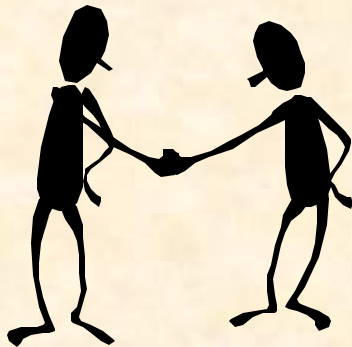# Risk Based Reporting Compliance

A Remote Examination

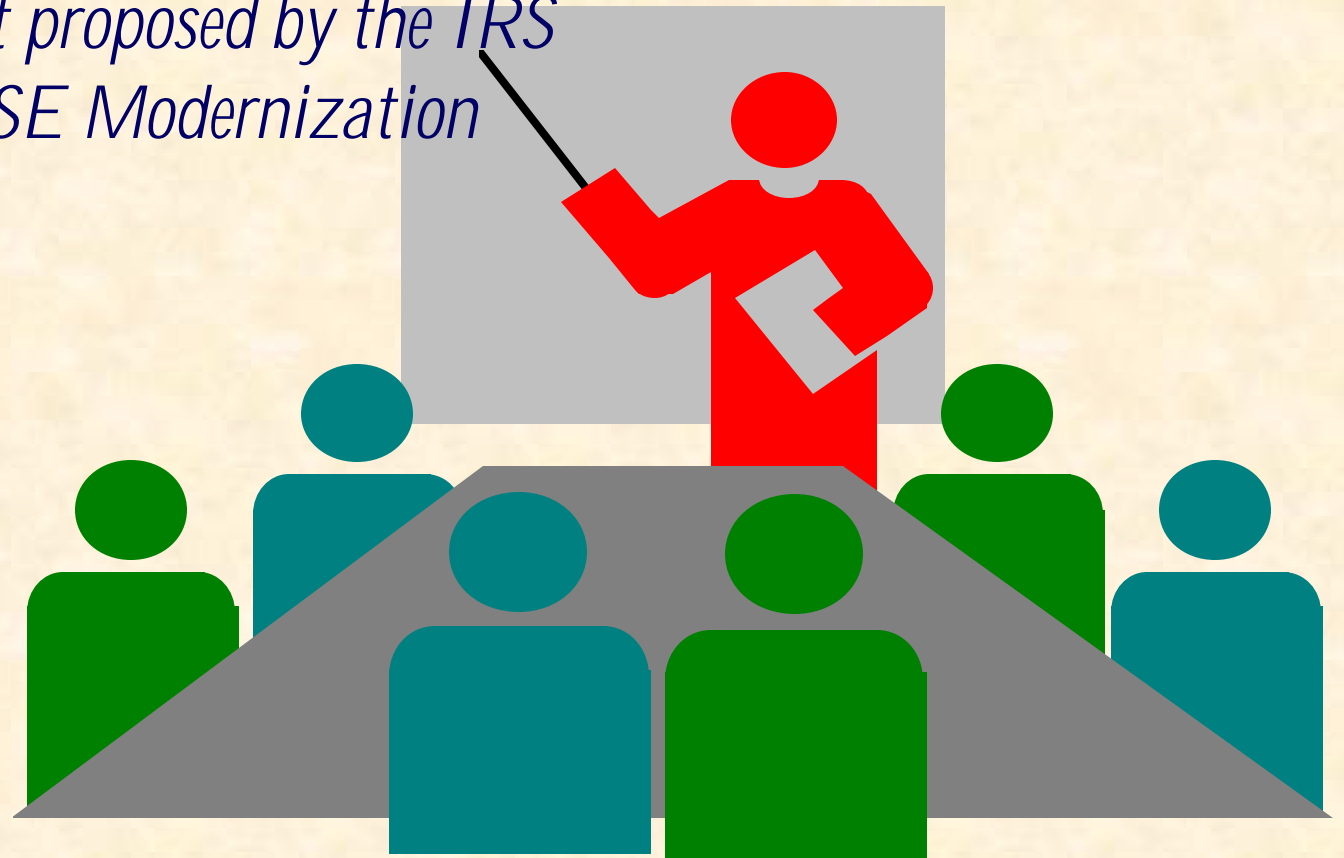## Selection Application

BY

RICK FRATANDUONO

JOHN KAM

IRS RESEARCH CONFERENCE

JUNE 11, 2002

RISK BASED COMPLIANCE

A new Paradigm in Compliance Workload Selection and Management proposed by the IRS Phase II SBSE Modernization Team.
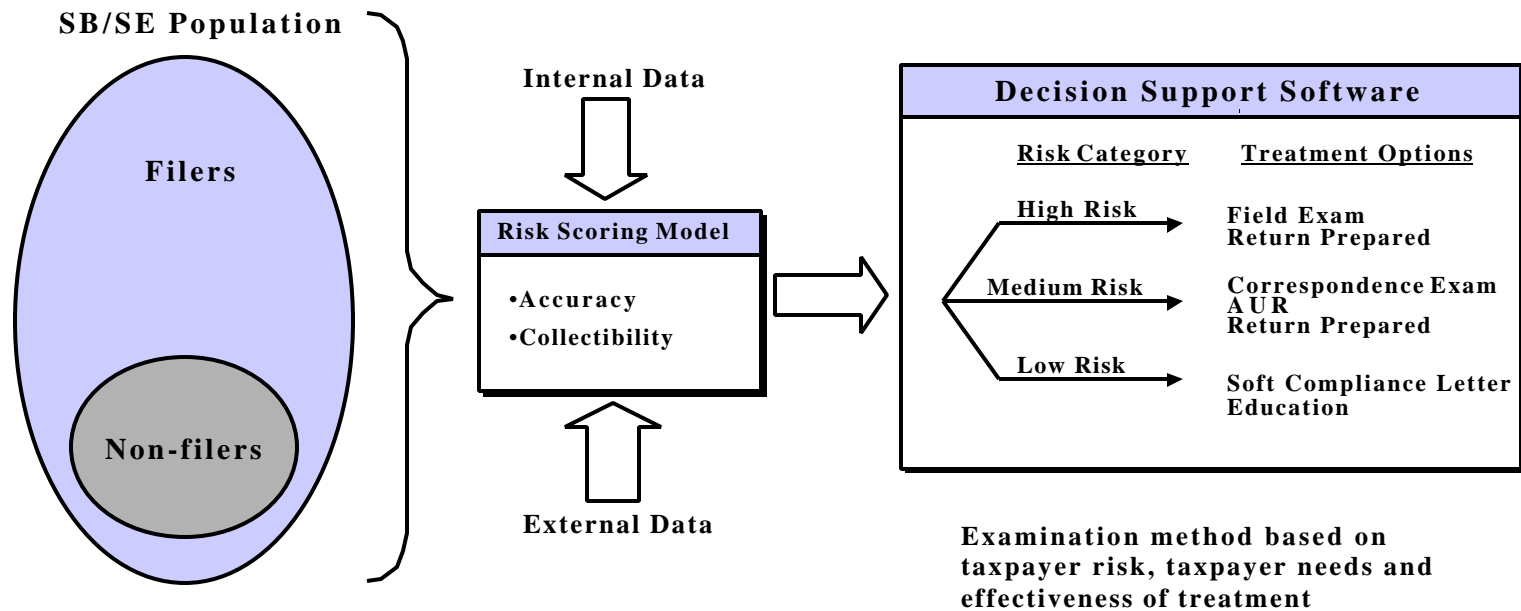
CORE CONCEPTS OF RISK BASED COMPLIANCE

– **Develop risk scoring models for tax returns at the issue level**

– **Match compliance treatments to specific risk factors**

HIGH LEVEL VIEW ON RISK BASED MODELS -1

Phase IIA Conceptual Description of a Risk Based Examination Process

Source: SB/SE Phase IIA Deck

Page V-D-22

SB/SE Population

Filers

Non-filers

Internal Data

Risk Scoring Model
- Accuracy
- Collectibility

External Data

Decision Support Software

Risk Category	Treatment Options
High Risk	Field Exam Return Prepared
Medium Risk	Correspondence Exam A U R Return Prepared
Low Risk	Soft Compliance Letter Education

Examination method based on taxpayer risk, taxpayer needs and effectiveness of treatment
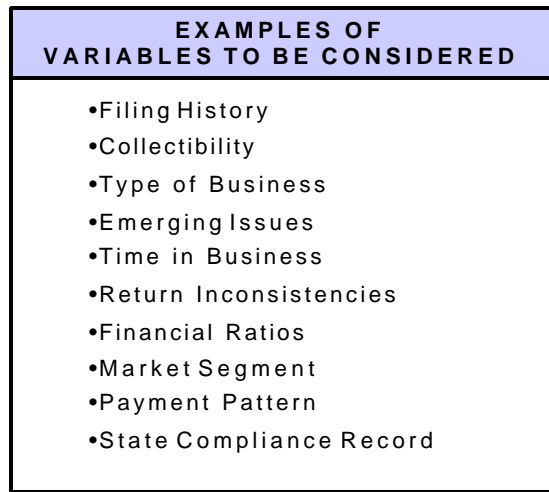
HIGH LEVEL VIEW ON RISK BASED MODELS - 2

CANDIDATES FOR EXAMINATION ARE IDENTIFIED BY ANALYZING DATA ON TAXPAYER BEHAVIOR, HISTORY AND NEEDS
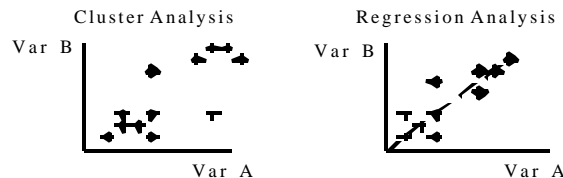
Source: SB/SE Phase IIA Deck

Page V-D-23

EXAMPLES OF VARIABLES TO BE CONSIDERED

- Filing History
- Collectibility
- Type of Business
- Emerging Issues
- Time in Business
- Return Inconsistencies
- Financial Ratios
- Market Segment
- Payment Pattern
- State Compliance Record

ANALYSIS OF VARIABLES

Cluster Analysis

Var B

Var A

Regression Analysis

Var B

Var A

EXAMPLES OF SCORES

- Accuracy
- Collectibility

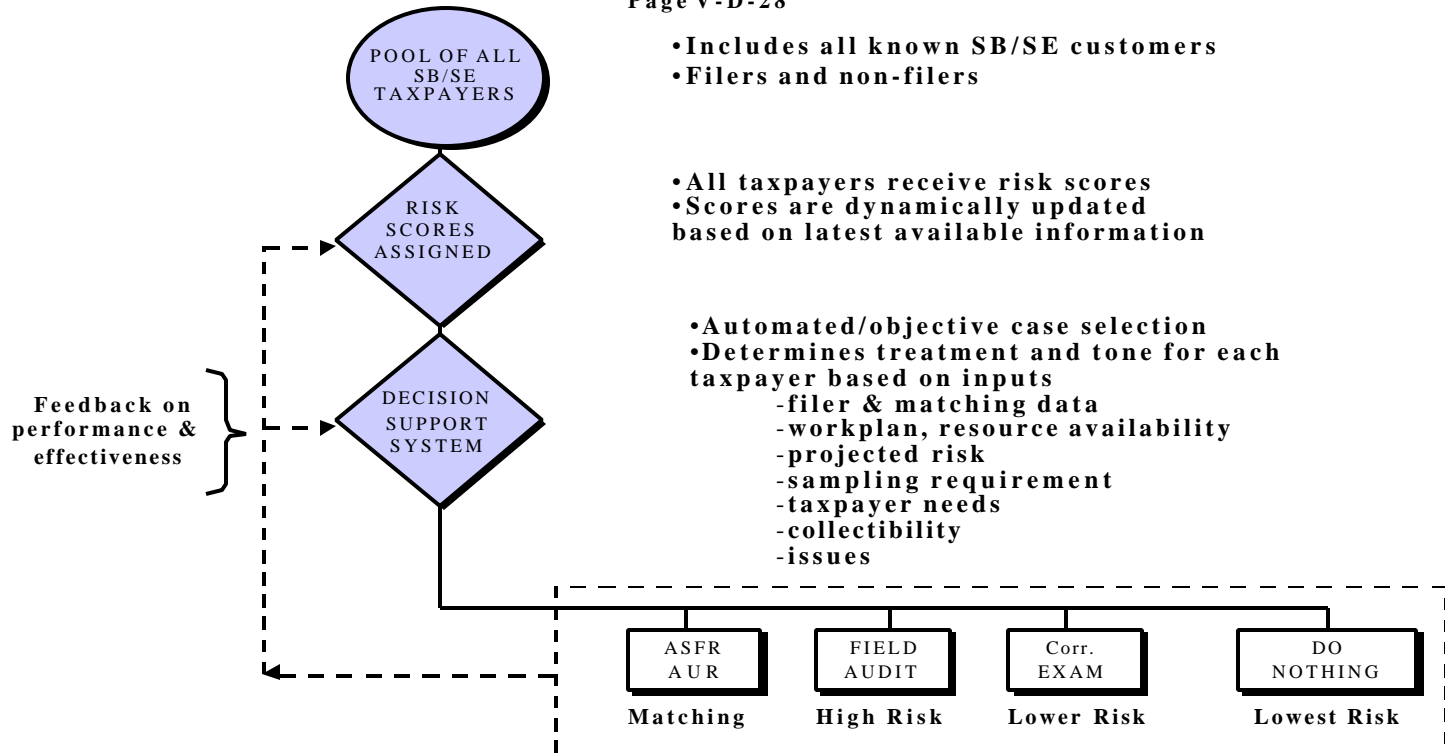| Up to 200 variables initially considered	30 - 50 Key Variables Identified	10 - 15 Variables Actually Used	2 - 5 Scores Calculated

HIGH LEVEL VIEW ON
RISK BASED MODELS – 3

ENVISIONED EXAM SELECTION

Source: SB/SE Phase IIA Deck

Page V-D-28

POOL OF ALL SB/SE TAXPAYERS

•**Includes all known SB/SE customers**
•**Filers and non-filers**

RISK SCORES ASSIGNED

•**All taxpayers receive risk scores**
•**Scores are dynamically updated based on latest available information**

DECISION SUPPORT SYSTEM

•**Automated/objective case selection**
•**Determines treatment and tone for each taxpayer based on inputs**
   -**filer & matching data**
   -**workplan, resource availability**
   -**projected risk**
   -**sampling requirement**
   -**taxpayer needs**
   -**collectibility**
   -**issues**

Feedback on performance & effectiveness

ASFR AUR	FIELD AUDIT	Corr. EXAM	DO NOTHING
Matching	**High Risk**	**Lower Risk**	**Lowest Risk**

CRITERIA FOR SUCCESSFUL RISK BASED MODELS

– **Availability of relevant internal and external data**

– **Ability to identify relevant issues for risk scoring**

– **Ability to apply appropriate treatments**

PRIOR IRS PROJECTS IN ISSUE IDENTIFICATION

– **Automated Issue Identification System (AIIS, late 1980's)**

– **Compliance Improvement Monitoring System (CIMS, mid-1990's)**

– **EITC Dependent Database System**

CURRENT RISK BASED COMPLIANCE PROJECTS

- **Examination Projects**
  - **Form 1040 Alimony Payments (W&I , SBSE)**
  - **Small Corporation Issue Selection System (SBSE)**
  - **Remote Exam Filing Analysis Module (W&I, SBSE)**

FORM 1040 ALIMONY PAYMENT COMPLIANCE PROJECT

<u>Objectives:</u>

- **Identify invalid SSN's entered as alimony recipients**

- **Identify different amount reported as alimony payment and income**

<u>Methodology:</u>

- **Apply rules based on tax law interpretations and data matching**

<u>Potential Treatments</u>:

- **Math Error notice, taxpayer education, correspondence audits**