

Management's Response to the Draft Report



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



March 30, 2001

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM:

*JGK* Joseph G. Kehoe *John F. Mark*  
Commissioner, Small Business/Self-Employed Division

SUBJECT:

Draft Audit Report – More Consideration Is Needed During  
Examinations to Identify Potential Fraud Issues And Refer  
Cases To Criminal Investigation

Thank you for the opportunity to provide comments to your draft audit report entitled "More Consideration is Needed During Examinations To Identify Potential Fraud Issues And Refer Cases To Criminal Investigation."

As you know, the Small Business/Self Employed (SB/SE) Compliance function is committed to improving the fraud referral program. We are in the process of implementing the recommendations made by the fraud referral working group and approved by the Executive Steering Committee September 8, 2000. We will soon have 65 fraud referral specialists (FRS) selected and placed throughout the country. They will be actively involved in training and in developing fraud referral cases. Additionally, we recently selected a National Fraud Program Manager, who is responsible for fraud program development across all of our operating divisions. We consider fraud a high priority and are working diligently to improve our efforts in this area.

We agree with several of your recommendations. However, we do not agree with your projection of potential referrals and lost revenue based on your conclusion that 11 cases in your statistically valid sample should have been referred. As we discussed with your staff, we do not believe that all of those 11 cases should have been referred to CID. Our review of those cases revealed insufficient badges of fraud, or contained justifiable, documented decisions to not pursue fraud, or would likely not have been accepted if referred based on other circumstances.

Your report makes 7 recommendations, 1A through 1D, 2, 3 and 4. Criminal Investigation has provided input and comment as to recommendation 1, 2 and 3 which was incorporated herein. We have also attached their response as an exhibit.

IDENTITY OF RECOMMENDATION 1(a)

The new fraud specialists should be used to identify open cases with potential fraud

issues on which they can provide advice.

#### ASSESSMENT OF CAUSE

Examiners and managers gave the following 3 reasons for not making referrals to CID:

- 1) RRA 98 created a fear of disciplinary action;
- 2) Employees presumption of probable rejection of CID cases, and that CID prefers work other than referrals;
- 3) Examiners stated they no longer work cases that have historically yielded fraud, and that details to non compliance work have negatively impacted their ability to make referrals.

#### CORRECTIVE ACTION

The IRS is in the process of implementing the recommendation made by the design team on fraud referrals as was mentioned in our opening paragraph. A critical part of the duties of our 65 fraud referral specialists will be the identification of potential fraud cases by working with our examiners. The issue of fear of disciplinary action can only be addressed with consistent, clear messages that employees will not be disciplined for appropriately doing their job.

#### IMPLEMENTATION DATE

Our target date for having the specialists selected and trained is July 1, 2001

#### RESPONSIBLE OFFICIAL

Commissioner, Small Business/Self Employed

#### CORRECTIVE ACTION MONITORING PLAN

Measures will be developed to monitor the level of fraud referral specialist involvement in open inventory once the fraud referral specialists and fraud referral specialist group managers are selected and in place. In addition to these yet undeveloped new measures, we plan on expanding currently existing monitoring reports to measure the number of criminal and civil referrals.

#### IDENTITY OF RECOMMENDATION 1B

It should be mandatory that cases with understated income over a certain dollar amount be discussed with the new fraud specialists.

#### ASSESSMENT OF CAUSE

The report indicates examiners do not adequately document case files with respect to recognizing and considering fraud.

#### CORRECTIVE ACTION

Current procedure requires group manager involvement if unreported income exceeds \$10,000. We will reinforce this requirement during training and through operational reviews. Additionally, the \$10,000 threshold will be used as one of the badges of fraud required to request FRS involvement. CID also recommends that it be mandatory that cases with unreported income over a certain dollar amount be discussed with a fraud referral specialist. The dollar criteria should be set at such a level to include those

cases that have the most fraud potential. Case files should be documented to show that fraud was considered. In addition, when the examiner, group manager, and fraud specialist agree that potential for fraud exists, the case will be updated to the appropriate status code. While in this status and as potential fraud is being developed, these cases will be excluded from cycle time or aging computations. This will ensure that examiners have sufficient time to properly develop cases and submit quality fraud referrals.

**IMPLEMENTATION DATE**

Our target date to complete training is July 1, 2001 for FRS, and September 30, 2001 for front-line managers.

**RESPONSIBLE OFFICIAL**

Commissioner, Small Business/Self Employed

**CORRECTIVE ACTION MONITORING PLAN**

See 1A above

**IDENTITY OF RECOMMENDATION 1C**

The new fraud referral specialists should conduct reviews of closed cases to identify both best practices and problem trends, in order to be able to educate examiners better identify and develop fraud issues in the future.

**ASSESSMENT OF CAUSE**

The report indicates Small Business/Self Employed and Criminal Investigation will not meet program goals and expectations if fraud issues are not being developed on cases.

**CORRECTIVE ACTION**

The IRS is currently selecting 65 fraud referral specialists. Principal duties of the fraud referral specialist include being responsible for identifying trends and patterns of non-compliance, and for identifying training needs. Fraud referral specialists will be responsible for review of civil fraud cases as well as criminal referrals.

**IMPLEMENTATION DATE**

July 1, 2001

**RESPONSIBLE OFFICIAL**

Commissioner, Small Business/Self Employed

**CORRECTIVE ACTION MONITORING PLAN**

Fraud referral specialist group managers will monitor compliance during workload evaluations of fraud referral specialist involvement in field cases.

**IDENTITY OF RECOMMENDATION 1D**

Managers should include a discussion of potential fraud in all their reviews of the examiners work, whether detailed case review or not, and document the discussion.

**ASSESSMENT OF CAUSE**

The report states there is insufficient documented manager involvement in potential fraud cases.

**CORRECTIVE ACTION**

Managers will be reminded to document significant involvement in review of examiners' work, including potential fraud cases. We will reinforce this requirement during training and through the active involvement of the FRS.

**IMPLEMENTATION DATE**

July 1, 2001

**RESPONSIBLE OFFICIAL**

Commissioner, Small Business/Self Employed

**CORRECTIVE ACTION MONITORING PLAN**

Territory managers will be expected to evaluate managers' efforts during their operational reviews and assistance visits. Additionally, closed case reviews will include an evaluation of a manager's documentation as part of our Examination Quality Measurement System review program.

**IDENTITY OF RECOMMENDATION 2**

The Commissioner, Small Business/Self Employed Division and the Chief, Criminal Investigation need to continue demonstrating to front-line employees their commitment to the fraud referral program and regularly emphasize the priority. High-level executive communications should include publicizing successful referrals.

**ASSESSMENT OF CAUSE**

The frequency of fraud referral rejections has created the perception that the fraud referral program is not a high priority.

**CORRECTIVE ACTION**

The Commissioner, Small Business Self Employed Division and the Chief, Criminal Investigation will issue a joint memorandum to the field emphasizing the importance of the fraud referral program and pledging their support to it. Criminal Investigation will provide Small Business/Self Employed with feedback that highlights successful submissions of fraud referrals that may be used and highlighted in Small Business/Self Employed publications and newsletters. Criminal Investigation will invite examiners who have submitted successful fraud referrals and their managers to attend Criminal Investigation Continuing Professional Education (CPE) classes and will distribute appreciation awards for their support of the fraud referral program. The Commissioner, Small Business/Self Employed Division and the Chief, Criminal Investigation will discuss the fraud referral program at employee group meetings and training classes. In addition, the reduction of cycle time pressure in cases where there are indications of fraud will further demonstrate the importance of the fraud referral program.

**IMPLEMENTATION DATE**

October 1, 2001

**RESPONSIBLE OFFICIAL**

Commissioner, Small Business/Self Employed Division  
Chief, Criminal Investigation

**CORRECTIVE ACTION MONITORING PLAN**

Criminal Investigation will continue to work with our internal partners as we have done in the past to develop processes to recognize examiners, and their managers who have submitted quality fraud referrals. In addition, we will continue our presence at National meetings and will promote the fraud program through activities such as fraud awareness presentations. Actions taken to emphasize the importance of the fraud referral program will be monitored during operational reviews. The Commissioner Small Business/Self Employed will continue to emphasize the fraud program in meetings, training classes, and through attendance at fraud program gatherings.

**IDENTITY OF RECOMMENDATION 3**

The Chief, Criminal Investigation needs to set clearer guidelines and definitions for examiners as to what are considered fraud issues, what makes a successful fraud referral, and what will be accepted and why.

**ASSESSMENT OF CAUSE**

The frequency of rejecting referrals has caused confusion among examiners and managers regarding what constitutes fraud issues, what makes a successful fraud referral and what is acceptable and why.

**CORRECTIVE ACTION**

Criminal Investigation will assist Small Business/Self Employed in providing fraud training to the fraud managers and specialists by furnishing technical support and instructors. The training will provide clear guidelines and definitions of what constitutes a successful fraud referral. In addition, Criminal Investigation will increase its outreach efforts and provide continuing professional education to other operating division employees.

**IMPLEMENTATION DATE**

July 1, 2001

**RESPONSIBLE OFFICIAL**

Commissioner, Small Business/Self Employed  
Chief, Criminal Investigation

**CORRECTIVE ACTION MONITORING PLAN**

This will be monitored through program reviews by Small Business/Self Employed and Criminal Investigation.

**IDENTITY OF RECOMMENDATION 4**

As the Small Business/Self Employed hires new examiners, the Commissioner, Small Business/Self Employed needs to adjust the mix of cases being examined, specifically by increasing the number of schedule C, F, and other source returns that have historically yielded cases that have fraud potential.

**ASSESSMENT OF CAUSE**

The report indicates a significant decline in examination of tax returns having a higher potential for fraud issues.

**CORRECTIVE ACTION**

The stand up of Small Business/Self Employed will result in more focus on small business tax returns, including both schedule C and F filers. Additionally, implementation of the Tax Compliance Officer position will result in more time being allocated to schedule C and F filers. In FY 2001, there is an increase in planned time allocated to high income filers, both with and without schedule C and F. For FY 2002, we anticipate that taxpayer service support will decrease 50%, resulting in more direct exam time, which will be allocated over individual return categories.

**IMPLEMENTATION DATE**

October 1, 2001

**RESPONSIBLE OFFICIAL**

Commissioner, Small Business/Self Employed

**CORRECTIVE ACTION MONITORING PLAN**

Time devoted to schedule C and F return will be monitored via Table 36 and 37. Fraud cases from these types of returns will be monitored via quarterly submission reports.

Thank you for your report, and the opportunity to provide our comments. Should you have any questions please contact me, or if you prefer you may call Martin F. Malarkey III, National Fraud Program Manager at 202-343-0035

Attachments (1)



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

Criminal Investigation

MAR 28 2001

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS SELF EMPLOYED  
DIVISION

FROM: *ME*  
Mark E. Matthews *MS*  
Chief, Criminal Investigation

SUBJECT: Response To Draft Audit Report-- More Consideration is  
Needed During Examinations to Identify Potential Fraud  
Issues and Refer Cases to Criminal Investigation  
(Audit # 200030027) ECMS IR No. 0102-4UDRM9YC

We appreciate the opportunity to express the views of Criminal Investigation (CI) concerning the above report. The CI organization has consistently maintained a commitment to the success of the fraud referral program and seeks to find ways to improve it. We have worked with the examination function to highlight and publish successful fraud referrals in publications and newsletters. We recognized and rewarded examiners and their managers for their support of the program and plan to continue developing processes to recognize quality. In addition, CI continues to maintain its active outreach program. The Chief, CI stresses the importance of the fraud referral program in his appearances at Senior Executive meetings, Collection Manager meetings, Small Business Self Employed (SB/SE) Division Managers meetings, CI Modernization meetings, and at external meetings and conferences. The Commissioner spoke about the significance of the program in maintaining our system of voluntary compliance at all managers' meetings. CI plans to continue these activities in the future.

There are three recommendations that are directed toward CI. We are submitting the following comments regarding these recommendations. Please incorporate them in your response to this draft report and include our office in the clearance of your document.

IDENTITY OF RECOMMENDATION #1(b)

It should be mandatory that cases with understated income over a certain dollar amount be discussed with the new fraud specialists.

ASSESSMENT OF CAUSE(S)

Examiners and managers gave three overall reasons for not making referrals:

- The IRS Restructuring and Reform Act of 1998 (RRA 98) has made employees reluctant to refer cases because they are concerned that taxpayers will retaliate and complain, and as a result, employees will be punished.
- Examination function employees are de-motivated because of their perceptions of how frequently CI rejects their referred cases.
- Examination function employees are concerned that they are no longer working the types of cases that result in referrals. For example, the number of small business individual returns examined has decreased from 139,261 in fiscal year (FY) 1998 to 64,091 in FY 2000.

In addition, cycle time pressures placed on examiners by managers also discourages referrals.

#### CORRECTIVE ACTION(S)

The IRS is in the process of hiring five fraud group managers and 64 fraud specialists who will provide guidance to examiners and their managers concerning matters of fraud. Currently, examiners are required to consult their managers when unreported income exceeds the \$10,000 threshold. We agree that it should be mandatory that cases with understated income over a certain dollar amount be discussed with the fraud referral specialists. The dollar criteria should be set at such a level to include those cases that have the most fraud potential. The fraud specialist will provide documentation for the case file showing that fraud was considered, the recommendation, and reasons for the recommendation. The examiners' managers will ensure that examiners consult the fraud specialists. In addition, when the examiner, group manager, and fraud specialist agree that potential for fraud exists, the case will be updated to the appropriate Status Code. While in this Code and potential fraud is being developed, cycle time will be excluded from the "aging" computations in Management Information Reports. This will ensure that examiners have sufficient time to properly develop cases and submit quality fraud referrals.

#### IMPLEMENTATION DATE

October 1, 2001

#### RESPONSIBLE OFFICIAL(S)

Commissioner, Small Business Self Employed Division

#### CORRECTIVE ACTION(S) MONITORING PLAN

Managers will monitor examiner compliance during workload reviews of examiners' cases.

**IDENTITY OF RECOMMENDATION #2**

The Commissioner, Small Business Self Employed Division and the Chief, CI need to continue demonstrating to front-line employees their commitment to the fraud referral program and regularly emphasize the priority it has. High-level executive communications should include publicizing successful referrals.

**ASSESSMENT OF CAUSE(S)**

The frequency of fraud referral rejections has created the perception that the fraud referral program is not a high priority.

**CORRECTIVE ACTION (S)**

The Commissioner, Small Business Self Employed Division and the Chief, CI will continue their proactive communications efforts that will include a joint memorandum to the field emphasizing the importance of the fraud referral program and pledging their support to it. The Chief, CI has addressed all managers groups in the operating divisions to highlight and publish successful fraud referrals. The internal communications function for both CI and SB/SE will work together to continue to highlight and publicize quality submissions of fraud referrals in SB/SE publications and newsletters. In addition, CI continues to maintain its outreach program. The Chief, CI stresses the importance of the fraud referral program in his appearances at Senior Executive meetings, Collection Manager meetings, Small Business Self Employed (SB/SE) Division Managers meetings, CI Modernization meetings, and at external meetings and conferences. The Commissioner, Small Business Self Employed Division and the Chief, CI will continue to discuss the fraud referral program at internal as well as external meetings. The Chief, CI will continue to use employee forums to communicate to examiners and their managers support of the fraud referral program and to publicize successful referrals.

**IMPLEMENTATION DATE**

October 1, 2001

**RESPONSIBLE OFFICIAL(S)**

Commissioner, Small Business Self Employed Division  
Chief, CI

**CORRECTIVE ACTION(S) MONITORING PLAN**

Criminal Investigation will continue to work with our internal partners as we have done in the past to develop processes to recognize examiners who have submitted quality fraud referrals and their managers. We will continue to provide feedback that highlights and emphasizes successful submissions of fraud referrals. In addition, we will continue our presence at national meetings and will promote the fraud program through activities such as fraud awareness presentations. Actions taken to emphasize the importance of the fraud referral program will be monitored during operational reviews

**IDENTITY OF RECOMMENDATION #3**

The Chief, CI needs to set clearer guidelines and definitions for examiners as to what are considered fraud issues, what makes a successful fraud referral, and what will be accepted and why.

**ASSESSMENT OF CAUSE(S)**

The frequency of rejecting referrals has caused confusion among examiners and managers regarding what constitutes fraud issues, what makes a successful fraud referral, and what is acceptable and why.

**CORRECTIVE ACTION (S)**

Criminal Investigation will assist SB/SE in providing fraud training to the fraud managers and specialists by furnishing technical support and instructors. The training will set forth clear guidelines and definitions of what constitutes a quality fraud referral. In addition, CI will increase its outreach efforts and provide continuing professional education to other operating division employees.

**IMPLEMENTATION DATE**

July 1, 2001

**RESPONSIBLE OFFICIAL(S)**

Commissioner, Small Business Self Employed Division  
Chief, CI

**CORRECTIVE ACTION(S) MONITORING PLAN**

This will be monitored through program reviews by SB/SE.

If you have any questions or need additional information, please contact me at (202) 622-3200 or a member of your staff may contact the Director, Planning and Strategy, Ralph L. Gay at (202) 622-3230 or Senior Management Analyst Marcus Williams at (202) 622-7758.

Attachment