match taxpayer data include Forms W-2 and Forms 1099 for miscellaneous, brokerage, interest, dividend, and cancellation of debt income.

23 IRM 4.19.2.2, *Overview* (Oct. 4, 2016).

24 For more information about these programs, see Most Serious Problem: *Fraud Detection: The IRS Has Made Improvements to Its Fraud Detection Systems, But a Significant Number of Legitimate Taxpayers Are Still Being Improperly Selected By These Systems, Resulting in Refund Delays*, *infra*; Most Serious Problem: *Identity Theft: As Tax-Related Identity Theft Schemes Evolve, the IRS Must Continually Assess and Modify Its Victim Assistance Procedures*, *infra*.

25 IRM 25.25.1.1, *Program Scope and Objectives* (Oct. 4, 2017).

26 IRM 25.25.6.1, *Program Scope and Objectives* (July 14, 2017). See also IRM 25.25.2.1(1), *Purpose and Program Goals* (Mar. 29, 2017). The IRS electronically screens tax returns using three independent systems: the Dependent Database (DDb), the Return Review Program (RRP), and the Electronic Fraud Detection System (EFDS).

27 See Most Serious Problem: *Fraud Detection: The IRS Has Made Improvements to Its Fraud Detection Systems, But a Significant Number of Legitimate Taxpayers Are Still Being Improperly Selected By These Systems, Resulting in Refund Delays*, *infra*; National Taxpayer Advocate 2016 Annual Report to Congress, 149-60, (Most Serious Problem: *Fraud Detection: The IRS’s Failure to Establish Goals to Reduce High False Positive Rates for Its Fraud Detection Programs Increases Taxpayer Burden and Compromises Taxpayer Rights*). See also National Taxpayer Advocate 2015 Annual Report to Congress, 45-55, 180-87; National Taxpayer Advocate 2014 Annual Report to Congress vol. 2, 44-90; National Taxpayer Advocate 2013 Annual Report to Congress 75-83; National Taxpayer Advocate 2012 Annual Report to Congress 42-67, 95-110; National Taxpayer Advocate 2011 Annual Report to Congress 48-73; National Taxpayer Advocate 2009 Annual Report to Congress 307-17; National Taxpayer Advocate 2008 Annual Report to Congress 79-94; National Taxpayer Advocate 2007 Annual Report to Congress 96-115; National Taxpayer Advocate 2005 Annual Report to Congress 25-54, 180-91; National Taxpayer Advocate 2004 Annual Report to Congress 133-36; and National Taxpayer Advocate 2003 Annual Report to Congress 175-81.

28 IRM 5.18.1.2, *Automated Substitute for Return (ASFR) Program Overview* (Apr. 6, 2016). To meet ASFR processing criteria, the proposed tax liability must meet or exceed a predetermined dollar threshold established by the IRS for the ASFR program.

29 *Id.* The IRS can use information returns (*e.g.*, Forms W-2 and 1099) filed by employers, banks, and other third parties to report various types of payments to individuals. These payments include wages, interest, and dividends, as well as payments to self-employed taxpayers for services rendered. The IRS collects and maintains this information through the Information Return Program (IRP).

prepare a substitute return for the taxpayer.³⁰ However, due to resource constraints, the IRS has significantly reduced its usage of the ASFR program.³¹

Although “unreal” audits may feel much like “real” audits to taxpayers, they do not carry the same protections as “real” ones. In the “unreal” audit context, taxpayers generally do not have the opportunity to seek administrative review with Appeals prior to the IRS issuing a statutory notice of deficiency.³² For math error notices, taxpayers must respond within 60 days and request an abatement of the tax or the IRS can summarily assess the tax without resorting to deficiency procedures.³³

In addition, “unreal” audits do not carry the same IRC § 7605(b) protections against repeat examinations as “real” audits. Although Treasury regulations provide only one example of an inspection of a taxpayer’s books and records that is not an examination within the meaning of IRC §7605(b),³⁴ the IRS takes a more expansive view. In Revenue Procedure 2005-32, the IRS lists four broad categories of taxpayer contacts or other actions that it does not consider to be examinations and inspections.³⁵ Explicitly included in these categories are math error, AUR, and ASFR “unreal” audit contacts.³⁶ Therefore, a taxpayer subject to an “unreal” audit may be subject to a “real” audit at a later time.

The National Taxpayer Advocate has previously noted in the Affordable Care Act (ACA) context how there may be virtually no distinction between how the IRS conducts an “unreal” versus a “real” audit. For example, when the IRS notices information reported by the Marketplace regarding a taxpayer’s Advanced Premium Tax Credit (APTC) does not match information regarding the credit on the taxpayer’s return, or the APTC was not reconciled on Form 8962, *Premium Tax Credit (PTC)*, the IRS will delay processing of the return and issue Letter 12C requesting a corrected Form 8962, or Form 1095-A, *Health Insurance Marketplace Statement*, to support the credit and reconcile the APTC. Depending on the type of PTC discrepancy, the IRS refers the return either to Examination to work as a traditional audit or to the Automated Questionable Credit (AQC) program for a similar “audit” process. If referred to AQC, Letter 4800C, *Questionable Credit 30 Day Contact Letter*, which proposes an adjustment and requests Form 1095-A, will be sent to the taxpayer. The letter states, “This is not an audit. Your return may be examined in the future;” however, the AQC process and the documentation

30 IRC § 6020(b) provides: “(b) Execution of return by Secretary. — (1) Authority of Secretary to execute return. — If any person fails to make any return required by any internal revenue law or regulation made thereunder at the time prescribed therefor, or makes, willfully or otherwise, a false or fraudulent return, the Secretary shall make such return from his own knowledge and from such information as he can obtain through testimony or otherwise. (2) Status of returns. — Any return so made and subscribed by the Secretary shall be prima facie good and sufficient for all legal purposes.” IRM 5.18.1.1.2, Authority (Dec. 13, 2017).

31 Treasury Inspector General for Tax Administration (TIGTA), Ref. No. 2017-30-078, *A Significantly Reduced Automated Substitute for Return Program Negatively Affected Collection and Filing Compliance* (Sept. 2017); The reduction in ASFR cases can be seen in Figures 1.4.1, 1.4.2, and 1.4.3 below. See also National Taxpayer Advocate 2015 Annual Report to Congress 188-95 (Most Serious Problem: *Current Selection Criteria for Cases in the ASFR Program Create Rework and Impose Undue Taxpayer Burden*).

32 As described below, in an AUR case, if a taxpayer makes a request for Appeals review with less than 365 days left in the period of limitations on assessment then this request will be denied. However, if there are more than 365 days left in the period of limitations on assessment, a taxpayer may request Appeals review an AUR case. However, it appears that taxpayers are not formally informed of this Appeals opportunity but would have to affirmatively make such a request. See IRM 4.19.3.21.1.8(1), *Appeals* (Aug. 22, 2017). This approach violates both the *right to be informed* and the *right to appeal an IRS decision in an independent forum*.

33 See IRC § 6213(b).

34 See Treas. Reg. § 301.7605-1(h) (providing that certain withholding agreements between the IRS and alien individuals are not examinations).

35 Rev. Proc. 2005-32, § 4.03, 2005-23 I.R.B. 1206.

36 See also IRS Chief Counsel Memorandum, *ASFR Questions Involving Subsequently Filed Delinquent Original Returns* (Mar. 29, 2005) (providing that IRS preparation of an ASFR is not considered an examination).

requirements imposed on the taxpayers under AQC are substantially similar to those in an examination. In fact, both the AQC and Exam request similar documentation for PTC verification.³⁷ Thus, there are situations where the IRS is essentially conducting a “real” audit under the guise of an “unreal” audit, thereby circumventing statutory protections against repeat examinations.

By Narrowly Defining “Real” Audits, the IRS Is Publicly Reporting Misleading Information Regarding Its Compliance Contacts With Taxpayers and Return on Investment

The IRS Does Not Include Unreal Audits in its Published Audit Rate Statistics

The IRS’s classification system, which distinguishes between “real” and “unreal” audits, results in the IRS publicly reporting misleading information regarding the extent of its compliance contacts with taxpayers. The IRS, in its annually-released Data Book, publishes a variety of statistics regarding its enforcement efforts, including examinations.³⁸ These Data Book figures show a consistent decline in the IRS’s audit rate over the last several years, which has been noted by the press and others.³⁹ However, the IRS’s audit rate figures only take into account “real” audits. Other compliance contacts, or “unreal” audits, are not included in the IRS’s audit calculations.⁴⁰

As shown in the Figures 1.4.1, 1.4.2, and 1.4.3, TAS performed an analysis of both “real” and “unreal” IRS audits of individuals for fiscal years (FYs) 2014 through 2016.

37 National Taxpayer Advocate 2015 Annual Report to Congress 173-76 (Most Serious Problem: *Affordable Care Act (ACA) – Individuals: The IRS Is Compromising Taxpayer Rights As It Continues to Administer the Premium Tax Credit and Individual Shared Responsibility Payment Provisions*); Automated Questionable Credit (AQC) requests “documentation proving premium payments, copies of insurance enrollment forms, invoices, or statements from the insurance providers that include the names of those covered by the benefits.” Exam requests “copies of insurance enrollment forms, invoices, or statements from your insurance providers.”

38 See, e.g., IRS Data Book 2016.

39 See, e.g., Kevin McCoy, *Your Odds of Facing an IRS Audit Are 1-in-143*, U.S.A. TODAY, (Mar. 6, 2017) <https://www.usatoday.com/story/money/2017/03/06/your-odds-facing-irs-audit-1-143/98808612/> (noting that IRS audit rates fell to a 14-year low in 2016); TIGTA, Ref. No. 2017-30-072, *Trends in Compliance Activities Through Fiscal Year 2016* 51 (Sept. 2017) (showing a decline in the audit rate for individual and business tax returns between fiscal years 2012 and 2016); See also IRS, *Prepared Remarks of John A. Koskinen Before the National Press Club* (Apr. 5, 2017) (Then Commissioner Koskinen noted the decline in the IRS’s audit rate and stated, “Last year, we audited about 1 million people. That may sound like a lot, but it’s less than one percent of individual returns filed. It’s also the lowest number of audits in more than a decade.”), <https://www.irs.gov/newsroom/prepared-remarks-of-john-a-koskinen-before-the-national-press-club-washington-dc-april-5-2017>.

40 See TIGTA, Ref. No. 2017-30-072, *Trends in Compliance Activities Through Fiscal Year 2016* 18 (Sept. 2017) (noting that “In addition to correspondence and face-to-face examinations, the IRS also uses several computer-matching and automated error-checking programs to verify the accuracy of tax returns. These routines often identify and recommend adjustments to tax liabilities. However, these adjustments are not included in the traditional examination coverage calculations and are not reported separately as enforcement efforts.”). In its Data Book, the IRS does provide some limited information regarding its AUR, ASFR, and math error programs. However, as noted, these programs are not included in the IRS’s audit rate calculations. See IRS Data Book 2016 at 35.

FIGURE 1.4.1, Real vs. Unreal Audits: FY 2014 Occurrences Compared to Returns Filed in Calendar Year 2013⁴¹

Adjusted Gross Income Category	FY 2014 Exams	Exam (Audit) Coverage Rate %	FY 2014 ASFR	FY 2014 AUR	FY 2014 Math Error	FY 2014 Taxpayer Protection Program	FY 2014 Wage Verification	Combined	Calendar Year 2013 Returns	Combined Coverage Rate %
No adjusted gross income	263,615	10.4%	190,941	13,559	33,549	127,291	251,440	837,579	2,534,533	33.0%
\$1 under \$25,000	458,310	0.8%		954,859	759,140	376,372	601,495	2,995,755	55,591,101	5.4%
\$25,000 under \$50,000	162,455	0.5%		1,109,790	505,006	88,941	200,301	2,017,617	33,478,934	6.0%
\$50,000 under \$75,000	92,650	0.5%		569,566	291,884	41,692	69,748	1,044,793	18,918,026	5.5%
\$75,000 under \$100,000	58,286	0.5%		359,315	181,699	22,884	34,423	645,930	12,052,040	5.4%
Subtotal - under \$100,000	1,035,316	0.8%	190,941	3,007,089	1,771,278	657,180	1,157,407	7,541,674	122,574,634	6.2%
\$100,000 under \$200,000	92,649	0.6%		603,650	238,184	29,927	52,980	1,003,331	15,449,869	6.5%
\$200,000 under \$500,000	64,930	1.6%		206,282	47,485	11,962	44,701	369,257	4,147,849	8.9%
\$500,000 under \$1,000,000	22,439	3.2%		38,965	6,562	3,087	26,054	95,399	697,262	13.7%
\$1,000,000 under \$5,000,000	18,937	5.5%		18,429	3,270	1,389	26,662	67,428	345,656	19.5%
\$5,000,000 under \$10,000,000	2,477	9.2%		1,129	321	112	3,945	7,834	26,832	29.2%
\$10,000,000 or more	2,505	14.2%		568	339	59	3,228	6,560	17,590	37.3%
Total	1,239,253	0.9%	190,941	3,876,112	2,067,439	703,716	1,314,977	9,091,483	143,259,692	6.3%

⁴¹ Data from the Automated Information Management System (AIMS), Individual Returns Transaction File (IRTF), Individual Master File (IMF), and Notice Delivery System from the Compliance Data Warehouse (CDW). The number of audits represent tax returns for which the IRS closed its audit in FY 2014. The statistics for returns secured through Automated Substitute for Return (ASFR) are from the IRS fiscal year (FY) 2014 Collection Activity Report No. 5000-139 (Oct. 9, 2014). Because ASFR returns are not filed by the taxpayer, no adjusted gross income (AGI) is associated with the return; however, these returns actually have a AGI (but unrecorded). Therefore, the combined coverage rate percentage for the no AGI category is somewhat overstated. The number of taxpayers receiving an Automated Underreporter (AUR) contact are those who received a CP 2000 or CP 2501 notice from the IRS in FY 2014. The combined coverage rate removes duplicates, so that a tax return is only counted once even if affected by two or more of these compliance programs in FY 2014. The coverage rate is computed by dividing by the number of individual income tax returns filed in each AGI category for Calendar Year 2013.

FIGURE 1.4.2, Real vs. Unreal Audits: FY 2015 Occurrences Compared to Returns Filed in Calendar Year 2014⁴²

Adjusted Gross Income Category	FY 2015 Exams	Exam (Audit) Coverage Rate %	FY 2015 ASFR	FY 2015 AUR	FY 2015 Math Error	FY 2015 Taxpayer Protection Program	FY 2015 Wage Verification	Combined	Calendar Year 2014 Returns	Combined Coverage Rate %
No adjusted gross income	257,217	10.5%	184,776	12,597	29,633	120,729	94,276	564,475	2,455,720	23.0%
\$1 under \$25,000	476,122	0.9%		936,516	705,570	1,019,482	467,285	3,202,112	55,345,582	5.8%
\$25,000 under \$50,000	150,849	0.4%		1,110,611	508,272	360,772	166,826	2,132,672	33,654,191	6.3%
\$50,000 under \$75,000	82,524	0.4%		563,110	272,084	161,619	71,445	1,070,202	19,114,016	5.6%
\$75,000 under \$100,000	54,557	0.4%		354,911	168,328	92,758	46,955	666,242	12,302,459	5.4%
Subtotal - under \$100,000	1,021,269	0.8%	184,776	2,977,745	1,683,887	1,755,360	846,787	7,635,703	122,871,968	6.2%
\$100,000 under \$200,000	91,018	0.6%		608,617	230,602	137,675	91,753	1,054,229	16,272,703	6.5%
\$200,000 under \$500,000	58,988	1.3%		213,372	52,063	65,329	74,213	407,059	4,503,701	9.0%
\$500,000 under \$1,000,000	22,842	3.2%		34,544	7,912	19,472	36,434	102,819	708,224	14.5%
\$1,000,000 under \$5,000,000	22,201	7.1%		12,656	3,262	10,652	31,173	65,478	311,420	21.0%
\$5,000,000 under \$10,000,000	3,457	16.4%		663	297	994	3,931	7,914	21,104	37.5%
\$10,000,000 or more	3,744	29.3%		338	288	620	2,743	6,007	12,766	47.1%
Total	1,223,519	0.8%	184,776	3,847,935	1,978,311	1,990,102	1,087,034	9,279,209	144,701,886	6.4%

42 Data from AIMS, IRTF, IMF, and Notice Delivery System from CDW. The number of audits represent tax returns for which the IRS closed its audit in FY 2015. The statistics for returns secured through ASFR are from the IRS FY 2015 Collection Activity Report No. 5000-139. Because ASFR returns are not filed by the taxpayer, no AGI is associated with the return; however, these returns actually have a AGI (but unrecorded). Therefore, the combined coverage rate percentage for the no AGI category is somewhat overstated. The number of taxpayers receiving an AUR contact are those who received a CP 2000 or CP 2501 notice from the IRS in FY 2015. The combined coverage rate removes duplicates, so that a tax return is only counted once even if affected by two or more of these compliance programs in FY 2015. The coverage rate is computed by dividing by the number of individual income tax returns filed in each AGI category for Calendar Year 2014.

FIGURE 1.4.3, Real vs. Unreal Audits: FY 2016 Occurrences Compared to Returns Filed in Calendar Year 2015⁴³

Adjusted Gross Income Category	FY 2016 Exams	Exam (Audit) Coverage Rate %	FY 2016 ASFR	FY 2016 AUR	FY 2016 Math Error	FY 2016 Taxpayer Protection Program	FY 2016 Wage Verification	Combined	Calendar Year 2015 Returns	Combined Coverage %
No adjusted gross income	151,639	6.3%	50,722	12,210	32,606	123,151	60,811	402,349	2,392,293	16.8%
\$1 under \$25,000	409,246	0.8%		771,410	681,795	1,182,997	313,754	3,157,201	54,347,216	5.8%
\$25,000 under \$50,000	156,209	0.5%		961,431	483,641	425,734	106,362	2,056,907	33,929,692	6.1%
\$50,000 under \$75,000	74,014	0.4%		498,649	257,347	184,367	45,817	1,023,476	19,389,871	5.3%
\$75,000 under \$100,000	60,343	0.5%		317,359	160,690	113,611	32,126	657,091	12,566,667	5.2%
Subtotal - under \$100,000	851,451	0.7%	50,722	2,561,059	1,616,079	2,029,860	558,870	7,297,024	122,625,739	6.0%
\$100,000 under \$200,000	99,155	0.6%		570,898	227,269	200,413	76,680	1,112,913	17,258,123	6.4%
\$200,000 under \$500,000	46,596	0.9%		208,363	53,183	110,113	78,921	451,177	4,985,176	9.1%
\$500,000 under \$1,000,000	15,258	1.9%		32,577	6,517	32,940	42,058	112,373	801,738	14.0%
\$1,000,000 under \$5,000,000	15,529	4.2%		12,327	3,000	20,069	37,899	76,985	365,701	21.1%
\$5,000,000 under \$10,000,000	2,518	9.6%		603	289	1,943	5,049	9,032	26,111	34.6%
\$10,000,000 or more	2,849	17.4%		318	297	1,471	3,554	7,470	16,390	45.6%
Total	1,033,356	0.7%	50,722	3,386,145	1,906,634	2,396,809	803,031	9,066,974	146,078,978	6.2%

⁴³ Data from AIMS, IRTF, IMF, and Notice Delivery System from CDW. The number of audits represent tax returns for which the IRS closed its audit in FY 2016. The statistics for returns secured through ASFR are from the IRS FY 2016 Collection Activity Report No. 5000-139 (Oct. 3, 2016). Because ASFR returns are not filed by the taxpayer, no AGI is associated with the return; however, these returns actually have a .AGI (but unrecorded). Therefore, the combined coverage rate percentage for the no AGI category is somewhat overstated. The number of taxpayers receiving an AUR contact are those who received a CP 2000 or CP 2501 notice from the IRS in FY 2016. The combined coverage rate removes duplicates, so that a tax return is only counted once even if affected by two or more of these compliance programs in FY 2016. The coverage rate is computed by dividing by the number of individual income tax returns filed in each AGI category for Calendar Year 2015.

As these figures show, the IRS's counting of only "real" audits in its public audit rate skews this rate and grossly understates the extent of its taxpayer compliance contacts. For example, in FY 2014, the IRS conducted "real" audits of over 1.2 million tax returns (an audit rate of 0.9 percent). However, the IRS conducted "unreal" audits of almost 8.2 million additional tax returns through its math error, AUR, identity and wage verification, and ASFR programs. When combining the IRS's "unreal" audits with its "real" ones, the coverage rate rose to 6.3 percent.

In FY 2015, the IRS conducted slightly fewer "real" audits than in FY 2014 and its reported audit rate declined to 0.8 percent. However, the IRS conducted over 900,000 more "unreal" audits than the prior year, with the total number of "unreal" audits reaching almost 9.1 million. Therefore, the IRS's combined coverage rate rose to 6.4 percent. In FY 2016, the IRS conducted fewer "real" audits than in FY 2015 and its audit rate slightly dipped to 0.7 percent. But again, the IRS conducted approximately 8.5 million "unreal" audits and the combined coverage rate was still over six percent. Thus, by reporting only its "real" audit activity, the IRS is masking the true extent of its compliance activities, which touch millions more tax returns each year. In addition, if the IRS would report the full extent of its compliance contacts with taxpayers, it might serve as a deterrent for those taxpayers who are noncompliant (or are considering noncompliance) due to the IRS's low "real" audit rate. Finally, a more accurate portrayal of the IRS's compliance activities would provide better information as to the level of resources needed for customer service, because audits, "real" or "unreal", often generate calls to the IRS.

In fiscal year 2014, the IRS conducted "real" audits of over 1.2 million tax returns (an audit rate of 0.9 percent). However, the IRS conducted "unreal" audits of almost 8.2 million additional tax returns through its math error, Automated Underreporter, identity and wage verification, and Automated Substitute for Return programs. When combining the IRS's "unreal" audits with its "real" ones, the coverage rate rose to 6.3 percent.

The IRS Does Not Calculate Its Return on Investment (ROI) for Certain "Unreal" Audit Categories

In addition to underreporting the extent of its actual compliance contacts with taxpayers, the IRS is also not fully transparent in reporting its ROI for all its "unreal" compliance contacts. The IRS provides annual ROI information to Congress regarding its major enforcement efforts as part of the budget process.⁴⁴ As expected, the IRS provides ROI information for its "real" audit activities (*i.e.*, correspondence, field, and office examinations).⁴⁵ The IRS also reports ROI for the "unreal" audit

44 See Department of the Treasury Internal Revenue Service, *Congressional Justification for Appropriations and Annual Performance Report and Plan FY 2018*, http://cfo.fin.irs.gov/SPB/BudgetFormulation/FY_2018/IRS_FY_2018_CJ.pdf. As noted in this report and as a matter of basic definition, return on investment (ROI) is calculated by dividing revenue by cost.

45 IRS response to TAS research request (Oct. 20, 2017); Department of the Treasury Internal Revenue Service, *Congressional Justification for Appropriations and Annual Performance Report and Plan FY 2018* 61, http://cfo.fin.irs.gov/SPB/BudgetFormulation/FY_2018/IRS_FY_2018_CJ.pdf.

categories of ASFR and AUR.⁴⁶ However, it does not report ROI for the “unreal” audit categories of math error, identity theft, and wage verification.⁴⁷ Therefore, the IRS is not providing a complete and accurate picture of its actual ROI for all compliance contacts with taxpayers.

“Unreal” Audits Have an Adverse Impact on Taxpayer Rights and Circumvent Statutory Protections That Are Present During “Real” Audits

“Unreal” Audits Foreclose Taxpayer Appeal Rights

As noted above, a hallmark of the “real” audit process is an opportunity for taxpayers to generally seek impartial Appeals review of an IRS proposed adjustment prior to receiving a statutory notice of deficiency.⁴⁸ Appeals can take a fresh look at a taxpayer’s case and consider settling it based on hazards of litigation, something that is not typically considered during an IRS examination.⁴⁹

To a taxpayer, “unreal” audits may look and feel similar to IRS correspondence examinations in that they are conducted by mail, may cover limited issues, and ask a taxpayer to respond or produce documents. However, unlike “real” audits, taxpayers do not have an opportunity to request Appeals review of an “unreal” audit case and have their documentation considered by an impartial third party prior to receiving a statutory notice of deficiency. The impact of no or limited appeal rights in “unreal audits” is as follows:

- The issue of appeal rights is most pronounced in math error cases, where the onus is on the taxpayer to respond to an IRS notice and request an abatement within 60 days.⁵⁰ If the taxpayer does not request an abatement within this time frame, he faces an IRS summary assessment and will not receive a statutory notice of deficiency, thereby losing the opportunity to go to Tax Court. The taxpayer’s only recourse would be to pay the tax, file a refund claim with the IRS, and litigate in federal refund forums. A taxpayer does not have the opportunity to seek Appeals review in math error cases. However, if the issue in the math error notice arose during a “real”

46 IRS response to TAS research request (Oct. 20, 2017). ASFR is included in the ROI for the IRS’s collection program while AUR ROI is reported as a separate category. Department of the Treasury Internal Revenue Service, *Congressional Justification for Appropriations and Annual Performance Report and Plan FY 2018* 61, http://cfo.fin.irs.gov/SPB/BudgetFormulation/FY_2018/IRS_FY_2018_CJ.pdf. The IRS classifies the revenue from its examination, ASFR, and AUR programs as “revenue protected.” IRS response to TAS research request (Oct. 20, 2017).

47 IRS response to TAS research request (Oct. 20, 2017). The IRS classifies the revenue from these three programs as “revenue protected.” It should be noted that a case from an “unreal” audit program in which ROI is not calculated (e.g., math error) could figure into an ROI calculation if it turns into a formal or “real” audit.

48 See IRS Publication 3498-A, *The Examination Process (Audits by Mail)* (Jan. 2014), <http://www.irs.gov/pub/irs-pdf/p3498a.pdf>. For times for requesting appeals conferences, see IRM 4.19.13.14.2, *Transfer to Appeals* (Jan. 1, 2016).

49 See IRM 8.6.4.1, *Fair and Impartial Settlements per Appeals Mission* (Oct. 26, 2007) (noting “A fair and impartial resolution is one which reflects on an issue-by-issue basis the probable result in event of litigation, or one which reflects mutual concessions for the purpose of settlement based on relative strength of the opposing positions where there is substantial uncertainty of the result in event of litigation.”).

50 For a discussion of the National Taxpayer Advocate’s concerns regarding the IRS’s math error authority, see National Taxpayer Advocate 2015 Annual Report to Congress 329-39 (Legislative Recommendation: *Math Error Authority: Authorize the IRS to Summarily Assess Math and “Correctable” Errors Only in Appropriate Circumstances*); National Taxpayer Advocate 2014 Annual Report to Congress, 163-71 (Most Serious Problem: *Math Error Notices: The IRS Does Not Clearly Explain Math Error Adjustments, Making It Difficult for Taxpayers to Understand and Exercise Their Rights*); National Taxpayer Advocate 2011 Annual Report to Congress vol. 2, 116-20 (*Math Errors Committed on Individual Tax Returns – A Review of Math Errors Issued on Claimed Dependents*). See also, Nina E. Olson, *Why Correctible Error Authority Raises Significant Taxpayer Rights Concerns – Part 1*, NATIONAL TAXPAYER ADVOCATE BLOG (Aug. 9, 2017), <https://taxpayeradvocate.irs.gov/news/why-correctible-authority-error-raises-significant-taxpayer-rights-concerns-part-1>; Nina E. Olson, *Correctible Error Authority Part 2: Why Correctible Error Authority Creates More Problems Than It Resolves*, NATIONAL TAXPAYER ADVOCATE BLOG (Aug. 16, 2017), <https://taxpayeradvocate.irs.gov/news/correctible-error-authority-part-2-why-correctible-error-authority-creates-more-problems-than-it-resolves>; Nathan J. Richman, *Expanding Math Error Authority Could Worsen Two Tax Systems Issues*, TAX NOTES TODAY (July 5, 2017).

The IRS plans, as part of its “Future State” Initiative, to enhance its use of these “unreal” audits, meaning that more and more taxpayers will be subject to these audit-like contacts where taxpayer rights are diminished or curtailed altogether.

audit, the taxpayer would generally receive a 30-day letter offering an opportunity to go to Appeals prior to petitioning the Tax Court.

- In an AUR case, the IRS may have received an erroneous Form W-2 or 1099 that triggered an AUR notice. In a “real” audit, a taxpayer would be able to challenge an erroneous form during the exam or in Appeals prior to the IRS issuing a statutory notice of deficiency. However, in an AUR case, taxpayers’ opportunity to request Appeals review prior to the issuance of a statutory notice of deficiency is limited.⁵¹
- In wage and identity verification program cases, which occur in a pre-refund environment, a taxpayer may have his refund held while the IRS conducts authentication and verification. Although the taxpayer may receive a notice notifying her of the hold, she might not hear anything from the IRS for weeks or months. The taxpayer may not be able to reach an IRS customer service representative (CSR) regarding the issue, and even if she does reach a CSR, the CSR does not have access to the appropriate IRS databases.⁵² Although the IRS’s position is that taxpayer contacts from these programs are not “real” audits, they are compliance touches that feel like “real” audits to taxpayers and have real-world consequences such as a lack of Appeal rights or refund holds without adequate information as to when the refund may be released.
- A taxpayer in an ASFR case may have third-party documentation that would reduce his tax liability. In the “real” audit context, this information would be considered in the examination and the taxpayer could seek Appeals review of the examination. However, although taxpayers may be able to request IRS reconsideration of an ASFR determination through the audit reconsideration process, it appears that they cannot seek formal Appeals review of an ASFR determination prior to the IRS issuing a statutory notice of deficiency.⁵³

The lack of the opportunity to seek Appeals review in the “unreal” audit context directly and profoundly impacts taxpayer rights, including the *right to challenge the IRS’s position and be heard*, the *right to appeal an IRS decision in an independent forum*, the *right to finality*, and the *right to a fair and just tax system*. The taxpayer rights issues are particularly glaring because, as shown in Figures 1.4.1, 1.4.2, and 1.4.3 above, “unreal” audits disproportionately impact low and middle-income taxpayers, who are least

51 In an AUR case, if a taxpayer makes a request for Appeals review with less than 365 days left in the period of limitations on assessment then this request will be denied. However, if there are more than 365 days left in the period of limitations on assessment, a taxpayer may request Appeals review an AUR case. However, it appears that taxpayers are not formally informed of this Appeals opportunity but would have to affirmatively make such a request. See IRM 4.19.3.21.1.8(1), *Appeals* (Aug. 22, 2017).

52 The National Taxpayer Advocate has raised concerns that the IRS’s filters are too broad and unnecessarily identify legitimate returns as potentially fraudulent. See National Taxpayer Advocate 2016 Annual Report to Congress, 149-60 (Most Serious Problem: *Fraud Detection: The IRS’s Failure to Establish Goals to Reduce High False Positive Rates for Its Fraud Detection Programs Increases Taxpayer Burden and Compromises Taxpayer Rights*).

53 See IRM 4.13.5, *Exam SFR Reconsiderations* (Dec. 16, 2015). For the National Taxpayer Advocate’s concerns about the ASFR program, see National Taxpayer Advocate 2015 Annual Report to Congress 188-95 (Most Serious Problem: *Current Selection Criteria for Cases in the ASFR Program Create Rework and Impose Undue Taxpayer Burden*).

able to afford representation to challenge the IRS. Further, the IRS plans, as part of its “Future State” Initiative, to enhance its use of these “unreal” audits, meaning that more and more taxpayers will be subject to these audit-like contacts where taxpayer rights are diminished or curtailed altogether.⁵⁴

“Unreal” Audits Circumvent Statutory Taxpayer Protections

As noted above, “unreal” audits do not carry the same IRC § 7605(b) protections against repeat examinations as “real” audits. The IRS takes a broad view of taxpayer compliance contacts or other actions that it does not consider to be examinations and inspections.⁵⁵ As discussed, explicitly included in these categories are math error, AUR, and ASFR “unreal” audit contacts.⁵⁶ Therefore, the IRS can circumvent statutory protections against repeat audits by conducting an “unreal” audit and then subsequently performing a “real” audit.

If the IRS were to change its position set forth in Revenue Procedure 2005-32 to consider certain “unreal” audits to be “real” audits, it would protect taxpayers from multiple reviews of the same return, force the IRS to identify *all* issues relating to that return that require some sort of documentation, and address those issues as early as possible in one proceeding.

The National Taxpayer Advocate understands the need of the IRS to conduct “unreal” audits for limited issues. However, to taxpayers, these “unreal” audits may feel like a “real” IRS correspondence examination. If the IRS were to change its position set forth in Revenue Procedure 2005-32 to consider certain “unreal” audits to be “real” audits, it would protect taxpayers from multiple reviews of the same return, force the IRS to identify *all* issues relating to that return that require some sort of documentation, and address those issues as early as possible in one proceeding.

The National Taxpayer Advocate recognizes that there are limited circumstances (such as a basic math error correction) where an IRS compliance contact does not constitute a “real” audit. For example, in true math error situations where the IRS has identified errors such as switching digits, transferring information incorrectly from one schedule to the other, or forgetting to include a schedule, the IRS should not be required to hold a return for months while it conducts a thorough review before it issues a refund to ensure it did not miss any other errors on the return. However, as a general matter and contrary to the IRS’s position, the National Taxpayer Advocate believes that for purposes of IRC § 7602, an audit generally includes both pre-refund and post-refund examinations of returns that,

54 See, e.g., IRS, *Exploring the IRS Future State: Balancing Taxpayer Needs with IRS Budget and Resource Constraints*, adapted from ABA National Institute on Tax Controversy, Las Vegas, NV 16 (Dec. 9, 2016), https://www.irs.gov/pub/newsroom/future_state_aba.pdf (noting that one of the focus areas of SB/SE and W&I is issue identification and filing resolution to “maximize prerefund automatic issue identification and self-correction”).

55 Rev. Proc. 2005-32, § 4.03, 2005-23 I.R.B. 1206.

56 *Id.* See also IRS Chief Counsel Memorandum, *ASFR Questions Involving Subsequently Filed Delinquent Original Returns* (Mar. 29, 2005) (providing that IRS preparation of an ASFR is not considered an examination). Identity and wage verification programs are not explicitly mentioned in the revenue procedure and did not exist in the form that they do today at the time that the revenue procedure was released. However, like the other “unreal” audit programs mentioned in the revenue procedure, the IRS would presumably not consider these programs to be examinations and inspections.

...there are “unreal” audit situations that clearly look like an audit, walk like an audit, quack like an audit, and should be considered a “real” audit.

like correspondence examinations, require the taxpayer to provide some level of documentation. This definition recognizes that certain “unreal” audits bear a close resemblance to “real” ones and would afford taxpayers appropriate rights and protections. As illustrated by the ACA example above, there are “unreal” audit situations that clearly look like an audit, walk like an audit, quack like an audit, and should be considered a “real” audit.

CONCLUSION

The IRS conducts the overwhelming majority of its compliance contacts with taxpayers through “unreal” audits, and this practice is expected to only increase with the IRS’s “Future State” Initiative.⁵⁷ By not including “unreal” audits in its audit rate calculations, the IRS is publicly reporting incomplete and misleading information concerning the extent of its compliance touches with taxpayers and not providing a full picture of its return on investment. More accurate reporting of this information might benefit the IRS in deterring noncompliance and provide useful data regarding resource allocation. In addition, “unreal” audits adversely impact taxpayer Appeal rights and statutory protections that exist for “real” audits. Because of the prevalence of “unreal” audits, the IRS should revisit its classification approach and provide taxpayers with additional opportunities for Appeals review of “unreal” audit cases and increased protections against repeat reviews of cases.

RECOMMENDATIONS

The National Taxpayer Advocate recommends that the IRS:

1. In collaboration with the National Taxpayer Advocate, conduct a comprehensive review of its audit definition under Revenue Procedure 2005-32 to reflect IRS compliance activity today, and the application of the Taxpayer Bill of Rights.
2. Include “unreal” audits in its audit rate and ROI calculations to properly reflect the actual compliance activity that it conducts.
3. Grant taxpayers the opportunity to seek Appeals review in certain “unreal” audit cases, such as in certain math error and AUR cases where Appeal rights do not already exist.
4. Where practicable, address all issues in a “real” audit rather than conducting an “unreal” audit and then subsequently conducting a “real” audit.

57 See, e.g., IRS, *Exploring the IRS Future State: Balancing Taxpayer Needs with IRS Budget and Resource Constraints*, adapted from ABA National Institute on Tax Controversy, Las Vegas, NV 16 (Dec. 9, 2016), https://www.irs.gov/pub/newsroom/future_state_aba.pdf (noting that one of the focus areas of SB/SE and W&I is issue identification and filing resolution to “maximize prerefund automatic issue identification and self-correction”).